

An Asia Society Policy Institute Publication



The Avoidable War

The Case for Managed Strategic Competition

BY THE HONORABLE KEVIN RUDD, President, Asia Society Policy Institute

The Avoidable War:

The Case for Managed Strategic Competition

A COLLECTION OF MAJOR SPEECHES DURING 2019

THE HONORABLE KEVIN RUDD
PRESIDENT, ASIA SOCIETY POLICY INSTITUTE

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ABOUT THE AUTHOR

The Honorable Kevin Rudd served as Australia's 26th Prime Minister (2007–2010, 2013) and as Foreign Minister (2010–2012). He led Australia's response during the global financial crisis—the only major developed economy not to go into recession—and co-founded the G20. Mr. Rudd joined the Asia Society Policy Institute in New York as its inaugural President in January 2015. He serves as Chair of the Board of the International Peace Institute and Chair of Sanitation and Water for All. He is a Senior Fellow at Harvard University's John F. Kennedy School of Government, a Distinguished Fellow at Chatham House in London, a Distinguished Statesman with the Center for Strategic and International Studies in Washington D.C., and a Distinguished Fellow at the Paulson Institute in Chicago. Mr. Rudd is a member of the Comprehensive Nuclear Test-Ban Treaty Organization's Group of Eminent Persons. He serves on the International Advisory Board of the Schwarzman Scholars program at Tsinghua University, and is an Honorary Professor at Peking University. Mr. Rudd is proficient in Mandarin Chinese. He remains actively engaged in indigenous reconciliation.

Chapters one through six of this collection include remarks as prepared for delivery.

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The Asia Society Policy Institute

Web: AsiaSociety.org/Policy-Institute

Twitter: @AsiaPolicy

Facebook: facebook.com/AsiaPolicy

Email: policyinstitute@asiasociety.org

New York

725 Park Avenue, 6th Floor
New York, NY 10021
+1 212 288 6400

Washington, D.C.

1779 Massachusetts Ave, NW, Suite 805
Washington, DC 20036
+1 202 833 2742

CONTENTS

FOREWORD	4
Henry M. Paulson, Jr.	
INTRODUCTION	7
The United States, China, and the Decade of Living Dangerously	
1. China's Strategic Vision, Strengths, and Vulnerabilities: Regional Responses across the Indo-Pacific	10
An Address to the 55th West Point Senior Conference, United States Military Academy, West Point, New York • April 9, 2019	
2. New Directions in Beijing and Washington: Are We Seeing the Beginning of a Chinese Policy Reset? And Will There Be a U.S. Reset Once the Trade Deal Is Done?	25
An Address to the 22nd Annual Harvard China Forum, Harvard Business School, Cambridge, Massachusetts • April 14, 2019	
3. The Trade War, Economic Decoupling, and Future Chinese Strategy toward America	35
Remarks at the Lowy Institute, Sydney, Australia • June 13, 2019	
4. China's Political Economy into 2020: Pressures on Growth, Pressures on Reform	51
An Address to the Conference on China's Economic Future: Emerging Challenges at Home and Abroad, Chatham House, London • July 11, 2019	
5. To Deal or Not to Deal: The U.S.-China Trade War Enters the Endgame	64
An Address to the American Chamber of Commerce (AmCham China), Beijing, China September 9, 2019	
6. To Decouple or Not to Decouple? That Is the Question for U.S.-China Relations	75
Robert F. Ellsworth Memorial Lecture, 21st Century China Center, University of California, San Diego • November 4, 2019	
7. The Avoidable War	98
A Conversation at the John F. Kennedy Jr. School Forum, Harvard Kennedy School, Institute of Politics, Cambridge, Massachusetts • December 5, 2019	

FOREWORD

Kevin Rudd served as Prime Minister and Foreign Minister of Australia during a period when four trends—each of them deeply connected to the rise of China—began to thoroughly reshape the international order.

First, the global *economic* order has been irrevocably changed by the emergence of China as the world's second-largest economy and its transition from a capital importer to a major exporter of capital to emerging and advanced industrial markets.

Rudd swept to office in 2007 at the head of a Labor government focused on sustaining Australia's economic momentum while broadening its opportunities in the world. But within just one year, the global financial crisis had altered the context for the pursuit of those policies.

As America's 74th Treasury Secretary, I worked closely with Rudd and other world leaders not just to stave off the worst economic crisis since the Great Depression of the 1930s but also to reduce the likelihood and severity of future financial crises.

At the time, China was playing a critical role. Its USD \$1 trillion economy when it entered the World Trade Organization had multiplied severalfold. Its cooperation was important in containing the crisis and driving global growth in the immediate aftermath of the crisis.

Today, China is a USD \$14 trillion behemoth and the world's second-largest economy, giving Beijing new weight as a source of global growth. Even more than in 2008, Beijing's choices and preferences, for good or ill, will now affect every element of the international economic order—how and where capital moves; the sources and drivers of growth; the roles of tariff and nontariff barriers and counter-barriers; and whether openness or protectionism will prevail.

In this collection of speeches, Rudd digs deeply into the implications of these economic changes, not just for the global economy but for how the world's major nations can and should relate to one another.

Second—and as a direct result of this economic reordering—the architecture of international *institutions* has changed.

By 2008, we believed that no global response to any truly global economic challenge could fail to include the world's fastest-growing economies, especially China and India. Here, Rudd worked closely with President George W. Bush, me, and other world leaders and finance ministers to pioneer a new Group of 20 (G20) Leaders Group to serve as the world's principal multilateral forum to coordinate and then rebuild from the crisis. The G20 has since come to supplant the G7, reflecting both the importance of a more representative grouping and China's emergence as a force in world affairs. Indeed, it was both a *practical* response to the realities of a world that had changed since the 1970s and integral to an aspirational effort to encourage the world's emerging economies to be responsible partners in global governance.

Rudd rightly recognized that China's goals were not the same as those of the leading liberal democracies, including Australia and the United States. But he also understood that with countries like China about

to figure so large in world affairs, our democracies would need both to fortify our preferred rules and standards and find ways to preempt China's desire to export its *own* preferred rules and standards.

Xi Jinping's rise to power has only intensified this challenge. Rudd's speeches in this collection address directly the nature and extent of Xi's effort to tout China's experiences as a "model" that can be exported and potentially assimilated by other countries. And to the extent that this represents a direct challenge to the democracies' preferred rules, standards, and institutions, that challenge is now at the core of debates about the future of the international order.

Rudd lived this—and tried to shape it—as the prime minister of a leading Westminster democracy. And he has thought deeply about the implications of China's present challenge to it. This collection of speeches enlivens this second set of debates too. It also proposes ways to adapt to China's challenge and a few ideas to try steering Beijing's emerging energies.

Third, the future of the world's *natural* environment—its climate, its energy future, and the fate of its delicate ecosystems—became an urgent global challenge in the years when Rudd led Australia. And the importance of attacking climate change has only intensified in the years since he left office.

In 2009, Rudd was a presence at the Copenhagen climate conference, leveraging Australia's role to try to shape a positive outcome. Yet, ultimately, the central story at Copenhagen became, once again, the growing role of China. Premier Wen Jiabao represented Beijing in contentious talks that, at various points, pitted China and certain like-minded countries against the advanced industrial economies, including Australia and the United States.

Today, climate change and energy adaptation remain singular challenges, not just to the natural environment but as perhaps the biggest risk to the future of the global economy.

The leading economies cannot afford a one-dimensional approach to China that turns solely on climate change while subjugating other priorities. Still, as climate impacts intensify, from the Australian bush to the American ocean coasts, Beijing's choices and approaches will be essential to the future of global collective action.

Rudd's speeches in this volume don't focus primarily on climate change. But in their emphasis on how Beijing's self-interested economic and industrial choices will affect *our* future, not simply its own, he is engaging one of the central policy questions of our time.

Fourth, the Indo-Pacific *strategic* setting has changed radically since 2007 when Rudd came to office as Prime Minister.

Australia exemplifies a contradiction that has faced many countries in the region over the last decade and a half. They have looked to Washington for security but Beijing for growing economic opportunity. Australia's principal security partner was, is, and will remain the United States, alongside whose forces

its troops have fought in every conflict since the Battle of Hamel in 1918. Yet its principal trade partner is China, whose demand for Australian-produced natural resources helped stave off economic crisis and helped Australia to grow even as other economies in the region suffered in the years after 2008.

As Rudd's speeches in this collection show, navigating this dichotomy will not be easy. And Australia will not be alone in this. The United States, Japan, India, Indonesia, and many others have become deeply uncomfortable with China's strategic behaviors, from the construction of artificial islands in the South China Sea to the use of economic leverage as a tool of political pressure. As by far the leading emitter of carbon and our best hope as a role model for much of the developing world, Beijing's climate policies, actions and green financing models are likely to play a determining role in the future success—or failure—of global collective action.

Rudd has thought long and deeply about this set of challenges to strategic stability in the Indo-Pacific. For those seeking to grapple with the region's future—and the world's—this collection is an especially rewarding place to start.

Henry M. Paulson, Jr.

Chairman, Paulson Institute, and 74th U.S. Treasury Secretary

INTRODUCTION

The United States, China, and the Decade of Living Dangerously

THE PURPOSE OF THIS SECOND VOLUME, titled “The Avoidable War: The Case for Managed Strategic Competition,” is to try to make sense of where the U.S.-China relationship is heading in this new period of strategic competition, which was formally inaugurated by the Donald Trump administration with the release of its National Security Strategy in December 2017. This is no easy thing. There are many contending views in Washington and Beijing on where the relationship should go, and from time to time, these different voices can be heard in the public square. But beyond the ups and downs of day-to-day developments, if we step back for a moment, we can discern a slow and steady structural shift in the U.S.-China relationship as it continues to head in a more adversarial direction. More importantly, however, this drift toward confrontation is occurring in the absence of any common strategic understanding, or high-level diplomatic mechanism, to manage the mounting security, economic, and technological tensions into the future.

The year 2019, like 2018, was dominated by the trade war. Many will breathe a sigh of relief that a “phase one” agreement was reached. Certainly that is the case in the financial markets, where the roller-coaster ride of the negotiating process roiled markets for the better part of 18 months—from the launch of the first round of tariffs in March 2018 until President Trump’s announcement of a deal in December 2019. Despite this deal, the uncomfortable truth is that many of the more intractable elements of the economic relationship have been “kicked down the road” to phase two negotiations—principal among them, the future of state subsidies for Chinese firms competing in the global marketplace.

There is disagreement on the level of urgency to attach to the second round of negotiations, with the Trump administration saying it will start as soon as the ink is dry on the first-round agreement, to be signed on January 15, 2020, but China saying it is important to nail down the implementation of the phase one agreement first. I suspect that the tacit understanding between the two sides is that any conclusion to the next round will slide into 2021. This would put it beyond the immediate scrutiny of the November 2020 U.S. presidential elections while keeping the financial markets relatively stable on the way through—both of which are important for President Trump’s reelection prospects. Meanwhile, in Beijing, the leadership is likely to prefer to see what sort of U.S. administration it will be dealing with for the next four years before signing off on anything more fundamental to China’s long-term economic interests.

While there may be a truce of sorts on the trade front during 2020, that will not be the case across the rest of the economic, political, and security relationship. The Huawei debate is likely to come to a head in 2020 as various countries, including most of America’s major allies, have to make critical decisions on the future of 5G (fifth-generation) mobile telecommunications infrastructure, and where China, at this stage, is offering the only technology available. The political and foreign policy disagreement between Washington and Beijing will continue to intensify, ranging across the Belt and Road Initiative, Xinjiang, Hong Kong, and allegations of Chinese political influence and interference in foreign countries’ internal democratic processes, as well as China’s increasingly close strategic collaboration with Russia. Militarily, tensions will continue in the East China Sea, the South China Sea, and the wider Indo-Pacific, together with confrontations less visible to the public eye in espionage, cyber, and space.

Against this background, and the steady erosion of diplomatic and political capital in the overall relationship, the 2020s loom as a decade of living dangerously in the U.S.-China relationship. On one level, China is becoming more confident in its future in the region and in the world as it moves rapidly, and often adroitly, to occupy a growing number of political vacuums left by an increasingly nationalist and isolationist America. But on a deeper level, China senses that the balance of power—or what the Soviets once called “the correlation of forces”—is steadily moving in its direction, against the United States. At the same time, Washington remains uncertain as to what sort of regional and global role it wants to play in the future and whether it wants to pay the price for doing so through the continued expenditure of the nation’s blood and treasure.

In the midst of all this comes the question of Taiwan, which in its January 2020 elections delivered a spectacular snub to Xi Jinping with a thumping reelection victory for Ts’ai Ying-wen of the pro-independence Democratic Progress Party. In 2021, China will celebrate the centennial of the birth of the Chinese Communist Party. For Xi Jinping, this will be no ordinary year, given his strident efforts over his seven years as general secretary to rebuild the Party along stricter ideological lines than we have since the Cultural Revolution. Returning Taiwan to Chinese sovereignty is seen in the Party as the unfinished business of the Chinese Revolution, and Xi is determined to succeed where all his predecessors, including Mao, demonstrably failed. On top of all this, from Xi’s perspective, there is an increasingly recalcitrant Taiwan that must be brought to heel. For these reasons, the Taiwan question is likely to assume center stage in the U.S.-China relationship in the 2020s, where no easy solution is in sight and Beijing is likely to resort to more coercive measures.

For these reasons, this year’s collection of addresses concludes with a December 2019 presentation to the Harvard Kennedy School on “The Avoidable War.” This conversation begins to outline an approach to managing the growing tinderbox of tensions across the spectrum of the U.S.-China relationship. I call this approach “managed strategic competition.” It builds on ideas that I first explored at Harvard University’s Belfer Center five years ago in what I then called “constructive realism”—an approach that recognizes the underlying reality and logic of the balance of power between the United States and China; identifies red lines around core national interests that remain non-negotiable, but with a mutual agreement not to risk going to war over them; and incorporates into this framework the diplomatic machinery necessary to reach agreement in other areas of strategic, economic, and environmental significance to both countries—bilaterally, regionally, and globally—in which all parties stand to benefit.

The rest of this 2019 collection deals with a range of critical challenges in the U.S.-China relationship:

- In an April 2019 presentation to the West Point Senior Conference, I explored China’s overall strategic vision, including its own perceptions of its national strengths and vulnerabilities.
- Also in April, I gave an address to the Harvard Business School on whether China’s leadership could engage in a major economic policy reset, away from Party control and in support of the market, by building on a trade deal with the United States to reinvigorate China’s domestic economic reform program.
- Then in June, at the Lowy Institute in Sydney, I began to explore the potential impact of the ongoing trade war on the possibility of a wider economic decoupling of the U.S. and Chinese economies.

- In July, at a Chatham House conference in London, I attempted a deeper dive on the state of the Chinese economy, faltering growth, and the pressures on the leadership to recommence the market economic reform process or face significant contraction with real political costs to Xi Jinping's leadership.
- Then, in a September address to the American Chamber of Commerce in Beijing, I examined a potential endgame for the U.S.-China trade war, which at that stage was looking problematic indeed.
- Then, in the Ellsworth Memorial Lecture at the University of California, San Diego, in November, I went into the question of what comprehensive economic decoupling between the United States and China could look like in trade, foreign direct investment, capital markets, technology, talent, and currency, before concluding that the reality is much more complex than a simple "decoupling" headline would suggest.
- Finally, I returned to Harvard with the John F. Kennedy Jr. School Forum in December to discuss the much wider question of "The Avoidable War" and how to manage the overall U.S.-China relationship in this new period of growing confrontation through what I call "managed strategic competition."

I would like to thank the Board and all my colleagues at the Asia Society, in particular our president, Josette Sheeran, for their continuing support in all this. I believe that the geopolitics and geo-economics of an increasingly confrontational relationship between the United States and China, together with climate change and the nature, intensity, and rapidity of global technological change, to be one of the three great global challenges of our time. Here at the Asia Society Policy Institute, we are working on all three.

The Honorable Kevin Rudd

President, Asia Society Policy Institute

A photograph of Chinese President Xi Jinping walking on a red carpet. He is wearing a dark suit and a blue tie, and is looking to his right. Behind him is a row of international flags, including the flags of Spain, Taiwan, Indonesia, India, South Korea, Turkey, France, Vietnam, the United Nations, and the Asian Development Bank. The text "1. China's Strategic Vision, Strengths, and Vulnerabilities: Regional Responses Across the Indo-Pacific" is overlaid on the image in white, bold, sans-serif font.

1. China's Strategic Vision, Strengths, and Vulnerabilities: Regional Responses Across the Indo-Pacific

**Address to the 55th West Point Senior Conference
United States Military Academy
West Point, New York
April 9, 2019**

FOR AMERICANS, WEST POINT SPEAKS TO SO MANY OF THE GREAT EVENTS of American history—from the birth of the Republic, to the horrors of the Civil War, to the roll call of great military commanders of recent history—Grant, Pershing, Patton, MacArthur, and Eisenhower. For an Australian, this academy speaks to the ties that bind our two proud, robust, in-your-face democracies and the deep shared history of our two militaries since we first went into battle, together, on the Western Front 100 years ago on July 4, 1918—and in every major international conflict since.

The world of 1918 was vastly different from that of 2019, although its deep resonances continue to be felt to this day. After decisively shifting the balance of forces in favor of the Allies in World War I, America after the Paris Peace Conference withdrew into its strategic shell for a generation. And the world was a worse place for it. After Pearl Harbor, America was once again fundamental to a final Allied victory. But this time, rather than retreat, America crafted a postwar international order, reinforced by the power of its military in all corners of the world, and a doctrine of containment that took it through nearly half a century of Cold War that eventually saw the collapse of its strategic nemesis, the Soviet Union.

But that was 30 years ago. The central question today in the minds of America's friends and foes alike is whether the United States will retain the political resolve and strategic capacity to underpin the global order of the future. Or will there be an emerging sense of strategic vacuum, within which its adversaries begin to move and its allies begin to hedge against a different future. Ultimately, this is America's decision, and America's alone. But the consequences are global.

The year 1919 has a different significance in Chinese historiography. Chinese political leaders and diplomats, following the dispatch of hundreds of thousands of Chinese construction workers to the Western Front at America's request to support the Allies, had been assured by President Woodrow Wilson that following the Paris Peace Conference, Germany's colonies in China would be returned to Chinese sovereignty. Indeed, Wilson's Fourteen Points were heralded as a beacon of hope for the fledgling Chinese republic as Chinese nationalists, socialists, and communists alike hailed him as a savior of the Chinese nation following three-quarters of a century of Western colonial occupation. Even a young Mao Zedong was captured, at least for a moment, by Wilson's magic. But when Wilson capitulated at the conference, surrendering Germany's Chinese territories to Japan instead, America, in the eyes of Chinese political elites of both the left and right, became responsible for the great betrayal. The peace conference gave rise to what is called in China the "May Fourth Movement," when Peking University students took to the streets, radicalizing China's politics and entrenching a deep Chinese historical narrative that neither the West nor the United States could ever be trusted again with China's future.

The May Fourth Movement, whose centennial will be commemorated next month across the Chinese-speaking world, also gave rise to the birth of the Chinese Communist Party just two years later. America and the West have been demonized in Communist Party propaganda ever since, drawing on skillfully intertwined ideological and nationalist reasons. First, because the United States and the West are bastions of liberal democracy and capitalism that still stand fundamentally opposed to the Marxist-Leninist orthodoxy of the Chinese Communist Party. Second, because the West carved up China, and America did little, if anything, to help. And now, third, because the United States and the West will do everything possible to contain China's twenty-first-century rise. These have become the enduring internal narratives on the Chinese Communist Party.

Xi Jinping will lead national celebrations for the centennial of the Communist Party in 2021. This will be a major national event, not least because this anniversary is one of the twin pillars of Xi's self-proclaimed "China Dream" of China reclaiming global great-power status; the second pillar is the centennial of the establishment of the People's Republic of China in 1949, by which time China's national transformation is to be completed. Again, the core political narrative of the Party will be that only through its leadership has China finally been delivered the national wealth and power dreamed of by previous generations of reformers, and this has been achieved despite the United States and the West, not because of their help, support, or engagement.

History matters in the U.S.-China relationship. Both in what actually happened, what it led to, and the series of causes and effects that followed. But equally important is the perceived historiography of each side, and their established national narratives of the relationship. Past perceptions, whether they are factually accurate or not, shape future behaviors.

Trajectories for the Indo-Pacific Region

This conference is not about China's rise, U.S.-China relations, or China's future in the global order. I have been asked to address future strategic trends in the Indo-Pacific region. But the truth is, I find it impossible to see the region's future other than through the principal lens of the U.S.-China relationship. Other dynamics are, of course, at play within the wider region. But how the security and economic future of the region will be materially changed because of the increasingly competitive and confrontational relationship between the United States and China, and how third countries begin to perceive, predict, and then anticipate through their actions the longer-term outcome of this new era of strategic competition, are overwhelming all other factors.

This matters now not just for the region, but for the world. This is because of the emerging centrality of the Indo-Pacific to the future of the global economy, trade, investment, capital flows, technology, innovation, and supply chains. It is also because of the growth of military expenditures by the states of the Indo-Pacific beyond that of all other regions. Likewise, it is in this region that we see the major drivers and consequences of climate change at work, with the potential for major population displacements. In addition, there are the enduring hazards of strategic geography, geopolitics, and energy supply routes, reinforced by an abundance of unresolved territorial disputes that directly engage the region's great powers. However comforting or distressing it may be to our European friends, the reality is that against virtually all measures, the center of global strategic gravity has now shifted to the Indo-Pacific region. This is dramatically demonstrated by the following data points.

- In 2009, Europe and North America accounted for 45 percent of global gross domestic product (GDP), while Asia contributed 37 percent. Today the figures are reversed, with Europe and North America contributing 38 percent and Asia 46 percent. The International Monetary Fund predicts that this gap will only widen.
- In 1990, the share of trade between Western markets was almost 60 percent of total world trade. Today it is 30 percent. At the same time, trade between emerging markets was a miserly 6 percent in 1990, while now it stands at almost 30 percent.

- China is now the second-largest recipient of foreign direct investment behind the United States. Recent reforms regarding foreign ownership of Chinese banks, brokerages, and insurance firms are likely to accelerate foreign direct investment over the coming years.
- Patent applications are surging in China. In 2017, they increased 14 percent from the prior year alone. Regionally, 65 percent of the world's patents in 2017 were registered in Asia, a 15 percent greater share than 10 years prior.
- In 2000, Asia accounted for 25 percent of the world's research and development expenditure; in 2015, it climbed to 40 percent. China alone is responsible for almost one-third of the global increase in research and development spending.
- This changing economic center of gravity to the Indo-Pacific is also reflected in the generation of greenhouse gas emissions. In 1990, Asia represented 25 percent of global greenhouse gas emissions, while now that figure is 49 percent. Today the top three global emitters are China, the United States, and India, at 28 percent, 15 percent, and 7 percent, respectively.
- Across the Indo-Pacific, military expenditure has not only matched rising economic growth, it has outstripped it. China's declared military expenditure has leapt from USD \$68 billion in 2007 to \$228 billion in 2017. This is about 35 percent of U.S. defense expenditure, measured at \$656 billion in 2017. However, in terms of growth over that span, U.S. military expenditure grew by 5 percent, while China's grew 230 percent. India's expenditure grew 165 percent.

All this has occurred in a region with unresolved territorial conflicts between North and South Korea and the United States; Japan and Russia over the Northern Territories; Japan and China over the Senkaku/Diaoyu Islands; China and the United States over Taiwan; multiple states over the South China Sea; the Sino-Indian border; India and Pakistan over Kashmir; as well as the growing debate over China's expanding number of naval bases across the Indian Ocean. It is therefore the great Indo-Pacific paradox—characterized by rapid economic growth and growing levels of economic integration, despite deep underlying strategic instability and relatively weak pan-regional institutions, all tempered by the emerging mega-challenge of climate change.

The China Dynamic

China is the new, great driving dynamic in the wider Indo-Pacific region, where few countries are not impacted by China's growing economic and strategic footprint. We see this across all economic indicators as a natural product of China's size, its increasingly assertive diplomacy, and its growing naval presence. Much is made in the international commentary of the ambitions of China's Belt and Road Initiative (BRI). But the reality is that the China factor is being felt much more acutely through a multiplicity of separate bilateral engagements across the region that have largely gone unreported, as regional governments wrestle with the opportunities and challenges of dealing with a resurgent China.

In part, this reflects China's continuing grand strategy over several decades. In part, however, it also reflects the new dynamics of Xi Jinping's leadership. To recap what I said here last year about Xi Jinping's worldview, I define this through seven concentric circles of interests, the core of which is the absolute centrality of keeping the Party in power. This is followed by:

- maintaining national unity;
- ensuring sustainable economic growth while preserving environmental sustainability;
- cultivating benign and ultimately compliant relationships with China's 14 bordering states;
- securing China's continental periphery by projecting its economic and geostrategic influence across the Eurasian continent;
- projecting its maritime power across East Asia, the western Pacific, and the Indian Ocean; avoiding armed conflict with the United States while decoupling, over time, America's network of Asian alliances;
- optimizing good relations with the developing world—across Asia, Africa, and Latin America—thereby enhancing China's position across the range of global institutions; and
- reforming the institutions of global governance over time, toward aligning their practices, personnel, and institutional culture more closely to Chinese interests and values.

China's Strengths

China's grand strategy has many strengths, although it also has significant weaknesses that seem to find much less space in the breathless global commentary we see on China's inexorable rise. Among China's strengths, perhaps the greatest is the consistency of its strategy, since Deng Xiaoping's return to the leadership of China 40 years ago, to make China wealthy and powerful through domestic market-based reforms encouraging private incentives, and then unleashing these entrepreneurs on the international market. But China also carefully tracks changes in the international political and economic environments and makes tactical adjustments whenever it judges necessary. It did so after the global reaction to Tiananmen in 1989. It did so again in response to the Asian and later global financial crises. It is doing so again in response to the recent slowdown in its domestic economic growth rates, as well as some international pushback against the BRI juggernaut. China's strategy is constant, yet always remains remarkably tactically agile. This is a great strength.

China's leadership...understands that its continuing political legitimacy in the eyes of the Chinese people rests with the economy.

because this is what they have internally judged to be the threshold necessary to sustain social stability. The Party tracks social discontent by multiple means and responds with a range of carrots and sticks. But whenever living standards and employment are at risk, the Party actively intervenes. To the great frustration of China's hardy team of liberal economic reformers, long-term structural reforms are regularly sidelined if the country's macropolitical circumstances warrant it. The Party, after all, is determined to survive.

Second, China's leadership also understands that its continuing political legitimacy in the eyes of the Chinese people rests with the economy. China's leaders have always intervened by fiscal, monetary, or administrative means to sustain growth at around 6 percent

A third strength of the regime is the formidable resources of China's internal security apparatus. China's domestic security services have more personnel than the entire People's Liberation Army. Their effectiveness

has also been turbocharged by the new surveillance technologies they have acquired or developed to keep the citizenry under control. China is governed not just by a Marxist party; it is also a Leninist party that understands full well what it means to obtain and sustain political power by all means—including violent means if necessary. China’s leadership undertook a 10-year-long intensive study of the collapse of the Soviet Union and has no intention of allowing anything similar in China. As we have seen on a number of occasions, China has few qualms about deploying force where necessary to guarantee Party control.

Fourth, China has achieved remarkable success in transforming its indigenous culture of technological innovation. China’s leadership recognized this as a strategic weakness in 2013. China embarked on a large-scale national turnaround strategy driven by a combination of state research institutions, some leading-edge state-owned enterprises (SOEs), and an increasingly rampant Chinese private tech sector. Xi Jinping has recognized the new technology industries as fundamental to China’s future global economic and military competitiveness. And in artificial intelligence, he has seen it as a possible means of leapfrogging the United States.

Finally, China’s additional strength has been the continuing absence of an American grand strategy in the post-Soviet era. China’s leadership has observed over many decades the passing parade of U.S. presidents but, until recently, has not detected any fundamental change in American policy toward China. While China was surprised by the U.S.-China trade war initiated by President Donald Trump, it is confident it will soon find a resolution. And while it is vigilant in seeking to identify evidence of deep changes in other domains of U.S. strategic behaviors toward it, for China, the jury is still well and truly out. Indeed, sometimes I think China is more brutally accurate than its American and international counterparts in its analysis and understanding of real as opposed to ephemeral change, both here in the United States as well as globally. Perhaps it is a deep intellectual training in Marxist dialectics that causes China’s leaders to separate what is in the headlines in the West from what constitutes deep underlying structural trends. China, for example, despite the trade war, still publicly defines the current period as one of great strategic opportunity for the country’s continued rise. Furthermore, when the Chinese observe the state of relations between the United States and its European and select Asian allies—the gradual dismemberment of the European Union, the growing fragmentation of Western politics, including the growing polarization between the far left and the far right—its analysis becomes more optimistic again. And on China’s central preoccupation with the future of its economy, China could not believe its luck when it saw the United States trashing the Trans-Pacific Partnership (TPP), and the absence of an American alternative to the BRI, not to mention America’s inability to hold even its allies in check on joining the Asian Infrastructure Investment Bank (AIIB). And now, it seems, America’s allies are not complying with its requested ban on Huawei’s 5G technology in their domestic communications networks. So, as Beijing sees it, things are not going badly at all.

China could not believe its luck when it saw the United States trashing the TPP, and the absence of an American alternative to the BRI, not to mention America’s inability to hold even its allies in check on joining the AIIB.

China’s Challenges

China, however, also has many challenges of its own, many of which are invisible to the Western eye but remain the daily concerns of its leaders. In many essential respects, these concerns represent the flip side of

the strengths I enumerated. First, Xi Jinping may have had remarkable success in consolidating his personal leadership position. Nonetheless, China has a long history of instability at times of leadership transition. This was most spectacularly evident after the death of Mao. We saw it again in the events of 1987–89. But there were also significant rumblings in 1992 when Deng intervened to secure the leadership of new Party Secretary Jiang Zemin. Then, during the most recent leadership transition to Xi Jinping, Bo Xilai was a contender before being imprisoned for corruption—with political convulsions ensuing across the country, resulting in the purge of a number of senior Party leaders who had been allies of Bo.

There are also divided views within China on the wisdom of Xi Jinping having abolished term limits at the 19th Party Congress for the position of president. It had been generally assumed that if Xi Jinping wanted to remain in active office by the time of the 20th Party Congress in 2023, he would be allowed to do so, although possibly in a position other than president. However Xi's decision to change the constitutional limits on high office, as well as his high-profile initiatives on island reclamation in the South China Sea, on the 2025 industry strategy championing China's high tech future, and on the Belt and Road, have caused some of his critics within the Party to accuse him of having gone too far. These critics further argue that this "overreach" has unnecessarily and prematurely provoked reactions from the United States and others across the West. This has not been a critique of Xi Jinping's grand strategy to make China wealthy and powerful and to reclaim its position as a global great power. Rather, it is a critique that by abandoning Deng Xiaoping's policy of "hide your strength, bide your time, never take the lead," Xi Jinping has made a significant tactical error by attracting international opposition much earlier than necessary.

On the economy, Xi also faces a number of deep challenges. These have been caused in large part by his own deep convictions about the future role of the Party in the economy. By instinct and ideological conviction, Xi is a Party loyalist. For those reasons, when he became Party general secretary in 2012, he concluded that he needed to act decisively to prevent the continuing decline of the Party as the country's core institution of political power. He initiated the anticorruption campaign. He strengthened the Party's hold over ideological rectitude across the country. He cracked down on political, academic, and religious dissent. And he has reasserted the role of the Party in the operations of the Chinese private sector.

This, however, has resulted in a negative reaction from China's rising entrepreneurial class. During the course of 2018, the Chinese private sector began an investment strike because of increasing objections to many tenets of the government's financial and economic policy. These objections focused on Xi Jinping's support for SOEs over private firms; his reported concern about private firms becoming too big, or at least bigger than the Party; his imposition of strict foreign exchange controls, constricting the ability of private firms to operate comfortably internationally; the skewing of the tightening of monetary policy, causing banks to withdraw lines of credit from a number of private sector firms while favoring SOEs in the rationing of credit; as well as Party secretaries in private firms having an increasingly substantive role in the company's operations, in contrast to their somewhat nominal position in the past.

The net result of all of the above, well before the impact of the U.S.-China trade war was felt, was a slowing of Chinese economic growth throughout 2018, until policy leaders in Beijing began to react decisively in the last quarter. Fiscal and monetary policy loosening followed, together with a number of policy statements by Xi and others aimed at rebuilding private sector confidence in the future. Nonetheless, with the private economy now representing 60 percent of Chinese GDP, Xi Jinping faces a continuing

structural challenge to balance his natural instincts favoring Party control, with an increasingly restive private sector that increasingly resents its economic future being muzzled by the reimposition of Party orthodoxies from the past.

A third problem presenting itself to China's leadership is the emergence of a structural current account deficit. China's current account surplus only a decade ago stood at 10 percent of GDP. It now stands at 0.4 percent of GDP. The decline in China's traditional surplus has been generated by increased Chinese imports, the declining international competitiveness of certain Chinese exports (because of improving wage rates within the country), together with Chinese consumers having finally decided that high savings rates are not the only way to plan for the future and that foreign goods and services have their own intrinsic attractions. China having to fund a current account deficit for the first time represents the underlying reason why Beijing, in the course of the last 12 months, has embraced a series of policy changes liberalizing its financial services industry. China has indicated that there will be new openings for foreign capital in Chinese equity markets, bond markets, as well as the development of its futures market. Announcements have also been made allowing more than 51 percent foreign equity in Chinese banks, insurance companies, and brokerage firms. These are large changes. They are not driven by a desire to appease foreigners. They are driven by the growing need to attract foreign capital in order to rebalance the current account. Of course, once this opening to international capital markets occurs, it will be very difficult to close the window. Indeed, if China does become structurally dependent on the net inflow of foreign capital, then it follows that foreign capital can also choose to leave the country if and when investors begin to doubt the fundamental market orientation of Chinese economic policy. In other words, if the Party turns further "left" on economic policy in the future, there could be a flight of foreign capital, under which circumstances China could conceivably face a current account crisis. This represents a significant long-term challenge for Chinese leaders seeking to balance the competing political and economic imperatives.

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A further challenge for Xi Jinping lies on the economic front, in China's double deficit dilemma. Public sector indebtedness has been fueled by local government debt over more than a decade. Indeed, when aggregated, China's national debt (albeit primarily domestically denominated) now runs at some 280 percent of GDP. China's monetary policy authorities have taken some corrective action on this score, and the numbers have started to slowly come down. But there is still a long way to go. However, it is China's budget deficit that arguably represents the larger long-term challenge for the authorities. China's budget dilemma is also worsened each time the Chinese leadership reaches for the fiscal lever to stimulate their economy to keep growth levels up. Furthermore, demographic change in China is seeing the rapid aging of the population, which the abolition of the one-child policy has failed to turn around. All this means that China faces a deep budgetary challenge in dealing with growing health, elderly care, and social security costs for its population. Proper public provision in these domains will be essential for the preservation

of long-term stability. But the more that domestic budget pressures are felt in these areas, the more that constraints will emerge for the Chinese government in making large-scale expenditure decisions in other areas, including on the military.

On the international front, China has also encountered resistance to the rollout of major policies such as the BRI. The election of Mahathir Mohamad as prime minister of Malaysia provides a case in point. There has been resistance in Sri Lanka, too, witnessed by their public reaction to handing over to China a port facility built with Chinese capital after Sri Lanka could no longer service the debt on the Chinese government loan. Even among loyal allies such as Pakistan, there has been local political reaction to Chi-

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nese-funded infrastructure projects through the BRI. Furthermore, given the potentially enormous financial dimensions of the BRI, Chinese financial institutions have quietly indicated to the Party that they themselves have limitations in terms of how much they can fund of infrastructure projects across the more than 60 countries that have expressed interest in the BRI in some form. This is particularly the case when many of these projects are unlikely to generate a financial or even economic rate of return for a very long time, if at all. As further evidence of its tactical agility, China has now decided that the best way forward is to increasingly internationalize the BRI in order to diversify the

sources of investment. It may also seek to scale back its scope. China has recently gone into global listening mode on the future of the BRI. The initiative will continue, but its operationalization may be tempered into the future.

Finally, on the domestic front, a number of local aspirations and tensions remain, each capable of boiling over in the future. Environmental concerns lead the way. While significant improvements have been made in reducing air pollution in China's major cities, this is not uniformly the case across the country. And the impact of urban air pollution has already begun to have an effect on respiratory diseases, cancer rates, and urban life expectancy. The inadequacy of China's health care facilities for the general public is also a source of continuing social and political tension across the country. Just as we also find that the Party's reaction to rising religious sentiment (including Protestant Christianity, Buddhism, and Islam in the case of Xinjiang) is generating ground-level dissatisfaction across the country. China remains officially Marxist and atheist. Xi Jinping has repeatedly emphasized this fact throughout his term. Crackdowns against Islam in Xinjiang, and in many Chinese provinces against unauthorized church construction and religious activity, reflect the Party's concern about different sources of ideational authority emerging across the country. For these reasons, domestic political criticism arising from grassroots social concerns represents a continuing challenge to the Party's long-term hold on power.

Relations with Russia

Nonetheless, when China contemplates its aggregate national balance sheet of assets and liabilities, what Beijing still sees, with some justification, is a cup half full. One additional geopolitical trend that has

been working in China's favor for some decades now is the normalization of Sino-Russian relations. The depth of the Sino-Soviet conflict of the 1960s, 1970s, and 1980s cannot be underestimated. However, the resolution of the Sino-Soviet border in 1989 between Deng Xiaoping and Mikhail Gorbachev and the subsequent collapse of the Soviet Union brought about a fundamental change in China's strategic posture toward its Russian neighbor. Not only did Sino-Russian relations begin normalizing in the 1990s, but once Vladimir Putin returned to the Russian presidency in 2000, the pace of engagement between Russia and China began to intensify further. This accelerated again under Xi Jinping. Indeed, the intensity and the intimacy of the relationship between Putin and Xi should not be underestimated. The evidence suggests that we are beginning to see the emergence of a de facto military alliance between China and the Russian Federation, despite official denials to the contrary.

Beijing and Moscow have virtually identical positions on all major global political issues. Their foreign policies are well coordinated at the United Nations Security Council. There is an effectively agreed-upon protocol between them that Russia will follow China's lead on the Asia-Pacific, whereas China will follow Russia's lead in the Euro-Atlantic region and the Middle East. Furthermore, the intensity of military exercises between the two countries has increased. Combined naval exercises as far away as the Mediterranean and the Baltic suggest that something of structural significance is unfolding in the relationship. Of course, there have been frustrations, not least over China's failure to meet deep Russian expectations to fill the financial gap left by the imposition of Western financial sanctions following the Russian invasion of Ukraine in 2014. Nonetheless, the conclusion in Moscow has been that China represents Russia's only alternative. It would be profoundly wrong for Western analysts to conclude this deep shift in the Moscow-Beijing relationship is only temporary. It is beginning to evidence all of the characteristics of a mutually convenient, long-term arrangement.

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Regional Responses

When we look beyond China to the wider Indo-Pacific region, from Beijing's perspective, we also see a series of relatively benign responses to China's rise in general, as well as to the particular dynamics of the unfolding strategic competition emerging between China and the United States.

On the Korean Peninsula, China is now in a stronger position than it was with both the Koreas only a year or so ago. The tumultuous year following President Trump's decision to directly engage Kim Jong-un has also had a profound effect on China-North Korea relations. Trump's North Korean diplomacy has resulted in the unfreezing of Beijing-Pyongyang relations, which had been in deep freeze for over five years. Prior to Trump's new diplomacy toward Kim Jong-un, Xi Jinping's attitude toward "Kim the Younger" bordered on absolute contempt. But if it was good enough for Trump to meet with Kim without conditions attached, it was also good enough for Xi. And so began a much deeper reconciliation between China and North Korea than has so far occurred with the United States. China will never compromise its strategic relationship with the North by forcing the North to denuclearize. That is because abiding Chinese

strategic doctrine is predicated on maintaining a benign strategic buffer between China and South Korea, Japan, and the American forces based there.

As for South Korea, the danger of President Trump's North Korea policy is that it has created political expectations in the South for some sort of accommodation with the North, even if the North refuses to denuclearize. While refusal to denuclearize is anathema to U.S. policy, that is not necessarily the case in the South under the current center-left government in Seoul. Indeed, given that the North is highly unlikely to denuclearize, it is possible to see a scenario unfolding in which the South begins to drift away from America's strategic orbit as Seoul looks for its own accommodation with the North, assisted by

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China. China does not want to see a united Korea on its doorstep, let alone one that is firmly in America's embrace. We should not forget that this was what caused China to enter the Korean War in 1950. And now, through its own diplomacy nearly three-quarters of a century later, China seeks to bring about benign relations with both North and South Korea as both become progressively more dependent on the Chinese economy and the South is steadily coaxed away from the United States. This should not come as a surprise, given that it has long been China's declared strategy to see an end to all U.S. alliances in Asia. The unknown political variable in all this is what will happen with center-right political sentiment in South Korea, once it finally reorganizes after a long series of corruption scandals, and whether it will fundamentally oppose any significant distancing of the South from America.

The bottom line is that President Trump's North Korean diplomacy has unleashed new dynamics in the triangular relationship between Beijing, Pyongyang, and Seoul, which not only have an uncertain trajectory but may also have a landing point inimical to long-term American and allied interests.

As for Japan, Prime Minister Shinzo Abe continues to defy the history books on the political durability of his Liberal Democratic Party (LDP) administration. The center-left opposition remains in disarray. Japan remains one of the strongest pillars of American allied interests in Asia. That is likely to continue under any successor to Abe in the LDP leadership. Japanese foreign and defense policy has also become more activist and assertive under Abe's leadership. Japan led the rehabilitation of the TPP following the Trump administration's decision to leave by holding together the "TPP 11" states in an ambitious regional free trade agreement while still excluding China. Abe has also concluded a major free trade agreement with the European Union as many European states have been under pressure from the BRI and other Chinese trade and investment initiatives. Japan has also led the establishment of a USD \$200 billion Partnership for Quality Infrastructure, in cooperation with the Asian Development Bank, which to date represents the only sizeable alternative to the BRI for the countries of Southeast and South Asia. And in 2017, Japan joined with India in promoting the Asia-Africa Growth Corridor in direct response to China's Maritime Silk Road Initiative. As for defense policy, Abe has led successful efforts to reinterpret Article 9 of Japan's postwar pacifist constitution to enable the Japanese Self-Defense Forces (SDF) to operate in

more expansive military exercises and operations in the future—both independently and with the U.S. and other allies.

Nonetheless, it would be naive to conclude that Japan has placed all its eggs in a single strategic basket. Abe's important visit to Beijing in October 2018, after a seven-year effective freeze in the Japan-China relationship triggered by Japan's decision in 2011 to "nationalize" Senkaku/Diaoyu, indicates that Tokyo has also begun to hedge its future strategic bets. Chinese military activity around the disputed islands has significantly reduced, as have Japanese SDF deployments in response. Abe also opened the door to future Japanese collaboration on BRI projects by signaling the possibility of joining China's AIIB if Japanese environmental and transparency concerns could be addressed. Furthermore, Japan appears to be mindful of the limitations facing the future of the Quadrilateral Security Dialogue (the Quad) with the U.S., Indian, and Australian navies given India's on-again, off-again approach to full participation. Japan would therefore seem to be weighing its own strategic future as it assesses the long-term trajectory of U.S. policy under Trump and his successors on the strength and reliability of America's future security commitments to its allies.

Southeast Asia has become the new "great game" in strategic competition between China and the United States and its allies.

I have written elsewhere that Southeast Asia has become the new "great game" in strategic competition between China and the United States and its allies. China's overwhelming economic presence in these smaller economies has created a series of political and foreign policy opportunities for China from the Philippines to Brunei to Myanmar. China has also succeeded in quarantining the management of its territorial claims and land reclamation efforts in the South China Sea to a regional diplomatic process. This is designed to negotiate, over time, a "code of conduct" to manage conflicting interests in the region. Even states with a traditionally more skeptical approach to China, such as Singapore, Vietnam, and Indonesia, appear to be hedging their bets on the future as well, seeking to balance their relations between Beijing and Washington. There is also a growing political perception across ASEAN that President Trump does not recognize the strategic importance of the region, irrespective of what other branches of his administration may be doing, particularly through the State Department, the Pentagon, and the Indo-Pacific Command.

That does not mean the region has become plain sailing for China. As I mentioned earlier, the election of Malaysian Prime Minister Mahathir last year, in a campaign warning against the dangers of his country and others falling into a long-term Chinese debt trap, has sent ripples across the wider region. There are also significant infrastructure projects, including, most recently, sensitive port infrastructure in Indonesia, that have been awarded by Jakarta to Indian and Japanese bids over the Chinese. Furthermore, ugly racial reactions against the growing presence of ethnic Chinese in Southeast Asia is once again stirring ancient prejudices. Nonetheless, my overall argument is that Southeast Asia remains very much in play in this new "great game," although the United States must recognize that the sheer weight of the Chinese economic footprint, in the absence of an effective American alternative, would tend to favor Beijing as the winner over the medium to long term.

India is in the middle of national elections, where polling indicates a relatively close outcome. Prime Minister Narendra Modi's Hindu nationalist party over the last five years has moved India toward a closer

strategic relationship with the United States than any of Modi's predecessors. In the perhaps unlikely event that the opposition Congress Party and its coalition partners win the election, it is an open question how much a new Prime Minister Gandhi would seek to unravel what Modi has achieved in the U.S. relationship. The 2018 bilateral agreement on enhanced military, intelligence, and defense acquisition cooperation represents a major milestone in the security relationship. Bilateral military exercises with the United States, as well as trilateral exercises with the United States and Japan, have increased in frequency, although India has repeatedly balked at these expanding further to include Australia through the Quad. The strengthening of the U.S.-India relationship has been driven by a rising China; repeated major incidents along the

disputed Sino-Indian border; a continuing toxic relationship with Pakistan, which has long been supported by China; as well as the construction of Chinese naval and civilian port facilities across the Indian Ocean from Bangladesh to Sri Lanka, to Pakistan through to Tanzania, Sudan, and Djibouti.

India is nonetheless dissatisfied with its economic relationship with the United States, given the Trump administration's decision to strip India of its preferential tariff status in selling Indian goods into the American market. Furthermore, India's determination to continue to source various defense purchases from Russia creates a further obstacle in the evolution of the overall strategic relationship with the United States, particularly as these can trigger automatic sanctions under U.S. legislation. Finally, it is important to note

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that as with Japan's Abe, Modi has also sought to hedge his ultimate strategic bets with the United States and China through his own far-reaching bilateral summit with Xi Jinping in Wuhan in April 2018 and the “strategic guidance” both sides then issued to their militaries to better manage tensions along the border. Xi and Modi have met on four occasions since then and have publicly reported that there continues to be improvement in the bilateral relationship based on their rolling review of the framework agreed to at Wuhan. Once again, India is being cautious about its strategic future, including long-term U.S. policies, posture, and capabilities in the Indian Ocean.

This brings us finally to the Gulf. China's core interest in the Gulf is to secure its long-term energy supplies of oil and gas. More recently, however, China has initiated joint investments between Chinese sovereign funds together with their Saudi and Emirati counterparts in third-country projects in which China wants to mitigate its own financial risk. China would like Saudi Arabia, in particular, to participate in BRI projects, perhaps even turning Saudi Arabia into the BRI gateway to Africa. The visit of Crown Prince Mohammed bin Salman (MBS) to China in February 2019 was an important turning point in the relationship, given Saudi Arabia's increasing international isolation following the Jamal Khashoggi assassination. China's official media waxed lyrical following the MBS visit, not only on the significance of the Kingdom's new “look east” policy and its implications for the BRI, but also in providing Saudi Arabia with fresh opportunities to diversify its future strategic relationships beyond an unreliable America.

Once again, however, one swallow doth not a summer make. Both Saudi Arabia and the United Arab Emirates remain deeply skeptical concerning Beijing's much older and closer economic and military relationship with Iran, which Riyadh and Abu Dhabi have long identified as their fundamental strategic threat in the Gulf. This skepticism is compounded by China's close strategic relationship with Russia, which has stood opposed to Saudi interests in the resolution of the Syrian conflict. To this should be added growing concerns in the wider Muslim world over Chinese policies toward their own Muslim minority in Xinjiang. Nonetheless, the Gulf, for the first time, also now appears to be in play for China in a way that would have been unimaginable only a decade ago. Gulf governments, like governments across the region, are increasingly torn between the economic potential of their burgeoning relationship with China and the security dilemmas this creates for their relationships with Washington and Tehran. Importantly, American political leaders also seem to have overlooked the fact that as they have celebrated the end of American energy dependence on the Gulf through the development of the U.S. domestic fracking industry, it has been China that has filled the demand gap in taking Gulf oil and natural gas contracts. China has now become the Gulf states' largest energy market. And the pan-regional reality is that economic interests, over time, have a significant impact on political and foreign policy considerations, and security policy decision-making as well. Of this, Chinese decision makers are acutely aware.

American political leaders...seem to have overlooked the fact that as they have celebrated the end of American energy dependence on the Gulf through the development of the U.S. domestic fracking industry, it has been China that has filled the demand gap in taking Gulf oil and natural gas contracts.

Conclusion

Nothing is ever predetermined in national or international politics. Political agency means that, ultimately, governments decide on what futures they want for their countries. They then prosecute strategies, successful or otherwise, to give their aspirations practical effect. There are, however, deep structural forces also at work in international relations that over time begin to set the parameters for the freedom to maneuver for any individual state. History informs us that the most powerful of these parameters is economic. And it is here that we begin to contemplate the unfolding asymmetry of the U.S.-China relationship, both regionally and globally.

Across the coming decade, most analysts conclude that China is likely to become a larger economy than the United States using either purchasing parity pricing or market exchange rates. At the same time, the United States is likely to remain the dominant global and regional military power through until mid-century and possibly beyond. Ultimately, however, the history of national militaries is that they eventually yield to national economic realities. The current gravitational pull of the Chinese economy is unprecedented in modern economic history. We have seen this for some years in trade flows where China has already been the world's largest trading power for the last few years. We are beginning to see a similar trend in foreign direct investment flows around the world. Capital flows, innovation, and technology potentially stand poised to complete the picture.

The success or failure of Xi Jinping's dream, both at home and abroad, ultimately rests on the economy. As the preceding analysis has suggested, there are many things that can still go wrong with China's fundamental economic policy settings and associated environmental constraints. Of these, arguably the most significant is the as yet unresolved question within China

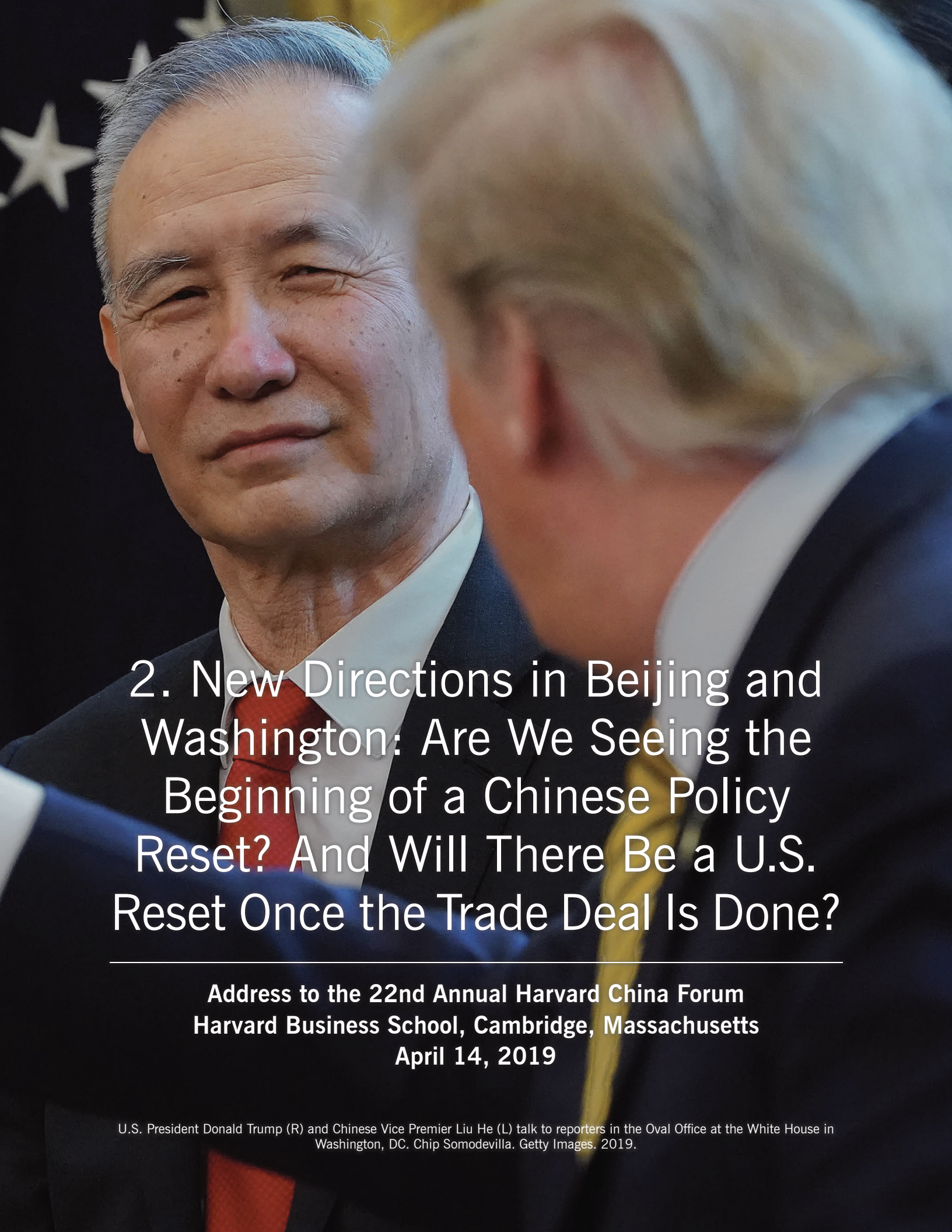
The success or failure of Xi Jinping's dream, both at home and abroad, ultimately rests on the economy.

on the long-term trajectory of its domestic political economy. The essence being, will the Chinese Communist Party continue to tolerate the next generation of market reforms for its economy, thereby enabling China to burst through the middle-income trap in order to realize Xi Jinping's dream? Or will the Party

balk at this challenge because it fears that by doing so, it creates an increasingly dominant private sector, outcompeting China's state-owned enterprises, and thereby creating a powerful private entrepreneurial class whose policy influence ultimately renders the Party politically redundant?

In many respects, we had a trial run on this question after the 2015 Communist Party Plenum, as the Party progressively abandoned its 2013 economic reform blueprint in the name of economic, social, and political stability. Although in recent months, slowing growth, combined with other structural forces at play within the Chinese economy, may have caused a policy rethink at the highest level of the Party and state. Reform of China's financial markets seems to point in that direction. But as for the rest of the economic reform agenda, the picture remains unclear.

As for the United States, I have not been asked to address U.S. strategy or its operational policy in the Indo-Pacific region. Therefore, I do not intend to comment further, other than to observe that if China has developed a consistent grand strategy over several decades, it is important that the United States starts to think and act in similar terms. I have read carefully the U.S. National Security Strategy of December 2017 and the National Defense Strategy of January 2018. I also understand that further work is currently under way in the U.S. interagency process. But I have yet to see substantive evidence of a whole-of-administration, let alone a whole-of-economy or whole-of-nation strategy to deal with the challenges of the future. Some argue that this is not possible in elected democracies. It is certainly true that democracies are less tidy than authoritarian states. But this does not of itself preclude the possibility of a fully integrated national strategy, with sufficient bipartisan buy-in, that would command American policy and action into the future.



2. New Directions in Beijing and Washington: Are We Seeing the Beginning of a Chinese Policy Reset? And Will There Be a U.S. Reset Once the Trade Deal Is Done?

**Address to the 22nd Annual Harvard China Forum
Harvard Business School, Cambridge, Massachusetts
April 14, 2019**

U.S. President Donald Trump (R) and Chinese Vice Premier Liu He (L) talk to reporters in the Oval Office at the White House in Washington, DC. Chip Somodevilla. Getty Images. 2019.

OVER THE LAST SEVERAL YEARS, deep changes have been unfolding in the overall dynamics of the U.S.-China relationship.

Xi Jinping, while seeking to maintain a respectful and constructive bilateral relationship with the United States—not least because of China’s deep recognition of America’s continuing economic and military power—has nonetheless embarked on a more activist and, in some cases, assertive policy toward the rest of the region and the world. At the same time, Xi has prosecuted domestic policy settings that have resulted in tighter Communist Party control over Chinese politics, society, and the economy. As a result, we have seen the emergence of a more nationalist, and indeed ideological, China than we have seen for many decades. We are also beginning to see that these shifts in China’s overall policy direction have begun to generate their own reactions, both at home and abroad, and not all to China’s liking.

Meanwhile, the Donald Trump administration has announced, and partly executed, a new policy of “strategic competition” with China. The U.S.-China trade war has been its most concrete manifestation

to date. But Vice President Mike Pence’s speech to the Hudson Institute in October 2018 foreshadowed a much broader “doubling down” against China across foreign policy, security policy, and human rights—as well as the eternally vexing question of Taiwan. Six months after the vice president’s speech, however, the precise operationalization of this new U.S. declaratory policy remains unclear—although the U.S. campaign to deny Huawei further access to global 5G markets is a harbinger of what may soon be on the way.

There are, nonetheless, two big new questions arising for policymakers, which so far have not featured prominently in the public debate but may significantly

shape the evolution of the U.S.-China relationship during the course of this year. The first is, are we witnessing the emergence of a significant change in economic policy direction in Beijing in response to the slowing of Chinese growth during 2018 that was brought about by a combination of domestic policy and trade war-related factors? If so, how do we best characterize this change in terms of further market liberalization—or, for that matter, the reverse? Is this change tactical or strategic? And will it be accompanied by any wider reset in Chinese foreign policy?

The second question, partly shaped by the answer to the first, is this: once a trade deal between President Trump and President Xi Jinping is signed in the weeks and months ahead, will there also be a reset in the overall U.S. strategy toward Beijing? Will there be a general hardening in U.S. policy measures against China across the board—including the nontrade dimensions of economic policy, foreign policy, and national security policy, as outlined in Vice President Pence’s October 2018 address? Or will President Trump, driven by his trade “success” with Beijing and his “deep personal regard” for President Xi, constrain the China hawks across his administration from implementing the new adversarial strategy foreshadowed six months ago?

Xi Jinping, while seeking to maintain a respectful and constructive bilateral relationship with the United States...has nonetheless embarked on a more activist and, in some cases, assertive policy toward the rest of the region and the world.

The reason why both of these questions are important is that the answers—which at this stage are still unclear—will determine whether the remaining ties between the two countries will continue to tear apart, or whether they will be held together by a new strategic moderation driven by the two leaders.

A Chinese Policy Reset?

In early December 2018, just after the summit meeting between President Trump and President Xi Jinping in Buenos Aires, I began probing the question of whether the Chinese leadership would use the U.S.-China trade negotiations as a political vehicle for re-firing their own domestic economic reform program. Those were early days. But since then, there has been some evidence, albeit far from definitive, that this may be occurring.

Back in 2013, the Party adopted what was then described as “The Decision,” which mapped out the next phase of China’s economic reforms in a document widely described as the “economic blueprint” for the Xi Jinping period. It might also be recalled that the final production of this document followed lengthy internal deliberations within the Party on the proper status of “the market” within the conceptual and policy framework of setting China’s economic policy for the future. That internal debate was finally resolved in favor of the market when it was concluded that “China will let the market play a decisive role in resource allocation in the economy.”

The blueprint was a comprehensive policy manifesto including some 66 separate proposed policy reforms governing the full gamut of the Chinese economic agenda. We at the Asia Society Policy Institute took this exercise seriously. And since 2017, we have released a quarterly “China Dashboard” mapping China’s success or failure at implementing the blueprint it embraced in the 2013 Decision.

Following some initial successes, China’s domestic financial crisis of 2015 had a profound effect on the future of these reforms. The meltdown that occurred in August of that year in the Chinese stock markets, coupled with other problems emerging in Chinese financial institutions, sent political shockwaves through China’s Party establishment. International reporting on the crisis at the time raised the question of whether China, which in past decades had successfully negotiated multiple twists and turns in its long-term reform process, had finally lost its economic magic. China’s political leadership was deeply unimpressed by these developments.

The net consequence of the 2015 crisis was a radical slowdown in the implementation of the 2013 blueprint. In fact, this slowdown would continue over the next three years, causing many analysts to conclude that the domestic economic reform process had stalled altogether. On top of that, new stringent capital controls were imposed by the government on Chinese firms and individuals to limit the outflow of foreign capital.

In 2018, however, China began to experience the consequences of this stalling of the reform process. The Chinese private sector, during the course of 2018, began to slow. In many cases, firms began suspending their private fixed capital investment plans for the future. Indeed, there was an emerging crisis of business confidence in China’s overall policy approach. These concerns took different forms:

- the cessation of state-owned enterprise (SOE) reform and broader competition policy reform, together with a reenergized SOE sector throwing its weight around against its private sector competitors;

- the Party's reservations about the size to which major private firms would be allowed to grow;
- the implementation of a credit tightening policy in a manner that cut credit supply to private firms, including those that were profitable and successful, while referencing the capital needs of SOEs;
- the enhanced status of Party secretaries within the management operations of private firms; and
- the continued vagaries of the Chinese legal system, together with the anticorruption campaign, which caused a number of Chinese entrepreneurs to be concerned for their personal futures.

These concerns were compounded by the foreign exchange controls introduced by the Chinese authorities following the 2015 crisis, which continued to impose significant administrative restrictions on the amount that private firms could transfer abroad, frustrating further their ambitions for global expansion.

By the last quarter of 2018, the data had begun to demonstrate a radical slowing of Chinese economic growth. Remember, as of 2018, China's private sector represented 60 percent of gross domestic product (GDP). Indeed, as Vice Premier Liu He reminded the nation in an important interview on October 19, 2018, the private sector represented 90 percent of new employment growth, 80 percent of urban employment, 70 percent of technological innovation, and 50 percent of total taxation.

The impact of declining private sector business confidence on China's overall economic growth in 2018 was compounded by the rapidly unfolding trade war between China and the United States. During President Trump's first year in office, Beijing thought that it could manage the trade and economic tensions in the U.S.-China relationship, despite the strength of the language used by President Trump during the 2016 election campaign.

China's analysis proved to be wrong. During the course of 2018, it became increasingly clear that President Trump meant business, and as a result, we saw the imposition of tariffs—first by the Americans, and then by the Chinese in retaliation. As of today, we have American tariffs covering USD \$250 billion of Chinese exports to the United States. We also have Chinese tariffs applied to USD \$110 billion of American exports to China. Given the export dependency of many private Chinese firms on the massive American market, the trade war began accelerating China's economic slowdown.

Those who track these developments closely will note that the turning point in the high level Chinese policy response to the slowing of the Chinese economy occurred between October and November of last year. In a critical speech delivered by Xi Jinping on November 1, 2018, he said, "Private firms are an essential part of our economic system; private firms and private entrepreneurs are of our own." However, this was not just a speech. There followed in rapid succession a number of policy measures aimed at dealing with the immediate growth challenge and restoring a level of private sector business confidence.

To stimulate the Chinese economy, the authorities drew on the traditional instruments of monetary and fiscal policy to repair the emerging growth gap. On the monetary policy front, China reduced the capital reserve requirements for banks to lend to small and medium-sized private sector firms. It also issued

an edict for large state-owned banks to increase lending to small businesses by 30 percent. The result has been that interbank and commercial lending rates have declined, and there has been general improvement in liquidity.

On the fiscal policy side, significant changes were introduced to the corporate tax. The value-added tax (VAT) for manufacturing industries was reduced by 3 percentage points to 16 percent. The VAT for the agricultural, transport, construction, leasing, wholesale, retail, and real estate sectors was reduced to 10 percent. Furthermore, to improve the financial circumstances of firms, the authorities backtracked on social security reforms. Provincial governments were given greater freedom to set rates for individual paychecks. Even more extraordinary was that companies that had not paid their social security tax obligations had these obligations forgiven. As a further stimulatory measure, China introduced personal income tax cuts, including an increase in the personal tax threshold from 3,500 yuan per year to 5,000 yuan.

On top of these classic fiscal and monetary policy measures, China also resorted to its traditional approach of increased infrastructure investment, in particular in urban transit systems. All these are classic stimulatory policies. They have been designed to plug an emerging growth gap. But they do not, of themselves, indicate a fundamental reorientation of the Party's direction on further economic reform in a direction consistent with the 2013 blueprint.

However, in recent days, we have begun to see some other signs of a rekindling of reformist enthusiasm. The recent announcement of significant changes to the Chinese *hukou* system by the National Development and Reform Commission are consistent with the core labor market reforms outlined in the 2013 reform blueprint. This includes the removal of old restrictions for house registration permits for migrant workers in cities of between one and three million habitants, as well as a significant relaxation for those who have migrated to cities with a population of between three and five million.

As for the rest of the 2013 economic reform program, there have been some additional straws in the wind. For example, the proposed sale of the state-owned controlling shares in Gree Electric Appliances may indicate a predilection for reversing a recent trend that has seen SOEs take up equity in successful private firms. This is significant because of all the policy regressions that occurred in the period after 2015, SOEs taking equity positions in some of China's more successful private firms was beginning to create fundamental confidence problems for Chinese entrepreneurs. Indeed, the mantra of recent years about China moving toward a "mixed economy model" seems to have been interpreted as enabling Chinese SOEs to buy their way into successful private firms. This, of course, stands in stark contrast to a classic mixed economy model—dominated by private firms but balanced by SOEs in critical infrastructure sectors.

A further important development on the economic policy front in 2018 has been in financial market reform. During the course of 2018–2019, China has introduced a series of reforms to allow greater direct foreign participation in its domestic financial markets. These have included:

- greater foreign investment in China's stock markets (so far, through Hong Kong's StockConnect, but prospectively through other entry points as well);
- the MSCI quadrupling the weighting of China A shares in its global benchmarks;

- Chinese RMB-denominated government and policy bank securities being added to the Bloomberg Barclays Global Aggregate Index starting April 2019 and phased in over a 20-month period, thereby inviting much higher levels of foreign investment in Chinese securities;
- the development of Chinese futures markets; and
- decisions by the Chinese regulatory authorities to approve 51 percent foreign-controlled ventures in the Chinese banking, insurance, and brokerage industries.

More reforms in the financial services sector are likely to follow. These are important measures. They have not, however, been driven by China's interest in accommodating American concerns about overall access to the Chinese market—although that will be one of its consequences. Rather, these changes have been driven by China concluding that, as of 2020 and for the first time in its recent economic history, China will face a current account deficit. Estimates vary as to the size. Some have indicated that from 2020 onward, it is likely to run at some USD \$250 billion per year. This has been brought about by China's growing appetite for imported consumer goods, the declining competitiveness of China's traditional exports because of domestic wage growth, as well as foreign direct investment into China not growing at the speed necessary to plug the emerging gap on the current account. Other measures, therefore, have

Chinese economic policymakers appear to be taking a calculated risk that making the country's capital markets more open to foreigners is worthwhile—both in terms of the immediate task of dealing with the practical problem of balancing the current account, as well as pinning the country's longer-term policy commitment to market reform.

become necessary to ensure that China's current account remains in balance. The net consequence of these measures is to establish a set of arrangements in which foreign-sourced capital will begin to play a bigger role in China's overall macrofinancial and macroeconomic policy circumstances.

There is, however, from the Party's point of view, a political risk attached to all the above: namely, that just as foreign capital, through these new market openings, is now welcome to come into China in far greater quantities than in the past, the same foreign capital can quickly exit the country as well. In other words, if markets were to form a view in the future that China's overall economic policy direction was heading "left" (that is more favorable treatment of state-owned enterprises as part of a

continuing political strategy of increasing Party control of the economy), then this would likely have a profoundly negative effect on underlying financial market sentiment. Of course, China could simply prevent foreign capital from leaving the country abruptly. But that would create a fundamental crisis of confidence with even deeper economic consequences for China's future. On balance, therefore, Chinese economic policymakers appear to be taking a calculated risk that making the country's capital markets more open to foreigners is worthwhile—both in terms of the immediate task of dealing with the practical problem of balancing the current account, as well as pinning the country's longer-term policy commitment to market reform.

So what does all this mean in terms of China's long-term economic direction? In summary, the slowdown in market-based economic reforms over the last three years has had an effect on Chinese growth rates. The greater imposition of Party control over the economy has had a similar effect. This reached a crisis point during the second half of 2018, when growth rates, employment rates, and private investor confidence began to be hit badly. Furthermore, China's policy correction in response to these developments has been along familiar lines—stimulatory policies on the fiscal and monetary policy front have been implemented of a type we have often seen in the past, which have already begun to have their effect and which postpone the final date of fiscal reckoning to a more distant point in the future. But, at the same time, we would be blind not to recognize the significance of the resuscitation of a number of domestic economic reform measures. Just as we would be foolish not to see the long-term significance of China's decisions to liberalize its financial markets further. The economic picture, therefore, is a complex one.

What does this mean as far as China's overall domestic political circumstances are concerned? China has an expression, *jing you, zheng zuo*. In other words, if you are going to the right on the economy, you go to the left on politics. It is no great mystery, therefore, that on the domestic political front in China, we continue to see a hardening in Party political control. We can see this in terms of tighter censorship regimes. We see it in the attitude to dissenting voices across the Chinese policy and political system. And we also see a much harder set of control measures used by the center to deal with religion, be it Protestant Christianity, Buddhism, or Islam. This domestic political tightening shows no sign of letting up anytime soon.

There is, however, a broader question about whether China's recent domestic financial and economic policy reset, brought about by China's challenging economic growth circumstances in 2018, will also provide Xi Jinping's administration with an opportunity to undertake a broader international policy reset as well. This, too, is an open question. But once again, there appear to be a number of straws in the wind which are worth noting.

China now appears to be embarking on a policy refresh in the implementation of the Belt and Road Initiative (BRI) so that it becomes less of an international political target in the future. Chinese policymakers appear to be interested in increasing the "internationalization" of the BRI by welcoming investments from all countries in BRI projects in order to lessen China's direct financial exposure, as well as mitigating local political reaction against BRI projects if and when they go wrong.

On the question of China's controversial "Made in China 2025" manufacturing strategy, and particularly its application to the high-tech sectors of the future, China has already begun to publicly deemphasize the political and policy significance of the strategy. It remains to be seen, however, whether China's previously stated desire to achieve industry dominance in these sectors, including artificial intelligence, has in any substantive way abated, or whether the shifts now under way are more cosmetic in nature.

China's declaratory language concerning its territorial claims in the East China Sea and the South China Sea has also been moderated in recent times. That is likely to continue. In the case of Senkaku/Diaoyu Dao, China's operational deployments to the region have decreased resulting in a parallel decrease in active Japanese deployments. Indeed, China has sought to take the temperature down in its overall relationship with Japan, as reflected in the October 2018 visit by Shinzo Abe to Beijing, which ended a seven-year-long freeze in the relationship. A similar de-escalation has been evident in the Beijing-Delhi relationship since

Xi Jinping's summit with Narendra Modi in Wuhan in April 2018. This pattern, however, has not been replicated in the South China Sea, where, at an operational level, the intensity of Chinese deployments seems to be headed in the reverse direction.

Nonetheless, it is important for us all to be alert to whether China uses the resolution of the U.S.-China trade war as a political window of opportunity to undertake a much broader policy reset—toward the United States, its BRI partners, and the broader international community. China has heard much international criticism of its “overreach” in recent years. This, in turn, has led to some considerable

reflection by the center. However, these are very early days, and we have yet to identify the extent to which any such policy reset would be tactical or strategic in nature. This remains very much an open question.

Together with the National Security Strategy of December 2017 and the National Defense Strategy of January 2018, Vice President Pence's [October 2018] speech embraced the end of strategic engagement and advocated a new era of strategic competition between the United States and China.

We should also reserve judgment on whether China will return to open and free markets, both at home and abroad, to sustain its growth performance over the long term. Xi Jinping's conclusion during his first term in office was that the ideological, political, and policy balance across the country and the economy was not right in the past. Xi has sought to rectify that balance in a direction more conforming to Xi's fundamental Marxist-Leninist worldview. He has also sought to reassert Party control. But at the same time, Xi Jinping has around him senior colleagues and economic advisors who understand deeply the impact

that declining market freedom will have on economic growth, employment, living standards, competitiveness, and productivity. Xi Jinping recognizes, however reluctantly, the fact that a buoyant private sector is fundamental to his “China Dream” of a “strong and powerful Chinese nation,” combined with a “great renaissance of the Chinese people.” Therefore, we are likely to see further acts in this long-running play between the competing “dramatis personae” in Chinese politics contending for China's economic future—continued Party authority in one corner, always roiling against fundamental market freedoms in the other.

A U.S. Policy Reset?

The second question I would like to address briefly today is also one that arises from the impending resolution of the U.S.-China trade war. This is not to do with the future of the Chinese domestic and international economic reform program, or even the possibility of a broader policy reset by China following the conclusion of the trade agreement in the months ahead. What it does have to do with is, once the trade deal is done, what will happen to the rest of the U.S.-China relationship—both in its nontrade economic dimensions, and more broadly across the foreign policy, national security policy, human rights policy, and the overall bilateral political relationship? In other words, once the trade deal is done, what happens to the rest of the relationship? Many diplomatic practitioners, both in Washington and in Beijing, have already turned their attention to this central question for the future.

Those of us who follow the overall dynamics of the U.S.-China relationship, not just its financial and economic dimensions, have analyzed closely Vice President Pence's speech of October 2018 at the Hudson Institute. This is arguably the single most hard-line speech delivered by any U.S. administration against China since the normalization of diplomatic relations in 1979. Together with the National Security Strategy of December 2017 and the National Defense Strategy of January 2018, Vice President Pence's speech embraced the end of strategic engagement and advocated a new era of strategic competition between the United States and China. According to the vice president's speech, this would involve a fundamental strategic reset by the United States across all domains of U.S. policy.

Certainly over the course of the last 12 months, the U.S. administration has been busy through the interagency *policy* process in putting flesh on the bones of this potential new strategic policy direction on China. However, what we do not know is what will happen in the internal *political* dynamics of the administration once the trade deal is signed, sealed, and delivered.

The first possibility is that President Trump, having secured the trade deal, and therefore in his mind having honored his promise to his political base during the 2016 campaign to secure a "fair deal" for the first time between China and the United States on exports and jobs, will then delegate the rest of the Chinese policy space to the rest of the administration to prosecute. In other words, under this scenario, the national security hawks in the Pentagon, the State Department, the National Security Council, and the Intelligence Community would then be unleashed to implement a comprehensive strategy against China, seeking to constrain China's increasingly assertive international behavior.

An alternative scenario is that President Trump, who has stated repeatedly his high personal regard for President Xi Jinping, will act as a broader "guardian" of the U.S.-China relationship and not allow the hawks within his administration off the leash to prosecute such a robust strategy against Beijing. President Trump, it will be noted from the official record, has rarely, if ever, attacked China over its strategic policies in the wider Indo-Pacific region, including the South China Sea. Nor does the president engage more broadly on China's broader geo-economic and geopolitical challenge to America's long-term status as the largest economy and largest military power in the world. Nor can we find in the presidential record any public position taken by President Trump on China's human rights record. Indeed, the president has often chosen to be publicly equivocal about human rights questions in the broader international diplomacy of his administration. Therefore, it is entirely possible that President Trump, to protect the implementation of his bilateral trade agreement with his Chinese counterpart, chooses to keep the rest of his administration in check to avoid damage being done to what he really cares about—namely, American trade and economic interests.

Xi Jinping will be particularly alert to how to secure maximum leverage over President Trump in the post-trade deal period—not only to prevent the breakout of a fresh trade war arising from alleged violations of the agreement, but also to prevent a wider breakout in the nontrade dimensions of the relationship.

The question of which way President Trump will jump in the post-trade deal world is at present a live consideration across Washington and Beijing. Chinese policymakers are understandably anxious about which way President Trump will go on this question, just as the hawks in his own administration are anxious as well. Xi Jinping will be particularly alert to how to secure maximum leverage over President Trump in the post-trade deal period—not only to prevent the breakout of a fresh trade war arising from alleged violations of the agreement, but also to prevent a wider breakout in the nontrade dimensions of the relationship. In this respect, Xi Jinping will be electric to what the Trump administration does next on Taiwan, including future arms sales to the island.

Conclusion

There are no neat answers to the two questions I posed at the beginning of this address. It is important, nonetheless, to be aware of the questions both sides are likely to be wrestling with in the immediate months ahead, and the possible contours of the responses that they may well develop.

Will China, through a more general economic and foreign policy reset, seek to tack toward the center, thereby increasing its growth prospects, on the one hand, as well as reducing its structural tensions with the United States, its immediate neighbors, and the wider international community, on the other? And is it conceivable that the United States, in the warm afterglow of a trade deal, seeks to do something similar, meeting China somewhere in the middle as both sides seek to maximize their common economic interests in trade, investment, and capitals flows; manage their emerging Cold War in high technology; and keep foreign and security policy tensions within tightly defined limits?

While not impossible, the odds would still seem to be stacked against it. Indeed, if there is a shift, on the part of either country, it is more likely to be tactical rather than strategic, shorter term rather than longer term. That is because of the deep structural divergence emerging between the two countries in their underlying values, the narrowing of the economic and military gap between them, and a mutual recognition that the race for the commanding heights of the high technologies of the future (of which artificial intelligence is but one) will ultimately determine their future claims to dominant superpower status. On top of all this, there is no new, common strategic narrative for the future of the bilateral relationship capable of binding the two countries together while managing and ameliorating the growing tensions between them.

The bottom line is the U.S.-China relationship continues to be brittle. There has been little engagement between the two sides over the last two years on the overall foreign and security policy dimensions of the relationship. Furthermore, the political and diplomatic ballast remaining in the relationship is also thin. Both the Trump administration, and Xi Jinping's equivalent, are deeply conscious of the fact that in the lead up to next year's presidential and congressional elections, Trump will face a Democratic Party that will attack him from the right on China on any perceived concessions he may make to the Chinese in the critical year ahead.

3. The Trade War, Economic Decoupling, and Future Chinese Strategy toward America

Remarks at the Lowy Institute
Sydney, Australia
June 13, 2019

MAKING SENSE OF THE U.S.-CHINA TRADE WAR IS DIFFICULT IN ITSELF. Trying to make sense of where it may lead in the context of a wider “decoupling” of the U.S. and Chinese economies is more difficult again. But understanding where both of these developments may take us in terms of China’s future grand strategy toward the United States is perhaps the hardest task of all.

Nonetheless, we have reached just such a juncture in U.S.-China relations—one that now requires us to ask ourselves these fundamental questions, given that the answers we formulate in response will also shape the future of this, the single most consequential relationship of the twenty-first century.

I wrote earlier this year in a short publication titled “The Avoidable War” that as of 2018, we had seen a major new inflection point in the postwar relationship between America and the People’s Republic of China. Phase one of the relationship covered the quarter century of strategic hostility from the founding of the People’s Republic until rapprochement under Richard Nixon and Henry Kissinger. Phase two covered the next 20 years of Sino-U.S. strategic collaboration against Moscow until the collapse of the Soviet Union in 1991. Phase three covered the next 20 years of economic collaboration and engagement, highlighted by China’s succession to the World Trade Organization in 2001 and its emergence as the new global factory, through the end of the global financial crisis.

Phase four has been marked by the rise of Xi Jinping and an economically self-confident China, one prepared to emerge from the shadows and exercise a more assertive regional and global foreign and security policy. It was also characterized by the reemergence of a renewed Chinese strategic partnership with the Russian Federation. And now, this fifth period of the relationship has seen the United States formally abandoning its 40-year-long policy of strategic engagement with Beijing, and instead its formal embrace of an undefined period of “strategic competition.”

In truth, this did not begin under the Donald Trump administration. During the second Barack Obama administration, the outline of a more robust American response could already be seen militarily in the U.S. “pivot to Asia” and then economically in the Trans-Pacific Partnership. If we are looking for official signposts to mark the end of one era and the beginning of the next, the release of the U.S. National Security Strategy in December 2017, followed by the new National Defense Strategy in January 2018, fulfills that purpose.

Since then, the U.S.-China relationship has entered into new and uncertain terrain where there are no longer any clear rules of the road. Both the conceptual framework of the past (strategic engagement) and the extensive institutional machinery of the relationship (the advanced bilateral apparatus growing out of the Strategic and Economic Dialogue) have been effectively abandoned. As of June 2019, nothing has effectively taken its place.

Apart from the bilateral trade negotiations led by the Chinese Vice Premier Lui He, on the one hand, and the uneasy American triumvirate of U.S. Trade Representative Robert Lighthizer, Treasury Secretary Steve Mnuchin, and Commerce Secretary Wilber Ross, very few other bilateral mechanisms have survived. This becomes particularly problematic when the single remaining track of the bilateral relationship (trade negotiations) ends up being suspended, as has been the case since the implosion of the eleventh round of negotiations in Washington in early May 2019.

We seem, therefore, to be thrown back to an almost nineteenth-century relationship in which the principal point of political contact between the two administrations has now reverted to embassies, ambassadors, and the occasional special envoy. Indeed, the relationship has become the most brittle it has been in the last 30 years, going back to the aftermath of Tiananmen in 1989.

We live in difficult and dangerous times when the absence of extensive political engagement and substantive political communication across the breadth of the relationship means that we now find ourselves depending on the ancient crafts of speechmaking and textual analysis and the crudities and ambiguities of diplomatic signaling. Given that this is such a consequential relationship, many of us find this strange indeed. Not just strange, but increasingly unstable and potentially dangerous as the politics of miscalculation and miscommunication become more pronounced.

My purpose today is to begin to examine the three questions raised at the outset of these remarks:

- where the U.S.-China trade war may go to next, including the prospects for some form of resolution;
- what the prospects are, with or without a trade deal, for a wider economic decoupling between China and the United States in the future; and
- where these developments may take us in the future as the Chinese leadership begins to reappraise China's long-term strategy toward the United States and its friends and allies around the world?

I do so because I still entertain the old-fashioned view that an analysis of what is actually going on is a necessary precondition for determining policy on what could or should be done about it.

The U.S.-China Trade War

This time last month, I was having breakfast with a Chinese friend in Chengdu, the prosperous provincial capital of Sichuan, and discussing the increasingly toxic U.S.-China relationship. The only newspaper available that morning was the less than world-renowned *Chengdu Commercial Daily*. But the headlines that day took my eye, particularly the bright box high on the front page, announcing publicly for the first time China's three new red lines in the ongoing U.S.-China trade war.

It was clear that we were now in a whole new world of pain in bringing an end to an increasingly debilitating trade war. China would not now be budging on America's insistence on retaining tariffs for a period following the deal's signing; nor would China be accepting the United States unilaterally reimposing tariffs in the future if the United States deemed China not to be in compliance, while denying China the right to take any retaliatory measures itself; nor would China tolerate President Trump's ever-increasing, administratively determined "purchase order" for American goods that China would be required to buy to bring down the bilateral trade deficit to a number of Trump's political choosing. The significance of all this was not so much the substance of China's objections, but that China chose to make them public, thereby making it impossible for Beijing to yield on them in the future. In China's eyes, if there is to be a deal, most, if not all, movement was now going to have to come from Trump.

Beijing then proceeded to unleash an avalanche of nationalist rhetoric against the United States of a type I had not seen in 30 years. America was now routinely described as a swaggering bully. The *People's Daily* reminded its readers that the People's Republic, less than 12 months after its founding, had fought the United States to a stalemate in Korea. Xi Jinping then went south to Jiangxi, from where the Communist Party had set out on the Long March in 1934 and lost 90 percent of its forces, before finally winning the war against the Nationalists 15 years later. Xi also happened to visit a rare earths facility in Jiangxi. While he was not so crass as to state publicly that America was ultimately dependent on Chinese rare earths for its needs across multiple industry sectors, the point was nonetheless made loud and clear that China had leverage, too. The message to the domestic body politic was also clear: that the world has thrown a lot at China over the last 5,000 years, but we Chinese have a long, long history of enduring pain, and we always prevail.

Meanwhile, on the policy front, China has calculated that a full-blown trade war, if it comes to that, will cost its economy around 1.4 percent in growth per year. A full range of fiscal, monetary, and infrastructure investment measures are already under way as part of a stimulus strategy to keep growth above the magical 6 percent threshold. Other measures are in the pipeline.

Adding fuel to the fire, President Trump on May 15 announced that the Chinese telecom giant Huawei would become a "listed entity" under U.S. law, effectively barring American firms from supplying Huawei with essential components for their products. China retaliated on May 31 by announcing its own "unreliable entities list," which would include any international firm that took "discriminatory actions" against Chinese firms or actions hostile to China's national security interests. Foreign firms, it seems, are about to be caught in the cross fire.

Given all of the above, what are the prospects for a resolution? The bottom line is that if the politics can still be managed, both sides still need a trade deal. If Trump wants to be reelected, he has to sustain U.S. economic growth through 2020 after what is already a very long growth cycle. To do that, he cannot allow negotiations to collapse, because market confidence would collapse along with them. The real economy could then go into recession in a year in which he can least afford it. As for Xi Jinping, there is a limit to how much China can continue to rely on economic stimulus to prop up growth. Chinese debt to gross domestic product now runs at approximately 248 percent (although this is largely domestic). China's private sector also performed badly in 2018 for reasons quite separate from the trade war. Putting the trade war to bed, therefore, is important for China in restoring market confidence—although not at any political price.

The likelihood of a deal now hovers around 50-50—the ultimate contest between politics and economics. My prediction is that the Osaka G20 Summit will see a "reboot" of the negotiating process. And after Osaka, Trump is likely to yield on the first two of China's new red lines. And Xi will increase the quantum of the proposed Chinese purchasing agreement from its previous offer, although not by as much as Trump has demanded. That way, enough face could be saved all around. Of course, raw politics may still derail the lot, including Trump's rolling calculus of what he needs to sell to his political base and what deal he needs to wedge the Democrats, who are currently seeking to outflank him to the right on China. Time will tell.

Cold War, Containment, or Decoupling

But while there *may* be a solution to the immediate trade war, the technology war has barely begun. On that score, we should all fasten our seatbelts to face the risks of an even more fundamental economic decoupling of the world's two largest economies in the future. This raises, in turn, the even more fundamental question of what economic decoupling might actually look like—in the internet, telecommunications, fintech, and the whole new uncharted world of artificial intelligence (AI).

If we think that trying to comprehend the prospective decoupling of the British and European economies is hard enough, as an analytical exercise, it pales in comparison with the complexities that would arise from unraveling the financial, technological, and global supply chain ties that now bind the United States and China, the world's two largest economies, after 40 years of sustained economic engagement.

The challenge is real—although the language we use to describe it is important, too. In international relations, words still matter. They don't just describe what is going on in the real world. They can also shape, and in some cases determine, what happens as well. That's because language influences behavior.

Cold War

There is, at present, a lot of loose talk, both in Beijing and Washington, about a “new Cold War,” a new doctrine of containment, as well as this notion of economic decoupling. I argue, for example, that the idea of a second Cold War between China and the United States violates basic definitional accuracy concerning the actual circumstances we now face. Unless, of course, the underlying political objective of those using this language is actually to bring such a Cold War about.

The last Cold War, between the United States and the Soviet Union, had four basic characteristics. First, both Moscow and Washington were committed to mutually assured destruction, a thousand times over, through the targeting of their massive nuclear arsenals at each other's command, control, and communication centers, as well as broader civilian populations. That does not accurately describe the nature of U.S. and Chinese nuclear weapons doctrine. And it leaves aside the fact that despite recent efforts to modernize its nuclear rocket forces, the Chinese arsenal is not even 10 percent the size of the American arsenal.

Second, the United States and the Soviet Union were engaged in a global ideological struggle to the death. Despite the fact that the Chinese and American ideological systems are deeply opposed, the reality is that beyond certain academic journals, it is hard to find much evidence in the real world of a struggle for hearts and minds between Chinese authoritarian capitalism and American liberal capitalism. To interpret the Belt and Road Initiative (BRI) as clear evidence of such a struggle represents considerable analytical overreach, at least at this stage of its evolution.

While there *may* be a solution to the immediate trade war, the technology war has barely begun. On that score, we should all fasten our seatbelts to face the risks of an even more fundamental economic decoupling of the world's two largest economies in the future.

Third, during the Cold War, the United States and the Soviet Union were engaged in multiple armed proxy wars across Asia, Africa, and Latin America. While China and the United States are currently involved in a global competition for political and economic influence, there is no evidence of any proxy wars between the two, either under way or in prospect.

Fourth, and most important of all, the Soviet Union and United States had negligible economic engagement with each other. By contrast, the trade, investment, and capital markets interconnections between the United States and China are comprehensive, mutually dependent, and of profound importance to both countries' future economic growth. In addition, China, unlike the Soviet Union, is fundamental to the future of the global economy as well.

In other words, Cold War analogies do not take us very far at all in understanding the current challenges of the U.S.-China relationship. It is perhaps understandable that commentators and analysts in both capitals struggle to identify appropriate historical analogies from the past to illustrate the relationship's current complexity, let alone its possible future trajectories. But as suggested earlier, deploying the language of a new Cold War right now has little utility, unless, of course, those using it seek to give effect to their own self-fulfilling prophecies.

Containment

This leads us to the question of containment. It should be recalled that when George Kennan developed the idea of containment, through a combination of his famous "Long Telegram" from Moscow in 1946 and his "X" article of 1947, he did so from Moscow, when the outline of the Cold War was already clear.

Second, the logic of containment was to prevent other states from falling into the Soviet strategic orbit, as had already occurred in Eastern Europe. A clear strategic line in the sand was being drawn between those states and Western Europe. Again, while some may seek to define China's BRI strategy as pointing in the same or a similar direction, at present, that would constitute a very long reach indeed.

Third, and perhaps most importantly, Kennan's underlying assumption was that by circumscribing the Soviet Union's global economic engagement, ultimately the Soviet domestic economy would implode under its own internal pressures, driven in large part by the oppressive burden of an ever-expanding Soviet military budget. In the case of China, it is difficult to see how these economic preconditions apply. China is already the largest economic partner of more than 125 countries around the world. Indeed, that horse has already bolted. Despite the non-convertibility of the Chinese currency, China has also already become a core component of the global financial system, not least by having the largest single international holding of U.S. Treasury notes.

And while it is true that China's economic growth has been turbocharged by exports over the last 40 years, just as it is true that technically these markets could largely be cut off, China's future economic model assumes a large-scale conversion from external demand to internal demand as Chinese domestic consumption takes off. China's hybrid economic model, despite its continuing rigidities, is nonetheless infinitely more market flexible than anything the Soviet Union ever came up with. Not to mention that Chinese military expenditure as a proportion of the country's total budget is modest by ancient Soviet or, for that matter, even modern Russian standards.

None of this is to assume that an economic containment strategy against China would be incapable of delivering significant damage to Chinese growth. It would. Just as it would deliver enormous damage to both the American and the global economies on the way through. Nonetheless, it would be heroic to assume now, as Kennan did in the case of the Soviet economy, that the Chinese economy could be brought to its knees. Shutting the door on China's economy with the rest of the world might have been possible until the end of 2001, when China joined the World Trade Organization. But that opportunity has long since passed us by.

Finally, it is worth recalling on the containment question that it took more than 40 years for the Soviet economy to implode in 1991. In China's case, 2060 seems a very long way off indeed.

Decoupling

This brings us to, finally, to decoupling. This in fact seems to have become the preferred term du jour in many parts of official Washington and Beijing. But once again, it is important to be careful about the language we employ and what exactly is meant by it.

When we think, for example, about the concept of “decoupling,” it can be seen as a conscious strategy on the part of either China or the United States. Or it could be simply the unintended consequence of a series of actions by either party, which, in turn, set off a chain of events, whose cumulative effect over time is to create two competing sets of standards, systems, and patterns of engagement across the global economy, each with significant, critical economic mass.

Decoupling has already occurred between China and the United States with regard to the internet. This has been a direct consequence of the two countries' political systems. But whether it is internet content, search engines, or the broader regulatory regime, the bottom line is that we are already heading in the direction of two radically different digital worlds—one anchored in America, the other behind one form or another of the Chinese firewall. Third countries, particularly BRI countries, may find themselves in an increasingly uncertain no-man's-land in between.

We see the same development already unfolding in digital payment systems around the world. China's Alipay, WeChat Pay, and UnionPay systems have been rolled out not just across China but throughout much of the world. At the same time, traditional American credit card payment systems are not universally accepted in China. China has deployed many nontariff barriers to limit their penetration. The war is on, therefore, as to who will control the global digital payment system of the future. This is critical because we are talking about the financial engine room of digital commerce and the wider global digital economy.

The decoupling of the two countries' telecommunications systems is also well under way. This is justified by both countries on national security grounds. American telecoms have negligible access to the

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Chinese domestic market, although American mobile devices have some market penetration. Huawei has now become a listed entity under U.S. law. Other Chinese telecom providers also face the prospect of far-reaching American restrictions. Furthermore, the battle for Huawei is under way across third-country markets, both in the developed and the developing world. Huawei already dominates 5G technology in much of developing Asia, Africa, and Latin America. The United States is seeking to prevent further encroachment by Huawei in Western markets, including its closest military allies.

Once decoupling in the telecom, broadband, and digital economy sectors is complete, we are left to speculate as to the consequences for the future of existing Chinese and American global supply chains. China's new "unreliable entities list," created in retaliation against America's listing of Huawei and potentially other Chinese companies, will result in corporations around the world having to navigate this increasingly complex minefield as they revise their future global supply chains to avoid the animus of these two giants of the twenty-first-century global economy. This, rather than technological innovation, could well become the cause of the next great global disruption.

Given the complexity of these supply chains already, and the multiple technological components that make up a single product, it is not difficult to envisage a return to more inefficient forms of vertical integration within single firms, or the rearrangement of future supply chains within either of these emerging, self-contained geopolitical spheres of influence. Thus, we begin to see the beginning of the end of globalization itself, the structural efficiencies it has delivered to the global economy through better resource allocation, as well as the increased global living standards and poverty reduction that have come about as a result.

Finally, of course, there is the decoupling already under way in AI. China is acutely conscious of its strengths and potential in this critical domain. It understands its unparalleled access to big data and the machine learning possibilities that come from it. China's leadership is acutely aware of the vast array of military, economic, and social applications that flow from whoever conquers first and most effectively the commanding heights of this new technological frontier. America, too, is conscious of the dilemma it faces in retaining its technological edge in high technology in general and in AI in particular, given the emerging China challenge, mindful of the limitations it faces in its own access to big data in light of the privacy and other legal constraints that exist in Western liberal democracies. For these reasons, we can already see the opening up of a binary AI world in which, once again, countries will ultimately be making a choice.

The question arising from all of the above is not where economic decoupling starts, but where it is likely to stop? And if it cannot be easily stopped, where does this decoupling, justified on national security grounds but facilitated by the growing political appeal of classical forms of protectionism and economic nationalism, actually lead us? If we are beginning to see a more fundamental unraveling of the economic globalization project that has been under way in earnest since the end of the last Cold War, then where does that take us? Are we wittingly, or unwittingly, creating the economic conditions for a real, rather than an imagined second Cold War of the type discussed earlier? And if indeed this becomes the case over the decade to come, what happens in foreign policy and national security policy? Do we end up creating the conditions for a more comprehensive political and strategic decoupling between China and the United States, thereby creating the conditions for a more generalized second Cold War? Or worse?

In summary, it seems as if the dynamics of economic globalization are slowly being turned on their head before our very eyes. For the last 30 years, the logic of economic globalization has been to transcend national politics and protectionism and to bring the world closer together. Yet now, with economic globalization reaching its apogee by the start of the global financial crisis almost a decade ago, it has now generated its own internal contradictions, powered by the politics of populism, protectionism, and classical geopolitical rivalry, to generate a different and more fragmented world altogether.

For these reasons, both the United States and China, together with other members of the international community, need to think very carefully about where these new and unsettling trajectories may now take us all—both for their own interests, and the world's.

Implications for Chinese Strategy toward the United States

Having recently spent several weeks in Beijing in May and June of this year, it seems that these recent developments in the U.S.-China trade and economic relationship have caused our Chinese friends to undertake a fundamental rethink of the long-term direction of their own strategy toward the United States. This occurs within the context of a wider review of China's long-standing assumptions underpinning its overall worldview of the sort of international order Beijing is likely to face in the decades ahead. Indeed, Beijing is beginning to conclude that the world of the last 20 years may no longer be the world it faces in the future, thereby requiring a possible change of strategic course on China's part as well.

China's Continuing Strategic Objectives

It is therefore important to remind ourselves of what China's enduring strategic objectives are. To recap a recent address that I delivered at the United States Military Academy at West Point, I argue that there are seven core elements of the Chinese Communist Party's worldview. Indeed, these are perhaps best understood as seven concentric circles of interest, moving from the domestic to the international, although in the Party's mind, all are clearly linked. Together they make up what I describe as the Chinese national equivalent of Maslow's hierarchy of needs.

At the core of these interests lies the absolute centrality of keeping the Communist Party in power. As a Marxist-Leninist party that secured power through violent revolution, this should never be forgotten. This is followed by:

- maintaining national unity, including Tibet, Xinjiang, Taiwan, and Hong Kong, all of which are central in the Party's eyes to its continuing national political legitimacy;
- ensuring economic growth on order to raise living standards to advanced economy levels while maintaining environmental sustainability;
- cultivating benign and ultimately compliant relationships with China's 14 bordering states;
- securing China's continental periphery by projecting its economic and geostrategic influence across the Eurasian continent;
- projecting its maritime power across East Asia, the western Pacific, and the Indian Ocean and avoiding armed conflict with the United States while seeking to decouple, over time, America's network of Asian alliances;

- optimizing good relations with the developing world—across Asia, Africa, and Latin America—thereby enhancing China’s position in developing country markets while also consolidating Chinese interests in the institutions of global governance where G77 support is often critical; and
- reforming the existing institutions of global governance over time, gradually aligning the practices, personnel, and culture of these institutions in a manner more closely aligned with Chinese interests and values, while also creating new international institutions where China is at the core.

China’s Analysis of Its Changing Strategic Environment

In seeking to understand how China forms its national strategy, we need to have a clear understanding of how China views its international operating environment. The reason this is important is that while the seven sets of objectives just described may be relatively constant, the political and policy environment in which China operates, both at home and abroad, is subject to constant change.

That is why China deploys its own formal, analytical processes to try to define the “objective” nature of the short- and long-term historical developments and trends with which the Party must contend. The disciplinary framework that the Chinese bring to bear on this task is heavily shaped by the Marxist-Leninist theoretical frameworks of their inheritance, combined with certain classical Soviet methodologies for understanding the changing nature of state power. These include the analytical disciplines of historical materialism and dialectical materialism, as well as Soviet concepts of “comprehensive national power” and the “correlation of forces.” Furthermore, it is important to understand that our Chinese friends regard these processes as “scientific” and the conclusions wrought through them as being “objectively correct.” These conclusions are not reached lightly. They are the product of focused intellectual effort. And once reached, they tend to remain in place for a long time, rather than shifting with a single U.S. presidential election, the rise and fall of governments around the region or the world, let alone the highs and lows of the long-term economic or business cycle. In other words, China seeks to take a deeper analytical view of the underlying drivers of regional and global change, before locking in to its conclusions about what China is facing, and what Chinese policy should be in anticipation or in response.

For nearly 20 years—indeed, since 2002—the key Chinese conclusion about the domestic and international environment it faces has been that China continues to experience a period of unprecedented “strategic opportunity.” It is important to understand what Chinese political leaders and policy analysts mean by this term.

Specifically, it means that China is able to pursue its domestic economic development agenda in a stable and peaceful environment without any real risk of major war. Second, it means that the forces driving economic globalization will continue, and that these will continue to accommodate, support, and enhance China’s modernization agenda. Third, it sees the United States in a period of relative international decline, and while the United States will remain for some decades the world’s only economic and military superpower, a more multipolar global order is seen as slowly emerging, one in which China’s relative influence will continue to increase. Fourth, these processes of relative American decline have been accelerated by America’s preoccupation with the rolling military engagement in the Middle East across multiple wars; the

damage done to American economic power and prestige by the global financial crisis; and the increasing travails of what is seen as a dysfunctional American, and now broader Western, democratic system.

Changing Chinese Strategy under Xi Jinping and the Domestic Political Reaction to It

Until the rise of Xi Jinping, China's strategy in response to this analysis was a gradualist one, best encapsulated in Deng Xiaoping's famous maxim of "hide your strength, bide your time, never take the lead," (and only take selective initiatives when you can). As I've written before, this gradualist approach changed in 2014 under Xi Jinping following the Party's Foreign Affairs Work Conference of late that year, when China embarked on a more activist strategy around the region and the world. This new strategy took many forms in China's international policy settings. It was also amplified by a more activist political and economic strategy on the home front.

Xi Jinping has become deeply mindful of the Chinese people's basic expectations for clean air, clean water, clean soil, and clean food, as well as national and international action on climate change.

For example, to secure the Party's future, Xi Jinping embarked on an unprecedented anticorruption campaign. To secure his own political position, he also engineered the purge of all his active political opponents. He then abolished term limits for the position of presidency in order to pave the way for the possibility of continuing in office beyond 2022. He also outlined a new ideational vision for the Party and the country in three parts, all with an eye toward consolidating the Party's legitimacy in the eyes of the people:

- for China to build a "moderately prosperous society" by the time of the Party's centenary in 2021;
- for China to become a "modernized, fully developed, rich and powerful" nation by the 100th anniversary of the People's Republic in 2049; as well as
- an intermediate objective, now set for 2035, whereby China would become fully "modernized," a date that appears to coincide with the Party's estimation of when it will have surpassed the United States as the world's largest economy according to market exchange rates, and a date when Xi Jinping could still conceivably be in office.

On the question of national unity, Xi Jinping has presided over a large-scale crackdown in Xinjiang, an increasingly assertive policy toward Taiwan, as well as a hard-line approach to Hong Kong, although recent developments there may suggest the limits of such an approach. On the economy, Xi Jinping has insisted on a much bigger and bolder role for the Party, as opposed to leaving economic management in the hands of the technocrats of the state apparatus, as occurred under his predecessors. He has also sought to do so in a manner that is now compatible with the principles of sustainable development, or, to deploy the Chinese terminology, the principles of "eco-civilization." In this sense, Xi Jinping has become deeply mindful of the Chinese people's basic expectations for clean air, clean water, clean soil, and clean food, as well as national and international action on climate change. Furthermore, on the economy, Xi Jinping has embraced a China 2025 strategy aimed at overcoming China's historical weaknesses in innovation

and technology, but also stating explicitly China's intention of dominating these domains in international markets in the future, including his new national strategy on AI.

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As for China's neighboring states, Xi has pursued a complex strategy of both confrontation and accommodation, driven in part by the overall temperature and trajectory of the U.S.-China relationship. For example, Xi prosecuted a sharp set of border engagements with both Japan and India during his first term,

only to extend the olive branch to both Tokyo and Delhi after the election of Donald Trump in 2016. In the meantime, Xi has invested much political energy in the deep reform of the China-Russia relationship, maximizing the two countries' common economic, security, and foreign policy interests, thereby turning Beijing's extensive northern border with Moscow into a zone of positive economic opportunity, rather than one of continuing strategic anxiety.

On China's maritime strategy, Xi Jinping has pursued a more assertive strategy in both the East China Sea and the South China Sea. His island reclamation program has been extensive. As has been China's subsequent militarization. Similarly, China's maritime tactics against U.S. and other regional naval assets has been increasingly sharp. The number of near incidents at sea involving U.S. naval vessels has also increased. China's naval modernization has become the fulcrum of Xi Jinping's doctrine on the professionalization of the People's Liberation Army—so that it can “fight and win wars,” not just put on impressive parades.

On China's continental periphery, the Belt and Road Initiative across Eurasia speaks for itself. A strategic accommodation has been reached with Russia over Central Asia. China now has a growing strategic presence in the Gulf, the Red Sea, and East Africa and across the Indian Ocean. Just as China's diplomacy toward Eastern and Western Europe, as well as Brussels itself, has become ever more active as China seeks to turn Europe into a major economic and ultimately strategic ally.

As for the global rules-based order, Xi Jinping's China has been more active in the institutions of the United Nations and the Bretton Woods institutions. As well as investing in new institutions beyond the postwar order, including the Asian Infrastructure Investment Bank, the New Development Bank, and, once again, the BRI.

Most international commentators are aware that these initiatives by Xi Jinping's administration have attracted criticism abroad. What they are less familiar with is that there has been some criticism at home as well.

The anticorruption campaign has been criticized for being politicized and for its selective targeting of political opponents. The China 2025 strategy, particularly its explicit state targets for Chinese domination of all major high-tech sectors into the future, has also attracted significant internal criticism for having

elicited a hard-line American and European response. There has also been criticism of the BRI for being too ambitious, too expensive, and too wasteful—as well as for generating negative reaction against China in many target countries. Similarly, there has been criticism of the strategic wisdom of island reclamation in the South China Sea, evidenced by the success of the Philippines’ legal case against China in the Permanent Court of Arbitration and wider political reactions across Southeast Asia, and of providing physical and photographic evidence to the American and international body politic that China now, by definition, was no longer a status quo state. On top of this, has been criticism of Xi Jinping’s decision to repeal term limits for the office of president, suddenly crystallizing in international political opinion the view that Xi Jinping will be not only China’s next Deng Xiaoping, but possibly China’s next Mao Zedong—in other words, leader for life.

The common theme in the various critiques of Xi Jinping internally has been strategic and political overreach, in conscious contravention of the long-standing wisdom of successive generations of Chinese political leaders following Deng Xiaoping’s long-standing doctrine of restraint. Instead, according to Xi Jinping’s internal critics, China has been out there “loud and proud” and, as a consequence, for the first time since 1978, generating significant structural opposition abroad to the realization of China’s long-term political strategy.

One further vulnerability on Xi Jinping’s part has been China’s soft economic performance in recent years. A number of factors have contributed to this. First, there was China’s homegrown financial crisis of 2015, which saw the collapse of Chinese equities markets and a run on various Chinese financial institutions until the state intervened.

Second, after the crisis of 2015, Xi effectively put on hold the new economic blueprint for China adopted by the administration back in 2013. That blueprint sought to move away from China’s old economic model of labor intensive, low-cost manufacturing for export, strong state-owned enterprises turbocharged by high levels of state infrastructure investment, to a new model based on domestic consumption, service industries, and a dynamic Chinese private sector, with new industries based on technological innovation and a declining state economic sector.

Third, following 2015, the Chinese private sector began to lose confidence in China’s overall economic policy settings, concluding that state-owned enterprises were now being preferred over the private sector in the allocation of credit and that the Party had begun to exert greater and greater levels of control over what private firms did and how much they could grow, resulting in declining levels of private sector confidence. This translated, in turn, into declining levels of private sector investment, growth, and employment.

These factors, taken together with the direct impact of the U.S.-China trade war during 2018–2019, as well as its more general impact on Chinese domestic economic confidence, began to place Xi Jinping under considerable economic pressure.

These, then, are the wider political circumstances in which Xi Jinping has had to respond to the recent politics and economics of the trade war during the critical developments of May 2019. In other words, the trade war is not simply an economic phenomenon for the Chinese leadership. It occurs in a context of Chinese politics as well, where some within the leadership have begun to question the wisdom of the leader’s perceived overreach across multiple policy fronts.

China's Current Strategic Reappraisal

Beyond the immediate politics and economics of the trade war and the possibility of a broader economic decoupling between China and the United States, the deeper question remains of a more far-reaching Chinese reappraisal of whether Beijing's overall strategic operating environment has now fundamentally changed for the worse.

As noted in the previous sections, Chinese strategic planners have long been disciplined in the business of separating the tactical from the strategic, the short term from the long term, and the trivial from the important. China's strategic culture disinclines it to respond to a single headline, or even several years of headlines in Western newspapers. Instead, Chinese planners' own analytical processes cause them to go back to basics to reach deep conclusions on the central question of whether China is still in fact in the same "period of strategic opportunity" that it concluded it has been in since it joined the World Trade Organization in 2001, or whether this has now fundamentally changed, requiring China, too, to set a new strategic course.

My observation from my recent time in Beijing is that all the assumptions of the last 20 years are now under formal review. At this stage, it remains uncertain as to what precisely this review process will conclude, although it seems as if China may now be on course to indeed change its overall strategic guidance to its various agencies of state, given the new complexity and unpredictability of global politics and economics as seen from Zhongnanhai. Indeed, the earliest indications from Beijing are that China sees its external environment as fundamentally changing on a number of critical fronts, and in a generally more hostile direction. Regional armed conflict is no longer seen as a remote possibility, given possible trajectories on the Korean Peninsula if and when Trumpian diplomacy with Pyongyang breaks down. China is also

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now anticipating a more vigorous U.S. response to its actions in the South China Sea, just as renewed U.S. arms sales to Taiwan are seen as potentially fomenting a future crisis across the Taiwan Straits. On the economy, globalization is now seen as being in retreat. And a more nationalist and protectionist West may well turn against China, in which case Europe, Japan, and, to some extent, India become the key. American hostility to China is now seen as structural, as a new Thucydidean dynamic takes hold of all sides of

Washington politics. Corporate America is no longer seen as a structural ally in supporting the stability of the U.S.-China relationship. And a newly energized human rights constituency is seen in Beijing as having more widespread political support, animated by recent developments in Xinjiang, Taiwan, and Hong Kong. It is of some consolation to Beijing that America's global brand is seen as becoming increasingly and perhaps irreparably damaged under Trump.

All of this would tend to point to a much more mixed strategic outlook compared with the "period of strategic opportunity" that has governed Chinese strategic thinking for the last 20 years. This, in turn, would require of China a more self-reliant, less internationally dependent national strategy for the future to safeguard China's interests in a much less stable world. Or it might result in China taking the truly bold step of throwing open the doors of its economy to the rest of the world, excluding the United States. Early

Chinese engagement with the Trans-Pacific Partnership would be a signal of the latter approach. The jury is still out, however, on what conclusions will be reached. And it will be for some time. After all, detailed dialectical analysis takes time.

The importance of all this for the rest of us in the international community is that if China does conclude that its international operating environment has turned in a fundamentally hostile direction, it will adjust its strategies and policies accordingly. That is why this period of review is so critical. If, for example, Chinese policy were suddenly to become more aggressively nationalist, or more stridently protectionist, or more binary in its international political engagement, the rest of the world would soon know it, feel it, and experience it.

In the meantime, however, China is likely to continue its current pattern of international engagement. The review process will take time. The Chinese ship of state rarely turns dramatically. It is a more gradual and deliberative process. But once conclusions are reached, and a new direction is identified, then turn it does. We have seen it before at certain critical junctures of its modern history.

American hostility to China is now seen as structural, as a new Thucydidean dynamic takes hold of all sides of Washington politics.

Conclusion

What China does in the future is important for us all. But watching China respond to these dynamics in isolation is a bit like the sound of one hand clapping. The other hand at play in all this is, of course, the United States. An open question remains as to which way the United States will now go in the prosecution of its own wider, long-term strategy toward China in this new age of strategic competition.

The core questions in Washington are what will happen to the rest of the U.S.-China economic relationship, not to mention the foreign policy, security policy, and human rights relationship, if President Trump does manage to secure a trade deal with Xi Jinping? Will economic decoupling continue to unfold, haphazardly or otherwise? If so, will it be limited to key technology sectors, or will it be broader than that? And will we see a much more vigorous response by the United States in relation to Taiwan, the South China Sea, the BRI, Xinjiang, and other core points of Chinese international political and policy sensitivity?

Second, what will happen in these other policy domains if we do *not* secure a trade deal?

Third, if President Trump is not reelected, what will be the points of commonality and difference between his administration's China policy and that of the next Democratic president, whoever she or he might be?

These three sets of questions all turn on a more fundamental uncertainty about what kind of global power President Trump wants America to be in the future, and what sort of global power the Democrats want America to be in the future. This fundamental question is important given the new social, economic, and political forces at work within the wider U.S. domestic body politic that are in the process of reshaping both Republican and Democratic Party politics, including their traditional approaches to foreign and security policy.

Finally, there is also the question of third countries as they seek to anticipate where China will ultimately land on the question of its long-term strategy toward the United States, its allies, the region, and the world—and where, for that matter, America will land in its own deliberations. For the Europeans, the Japanese, the Indians, the Southeast Asians, and the Australians, these profound dynamics at play right now in the future of the U.S.-China relationship are creating real uncertainties as they carve out our own contingency plans for the future. Already in parts of Europe, Japan, India, and Southeast Asia, there are early signs of some form of strategic hedging about the future. Indeed, it would be surprising if it were otherwise.

We live in difficult and dangerous times. For countries like Australia, this will require a razor-sharp lens on Beijing, Washington, and other critical global capitals to understand where these deep changes in global and regional geopolitics may now take us all.

4. China's Political Economy into 2020: Pressures on Growth, Pressures on Reform

Conference on China's Economic Future: Emerging Challenges
at Home and Abroad
Chatham House, London
July 11, 2019



Chinese President Xi Jinping applauds during the 40th anniversary of China's reform and opening-up at the Great Hall of the People in Beijing, China. Xie Huanchi. Xinhua. Getty Images. 2018.

TO UNDERSTAND WHERE CHINA'S ECONOMY IS HEADED IN THE 18 MONTHS AHEAD, leading up to the centennial of the Chinese Communist Party in 2021, it is important to understand the wider context in which China's current debates on the future of its political economy have been conducted in the period since Xi Jinping became China's paramount leader in 2012.

The year 2021 is the first weigh station for the Party and the country to evaluate progress in the realization of Xi Jinping's "China Dream." Xi promised in 2013 that by the centennial of the Party's founding, China will have eliminated poverty and achieved "moderate prosperity," usually interpreted in the official Chinese literature as middle-income status.

Whatever the actual numbers might be, let's be clear that the Party will proclaim that China has passed both these tests with flying colors. That is because it is central to Xi Jinping's legitimacy that China do so. But the truth is that the 2021 target does apply additional pressures in the meantime on China's economic managers not to allow the country's growth rate to slow too much, whatever the downside factors may be, either foreign or domestic.

There has been much discussion of why President Trump needs to bed down the U.S.-China trade war, as well as have accommodating monetary policy settings, to support his reelection campaign in 2020 with as robust an American economy as possible. But President Xi also faces his own reelection challenge at the 20th Party Congress in 2022, the year following the Party's centennial celebrations, where, despite constitutional change abolishing term limits for the Chinese presidency, he, too, will face political pressures of his own.

The most important of these pressures will be his government's ability to sustain economic growth above 6 percent in order to guarantee continuing increases in living standards and to avoid unemployment. To stumble on the economy, particularly at this most critical of political junctures, would be deeply problematic for Xi Jinping, and, indeed, potentially destabilizing.

The Enduring Dilemma of China's Political Economy

Against this background, my argument is that China is now at a crossroads in the history of its post-1978 political economy.

In part, this has to do with the U.S.-China trade war, together with the risk of a wider economic decoupling between the two countries, which is bringing new pressures to bear on China's domestic economic policy debate.

In part, however, and perhaps in larger part, it has to do with the type of China that Xi Jinping wants for the future, and how much he is prepared to allow market forces to shape that future at the cost of absolute Party control—in particular, the future role of private firms.

For China's post-Mao leadership, the central and continuing dilemma, or what the Party would describe as its "dialectic," has been there since the beginning. This is the tension within a Marxist-Leninist party, between a deep predilection for political control, on the one hand, and the need for a successful economy which increasingly must yield to the disciplines of a free market, on the other.

Indeed, for the Party to succeed in its national mission, it must achieve two fundamental economic objectives: first, to generate sufficient growth, increased living standards and employment opportunities to entrench the Party's long-term legitimacy in the eyes of its people, and second, through that growth, to enhance China's national economic capacity to enable the Chinese state to defend its core interests and increase its global power, influence, and international standing. Neither of these is possible without a fully functioning market economy. And virtually every single Chinese economist knows it.

The implementation of market economic reforms, therefore, has always been an uncomfortable process for the Chinese Communist Party.

That is because it has usually meant a relative loss of political control, as the Party's ideological apparatus has had to yield the political ground to a growing phalanx of professional economic and financial technocrats spawned across the various agencies of the Chinese state. Just as China's lumbering, Leviathan-like state-owned enterprises (SOEs) have had to yield market share to an army of nimble, entrepreneurial private firms. And, perhaps most critically of all, the Party has had to contend with the freer flow of information, ideas, and people as China has opened its economy to the world.

Over the first 35 years of the reform process, implementation, while uneven, has nonetheless produced spectacular economic results with which the world is now deeply familiar. It has also, however, produced a number of significant financial and economic vulnerabilities, of which the inefficiency and indebtedness of China's financial system has perhaps been the most problematic. This has occurred together with a Party that, until the rise of Xi Jinping, had become deeply, perhaps terminally, corrupt.

Nonetheless, the trend line was relatively clear, with an increasingly open economy producing a new generation of private firms at scale, gradually dominating the domestic market, and led by companies like Alibaba, beginning to take on the world.

The Economy under Xi Jinping

With Xi Jinping, the political economy compact between the Party and the market began to be rewritten. Once again, the process has been uneven, but the trend line has been observably different from what we have seen before. Driven by a range of ideological, political, and economic factors arising from China's stock market crash of 2015, the core organizing principle under Xi Jinping has been the reassertion of the centrality of the Party.

Over the last seven years since Xi's emergence as paramount leader in 2012, this process has gone through three complex and largely unplanned phases.

For the Party to succeed in its national mission, it must...generate sufficient growth [through] increased living standards and employment opportunities to entrench the Party's long-term legitimacy in the eyes of its people, and...through that growth...enhance China's... economic capacity to enable the Chinese state to defend its core interests and increase its global power, influence, and...standing.

The first phase, from 2012 to 2015, was marked by two core decisions. The first was launching the anticorruption campaign in 2013. This was the biggest in the Party's 100-year history and resulted in the incarceration and disciplining of hundreds of thousands of Party members, accompanied by the purge of Xi's principal political opponents.

The other was the Party's adoption of "The Decision" on the implementation of the next phase of China's economic reform program, defined as China's "new economic model." After ferocious internal debate, the market was, for the first time, explicitly nominated as the central organizing principle for the allocation of resources in the economy.

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The new model sought to accelerate the role of domestic consumption as the principal new engine of economic growth, driven almost exclusively by a rapidly expanding private sector, particularly in the services sector, and a more limited role for SOEs restricted to a defined list of critical industries, all tempered by new principles of environmental sustainability.

The 2013 "Decision" was accompanied by a detailed blueprint of 66 specific reforms across the entire economy. It was seen as Xi Jinping's answer to what had generally been called the "10 wasted years of economic reform" under his predecessors, Hu Jintao and Wen Jiabao.

The overall political and economic model that seemed to be emerging at the time was a Party strengthened though the restoration of its moral integrity but fully in sync with a bold program of next generation economic reform.

All this changed with the Chinese financial crisis of 2015, which marks the beginning of the second phase in China's unfolding political and economic debate in the Xi Jinping period. This was not just a crisis in the Chinese equities markets, as the authorities struggled with managing a stock market bubble driven by excessive liquidity and financially illiterate investors who saw investing in shares as the next best thing to the gambling tables in Macao. It also became a wider financial crisis given the proliferation of margin lending practices as consumers borrowed heavily from financial institutions to make investments in what was seen then as a permanently booming economy.

Both state and private institutions were directed, as part of what became known as the "national team," to invest heavily to try to stabilize the market, although this resulted in even further losses. Markets were finally stabilized at much lower prices early in 2016. But the damage had been done—the Shanghai

Composite Index collapsed 32 percent in less than three weeks in July 2015. At its 2015 high, market capitalization was \$10 trillion. By September 2018, it was still only half this high, at \$5.73 trillion.

The more important impact of these events during the second half of 2015 was to enrage the central leadership as millions of citizens lost their savings and blamed the Party and the government. As a result, the political appetite for the implementation of further broad-based market reforms, not just those in finance, was dulled considerably. A major casualty was the 2013 blueprint as the pace of reform ground to a virtual halt. Tight capital controls were implemented to prevent capital flight, which also made it more difficult for Chinese firms to expand abroad. Meanwhile, concern over China's debt-to-GDP ratio spiked, driven by a largely unregulated shadow banking sector and ballooning local government debt.

The strong regulatory clampdown on shadow lenders that followed, including a large-scale deleveraging campaign, had a suffocating effect on China's private firms. This was despite the fact that by this time, these firms had become the crucial, almost exclusive driver of economic growth.

Conversely, bloated and unproductive SOEs were given favorable access to credit, easing the impact of the broader deleveraging campaign on them, usually at the expense of the private sector. Indeed, many troubled private firms were either bought up by the state sector, in whole or in part, or went bust.

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The Party's Policy Response to Slowing Growth

The third phase in the evolution of Xi Jinping's political economy began to emerge in late 2018, after the Party center finally realized the extent of the radical slowing in Chinese growth numbers during the course of that year, driven by faltering private sector business confidence and growth. This was well before any actual or perceived effect from the trade war with the United States began to be felt.

There were many reasons for declining private sector business investment beyond the blunt and brutal impact of the post 2015 deleveraging campaign. These included:

- the Communist Party's unclear policy signals on how big major private firms should be allowed to grow;
- the increased status of Party secretaries within the management of private firms; and
- the ongoing vagaries of China's legal system, which, when paired with the anticorruption campaign, caused increasing angst among Chinese entrepreneurs for their personal futures.

In response to this growing crisis in private sector growth, the Chinese Party launched a fivefold response.

Reembrace the Private Sector

The Party's first policy response has been to politically reembrace the private sector. This was outlined by Xi Jinping in a major speech in November 2018, when he stated that "private firms are an essential part of our economic system; private firms and private entrepreneurs are of our own."

Vice Premier Liu He also stressed the need to support the private sector a few weeks earlier in October, when he reminded the nation that the private sector was responsible for 90 percent of new employment growth, 80 percent of urban development, 70 percent of technological innovation, and 50 percent of the country's taxation.

This rhetorical shift was followed by a number of policy measures to rekindle private sector growth and restore business confidence. Moves were made to channel credit to small private sector borrowers, by reducing the reserves banks are required to hold, along with a directive for large state-owned banks to increase their lending to small private sector borrowers by 30 percent.

In some cities such as Ningbo in eastern China, regulators also urged banks to expand their definition of collateral to cover a wider range of small businesses' assets, such as patents and trademarks, beyond typical assets such as real estate, which many lack access to. The State Council echoed these moves recently, calling for intellectual property to be more frequently used as collateral.

According to Chinese regulators, loans to small businesses from China's largest state-owned banks increased by nearly 17 percent in the first quarter of 2019. Yet according to other measures, loans to private firms only rose by 6.7 percent, compared to an overall growth in bank lending of 13.7 percent.

Meanwhile, in fiscal policy, the value-added tax for the manufacturing, agricultural, transport, construction, leasing, wholesale, retail, and real estate sectors was reduced. Beijing also reversed the implementation of social security reforms, easing the financial burden on private sector firms. Income tax was also reduced by increasing the personal tax threshold from 3,500 yuan to 5,000 yuan per year.

Accelerate Financial Sector Reform

A second line of policy response has been to embrace financial sector reform by liberalizing interest rates, changing the exchange rate setting mechanisms, and increasing foreign participation in China's financial services sector.

In March 2019, People's Bank of China (PBOC) Governor Yi Gang committed to the structural reform of interest rates, rather than further rate cuts, to support a slowing economy. Details were thin, yet his stated desire to increase competition in the banking sector and enforce price transparency was aimed at improving credit access to small and medium private firms by effectively lowering lending rates.

In May, the PBOC also issued plans to reform its exchange rate formation mechanism. Last month, Yi Gang appeared more open to having the renminbi fall below a rate of seven against the U.S. dollar amid

downward pressure on the renminbi. The stated policy objective here has been to make the currency more responsive to market disciplines rather than a simple administrative peg.

The most significant recent measures adopted by the Chinese authorities, however, has been to allow greater foreign participation in China's USD \$45 trillion financial services sector. In April 2018, time lines for allowing majority foreign ownership of Chinese securities companies and mutual funds were announced, along with similar policies for foreign insurance firms. Foreign ownership limits on banks were removed in August 2018. Foreign credit rating agencies were given full market access in January 2019, when S&P Global became the first wholly owned foreign credit rating agency to operate in China.

Foreigners have also been given greater access to Chinese equities markets. In February 2019, MSCI announced plans to increase the proportion of mainland Chinese shares in its Emerging Markets Index by a factor of four, to a weighting of 3.3 percent. And amid great fanfare this past June, the London-Shanghai Stock Connect scheme was launched, giving foreign investors the opportunity to purchase shares in Chinese companies, and likewise providing Chinese investors the chance to buy stock listed on the London Stock Exchange. The Bloomberg Barclays Global Aggregate Index also began introducing 364 Chinese fixed-income securities this April.

Superficially, this forms an impressive list of reforms. However, we need to be cautious about these announcements until we see how China's regulatory machinery adapts to these changes.

For example, conversations we have had with funds managers are replete with stories of overwhelming bureaucratic red tape. Another example is JPMorgan's ambitions to be the first foreign firm to have majority ownership of an asset management business. Recent reports revealed its bid for a controlling stake in their existing joint venture is at a 33 percent premium to an independent valuation. Yet this was the minimum bid price permitted by Chinese authorities. While the sale is not guaranteed, it serves as a further reminder that policy announcements need to be weighed with the ability of foreign firms to capitalize on them.

China is not acting philanthropically with any of these changes. Chinese policymakers are driven by a number of clear policy objectives.

This first policy objective is to make the Chinese financial system more efficient in the allocation of credit. The current system is, at best, 50 percent as effective in wealth creation against international benchmarks.

The second is to spread the risks currently alive within the Chinese financial system where bad loans are still rife. For example, the recent high-profile public takeover of the privately held Baoshang bank highlighted ongoing risks that China's financial sector faces because of uncontrolled lending.

Beyond specific policy support for China's struggling private sector, as well as a fresh commitment to financial market liberalization, has come a broader policy response to a slowing economy—namely, the reembrace of “institutional” economic reforms.

Furthermore, Baoshang does not appear to be an isolated case, with a number of other small and medium banks, rumored to being recapitalized in a quieter fashion. Other areas of risk in China's financial system include the shadow banking sector's surging reliance on short-term interbank lending.

The political message from both Xi Jinping and Liu He was clear: adverse external events were now driving China in the direction of more vigorous internal market reforms. Once again, however, we must await the evidence that the systemic reform program first announced in 2013 is, in reality, back on the agenda. Or not.

A third policy objective underpinning China's financial reform efforts is the country's declining current account surplus, with some analysts predicting an imminent current account deficit. For around 25 years, China has consistently operated a current account surplus. However more recently, this surplus has been declining. Fueling this is rising domestic consumption, which is beginning to reverse a tradition of high savings rates among the Chinese population. Further erosion of Chinese savings is also expected as the aging population draws on retirement reserves. Whether China soon reports a current account deficit will be largely dependent on market prices of imported commodities. With a narrowing current account

comes the incentive to attract foreign capital to plug the gap, and therefore an even stronger argument for reformers for continued financial opening.

A Political Recombitment to Systemic Economic Reform

Beyond specific policy support for China's struggling private sector, as well as a fresh commitment to financial market liberalization, has come a broader policy response to a slowing economy—namely, the reembrace of “institutional” economic reforms.

This was explicitly announced by Xi Jinping at a Politburo meeting in April 2019. Importantly, this was the very same meeting that rejected the text of the draft trade agreement with the United States. This was the first time in many years that this language of systemic economic reform had been used by the country's most senior leadership.

It was reinforced by Vice Premier Liu He in June, when he candidly admitted that while China faced “some external pressures,” this would “help us improve innovation and self-development, speed up reform and opening up, and push forward with high quality growth.” Liu also noted that these pressures were spurring the creation of stronger domestic capital markets, and more innovative industrial supply chains, which were welcome trends in China's transition “from being big to being strong.”

The political message from both Xi Jinping and Liu He was clear: adverse external events were now driving China in the direction of more vigorous internal market reforms. Once again, however, we must await the evidence that the systemic reform program first announced in 2013 is, in reality, back on the agenda. Or not.

Universalizing Trade, Investment, and Intellectual Property Reforms

A fourth line of policy response to the slowing of the Chinese economy has been to universalize trade, investment, and other economic reforms being offered to the Americans bilaterally in the context of their ongoing trade negotiations.

This was on display most recently with President Xi Jinping at the G20 Summit, where he announced a range of reforms, including an updated negative list that permits foreign investment in the mining, manufacturing, services, and agriculture sectors. He also announced plans to implement penalties for intellectual property infringement as part of a new foreign investment law in 2020. Details of some of these plans were subsequently fleshed out by Premier Li Keqiang in July at the World Economic Forum in Dalian.

These general commitments to reform have been met with cautious optimism by the international business community having heard similar announcements by China's leaders before. There has long been skepticism that whatever China announces as a new commitment at the policy level can easily be undone at the level of administrative practice. Or as the Chinese say of their own system, "above there are policies; while below there are counter-policies."

A Return to Good Old Stimulus

Of course, the final response to slowing growth has been the reembrace of economic stimulus. As noted earlier, this has included cuts in the value-added tax, cuts to personal income taxes, but also targeted consumption stimulus packages toward electronics, communications, automobiles, and construction. There has also been fresh infrastructure investment, particularly in urban rail projects.

China's leadership has consistently voiced confidence in China's ability to handle the economic impact of the trade war. Central bank governor Yi Gang said ahead of the G20 that in his view, "the room for adjustment is tremendous" in China's fiscal and monetary policy toolkit, with "plenty of room in interest rates and in required reserve ratios."

Officially, the message is that the Chinese economy remains healthy, and there is no major risk to growth for the time being. Or, as Liu He put it, "No matter what happens temporarily, China's long-term growth remains positive, which won't change."

All that is code language that China will do what it takes to keep growth above 6 percent—including making up for the hit to growth that would come from a prolonged trade war. If that means adding further to China's budget deficit or debt-to-GDP ratios, so be it. China continues to take great confidence in the fact that practically all its debt is domestically denominated and that with a still relatively high domestic savings ratio, there is considerable flexibility at its disposal.

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The problem remains, however, despite the political assurances to the contrary over the last six months, that stimulus continues to become the continuing, easy alternative to substantive economic reform. In the end, such a course could prove lethal to China's long-term economic trajectory.

The Trade War, Technology War, and Wider Economic Decoupling

China's long-standing difficulties with private sector business confidence have been compounded by uncertainties arising from the trade war, the unfolding technology war, and the growing debate in the United States and China about a wider decoupling of their economies. I dealt with these factors in some detail last month in an address to the Lowy Institute in Sydney.

China's long-standing difficulties with private sector business confidence have been compounded by uncertainties arising from the trade war, the unfolding technology war, and the growing debate in the United States and China about a wider decoupling of their economies.

It has long been my view that there will be a trade deal of some kind between the countries before the end of 2019. The reason is that both countries need a deal to stabilize their markets and economies going into the politically critical seasons that lie ahead—a presidential election year in the United States, and the lead-up to the Party centennial in China. There will be much debate about the intrinsic economic quality of the deal. But there will nonetheless be a deal that both sides can live with politically.

But the end of the trade war is highly unlikely to bring about an end to the technology war. Despite President Trump's ambiguous language in Osaka, it appears that Huawei will now remain listed. The United States has also listed five other entities. China has announced a retaliatory list for "hostile" foreign firms, although it has yet to nominate individual companies.

And beyond the trade and technology war, there is a growing expectation in Beijing that the United States is preparing for a much broader decoupling of the two economies. The next domain to be affected, at least in China's calculation, is the digital payment system, digital finance, and e-commerce, which China increasingly dominates through Alipay, WeChat Pay, and UnionPay.

There is a concern that the United States will then move on the finance sector in general, where U.S. institutions remain globally dominant, drawing on the formidable advantage afforded to the U.S. government through the continuing reserve currency status of the dollar. China has observed closely what it sees as the weaponization of the dollar and the international financial system more broadly against various strategic adversaries of the United States. Beijing anticipates the United States may be considering doing the same to China.

Finally, there is the unfolding impact of both the reality and the perception of decoupling on global supply chains as Chinese, American, and international firms seek to insulate themselves from a combination of tariffs, technology bans, and the longer-term possibility of financial sanctions. Companies that are part of global supply chains in sensitive industry sectors that are currently operating in China, whether they

are Chinese or foreign owned, have begun to offshore manufacturing facilities as a precautionary measure. Even if both the current trade and technology wars are resolved, it is unlikely that these decisions will be undone. The continuing geopolitical risk will still be significant in the eyes of corporate decision makers.

In summary, quite apart from the long-term consequences for the global economy of these uncertain decoupling scenarios, the bottom line for now is that all these factors, real or imagined, are further impacting business confidence in China and represent yet another contributing element to China's increasingly complex, near-term growth challenge.

Are China's Current Policy Responses Working?

The economic data in response to the Chinese government's policy actions to deal with the slowing economy so far has been mixed.

First-quarter 2019 Chinese economic growth was officially at 6.4 percent, stabilizing sliding economic growth from previous quarters, although independent analysts estimate growth to be closer to 6 percent. A significant portion of this growth is believed to be fueled by recent economic stimulus and remains dependent on it.

The most recent figures from May 2019 show industrial activity weaker than expected and fixed asset investment slowing slightly, although retail sales reportedly increased to 2.1 percent in May following a 0.6 percent decline in April. The official unemployment figure has remained steady at 3.8 percent in recent months.

It is concerning that almost half of Chinese exporters see the trade war as a permanent or long-term fixture of bilateral relations, according to a recent survey. This sentiment, and perceptions of its business impact, have steadily deteriorated over the past few months.

Conversations with business owners in second- and third-tier cities continue to reflect anxiety and uncertainty over the private sector business environment. Private entrepreneurs still do not trust Beijing. Many are still sitting on their hands, not taking new investment decisions.

All this is before the full wash-through effect of any future collapse of business confidence in the event of a nonresolution of the trade war.

China's Strategic Economic Choices for the Future

China's political economy therefore finds itself at a policy crossroads: Between the competing demands of Party control and the market. Between the competing demands of sustainable economic reform and continuing recourse to stimulus. Between an economy that over the last 40 years has integrated itself with global supply chains, technology markets, and finance, and a country that now fears it may progressively be cut off from all three if decoupling becomes a reality. The question, then, is what strategic response is China under Xi Jinping now likely to adopt.

One possibility is that China, in response to its internal pressures on growth, as well as the external pressures on trade, technology, and finance, accelerates the liberalization of the Chinese domestic economy

as per the 2013 blueprint. As part of this approach, China could also embark on an ambitious program of international trade, investment, and capital market liberalization. This could take many forms.

Global geopolitical risk is now
back with a vengeance. We
should all fasten our seatbelts for
a rocky road ahead.

In Asia, China could use the Regional Comprehensive Economic Partnership (RCEP), which includes 16 Asia-Pacific economies, to advance regional economic integration if that agreement is signed in 2020. China is also debating internally the desirability of seeking membership in the Trans-Pacific Partnership (now known as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership), a far more ambitious free trade agreement than RCEP involving 11 regional economies, from which the United States has withdrawn. Meanwhile, in Northeast Asia, China is seeking to accelerate the negotiation of a Northeast Asian Free Trade Agreement with Japan and South Korea.

In Europe, the European Union-China Investment Agreement is likely to come into force in 2020. China could use this agreement to turbocharge its wider economic engagement with the 28—soon to be 27—member states. China sees Europe as an important strategic economic partner in the future. This is not just because of the size and technological sophistication of much of the European economy. It is also because China sees Europe as being much less energized by the security concerns of the United States and its allies in Asia.

On technology in particular, China will also seek to advance its engagement with Japan, Germany, and Israel, where it has already sought to become a significant investor.

Globally, China may also seek to become a substantive champion of the World Trade Organization (WTO) and the global free trading system it underpins, particularly given the systematic assault on the WTO by the United States.

There is, however, a second script available to Xi Jinping's China. That is for the country to increasingly turn inward toward even greater Party control, economic self-reliance, and more mercantilist practices abroad.

If Chinese leaders conclude that a strategy of systematic economic decoupling has been embraced by the United States, and is indeed under way, then China may adopt a more radically conservative response to its circumstances. The Party may double down domestically against what it increasingly fears to be hostile forces operating within. China may seek to accelerate the expansion of domestic demand in the hope that domestic consumption can offset some of the impact of a much more adversarial international economic environment. And, rather than open its markets more to the world, or even the non-American world, it may seek instead to expand its selective economic engagement with friendlier Belt and Road Initiative states where Chinese goods, services, and technology standards are more welcome.

A third and more likely response from China would be an untidy combination of both of these approaches.

Given China's uncertainty about the precise contours of future American strategy on trade, investment, finance, tech, and broader decoupling, whether under Trump or any replacement Democratic

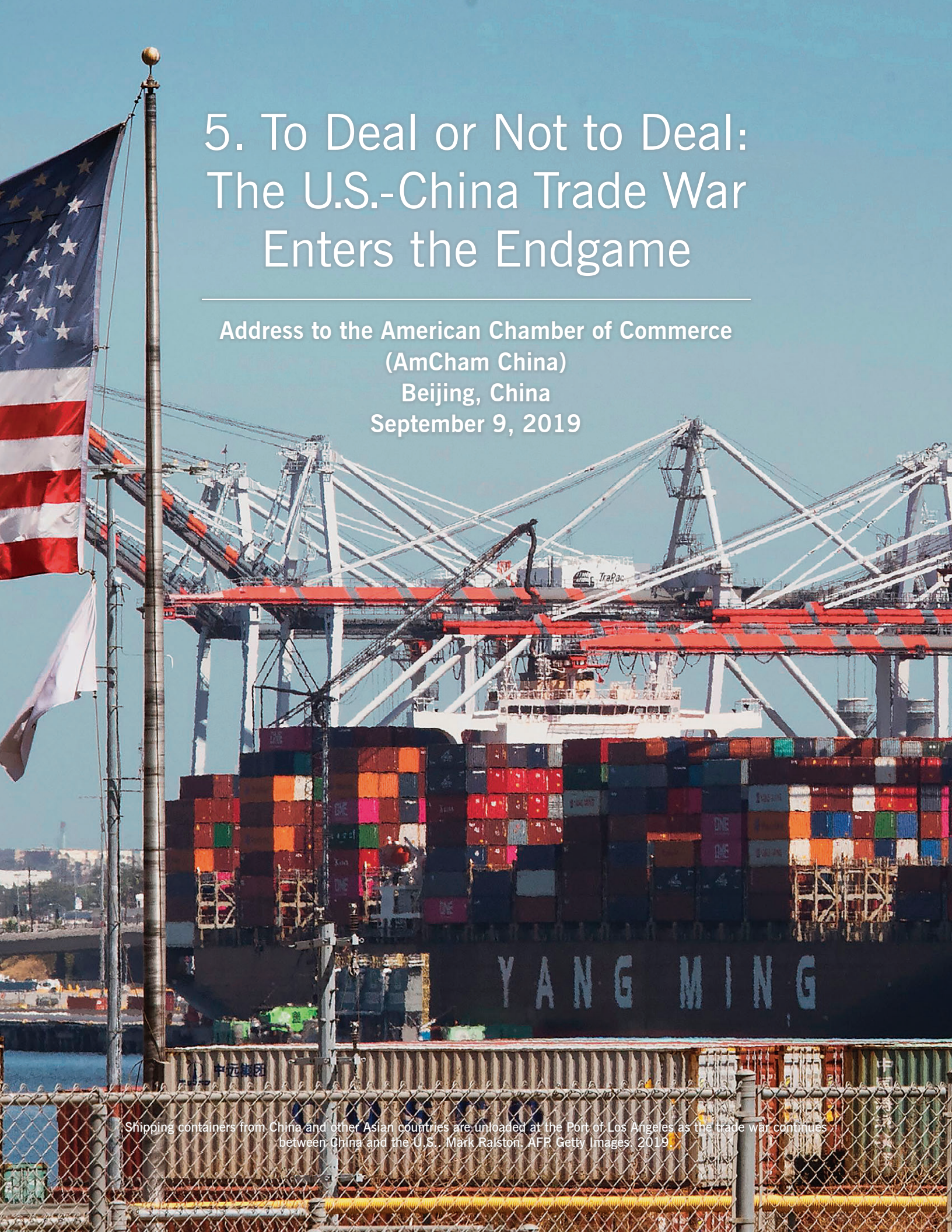
administration, as well as the additional uncertainty of whether U.S. friends and allies will cooperate with an American strategy of this type, China may well proceed cautiously until the strategic landscape is clearer.

China is now in a formal process of deep strategic review internally on the extent to which its external circumstances have changed and what China should do in response. Xi Jinping's recent reported remarks are nonetheless telling when he said in an internal speech that China now needs to expect another "30 years of containment and provocation from the United States" through until 2049.

The bottom line for all of us that the global strategic and economic landscape is now in a period of fundamental change. The open question for us all is how the Chinese political economy will respond to its own domestic growth challenges and to both the reality and the perception of economic decoupling from the United States.

As a McKinsey report warned recently, not only has the world changed China over the last 40 years, China, through the sheer size of its economy, its impact on global consumer prices, and the significance of its markets, has also changed the world. Therefore, how China now responds to these dual yet mutually reinforcing challenges will profoundly affect us all.

Global geopolitical risk is now back with a vengeance. We should all fasten our seatbelts for a rocky road ahead.



5. To Deal or Not to Deal: The U.S.-China Trade War Enters the Endgame

Address to the American Chamber of Commerce
(AmCham China)
Beijing, China
September 9, 2019

Shipping containers from China and other Asian countries are unloaded at the Port of Los Angeles as the trade war continues between China and the U.S. Mark Ralston, AFR Getty Images, 2019.

THE U.S.-CHINA ECONOMIC RELATIONSHIP has been through multiple twists and turns over the last 18 months. There has been much frustration, tension, and anger in this process, interspersed with periodic outbursts of diplomacy, reboots, and bilateral calm, all before the next round of tariffs, retaliatory tariffs, and stalemate. It has all the hallmarks of a messy divorce. If markets are confused about where all this is going, think, too, about the long-suffering global public and what sense they make of it all as they try to plan their long-term savings and investment strategies.

It is time, therefore, to make a fundamental assessment as to whether the underlying politics and economics of the relationship will allow a trade, technological, and financial war to be averted, or whether we are now on a course toward mutually assured economic destruction.

The argument I wish to advance here in Beijing is that, on balance, despite all the political noise, the evidence still points in the direction of a negotiated deal to be done before the end of the year. I say this notwithstanding the fact that this may place me in a minority of one versus what most of the commentariat is saying around the world today. I readily concede, though, that it is a separate question as to how comprehensive or permanent any such bilateral agreement might prove to be.

The Trade War Thus Far

It is now 18 months since the formal commencement of the trade war in March 2018, when President Donald Trump signed a memo directing the imposition of tariffs on a range of Chinese products as well as restricting Chinese investments in a number of key technological sectors in the United States. For those following the details, it has been a bewildering process.

I argue that we are about to enter the endgame of the U.S.-China trade war. The negotiations set to resume early next month represent the last chance to find a way through. Failing that, we should all buckle up and get ready for the rockiest of rides that the global economy has seen since the end of the global financial crisis a decade ago. This includes the risk of America sliding into recession. Not to mention the fundamental poisoning of the well for the future of the overall U.S.-China relationship, thereby reinforcing a growing constituency in both countries who believe that the United States and China are, to borrow the title from Graham Allison's book, "destined for war."

The recent decision to recommence trade negotiations is significant in itself. It marks the beginning of phase four of the trade war. Both sets of combatants are tired but determined, convinced of the righteousness of their causes. But neither Beijing nor Washington would have taken the political risk to restart the process unless they had judged there was at least some prospect of success.

Phase one began with the imposition of the first round of U.S. tariffs last February and March, when Trump concluded that he had to act in order to get China to get serious. Phase two we could call "the Argentine reset," when both Trump and Xi Jinping agreed at the G20 Summit in December 2018 to conclude the core parts of an agreement within 90 days. This imploded in late April/early May of this year, despite the fact that both sides had started to plan signing ceremonies, with each then accusing the other of major last-minute changes to the draft agreement. Phase three could best be described, to paraphrase Shakespeare, as the "summer of our discontent," when a fresh series of tariffs were imposed by the United

States, countered by retaliatory tariffs from China, with some still scheduled to take effect in the last quarter of this year.

And, to up the ante, China announced its equivalent of the U.S. “foreign entities list,” poetically called an “unreliable entities list,” targeting American firms in retaliation for the listing of Huawei and five other Chinese tech companies. All this is occurring against the background of American hawks saber-rattling about the need for a “general economic decoupling” from China as a precursor to a new Cold War, while China began publicly rekindling the spirit of the Communist Party’s feats of endurance during the Long March and reminding everybody that China had also fought the Americans to a standstill in the Korean War.

Apart from that, it’s all been going swimmingly. As of today:

- The United States has imposed tariffs on 68 percent of all imports from China, at an average tariff rate of 21.2 percent.
- China has retaliated with tariffs on 58 percent of total American imports, now at an average rate of 21.8 percent.
- If Trump continues through with his threatened additional tariffs, by the end of the year, U.S. tariffs will impact just over 96 percent of all Chinese exports to the United States.

Given all this, what has caused the two sides suddenly to get the band back together again? Very simple. Both economies are in trouble and if this worsens into 2020, there will be a political price to pay. This would endanger Trump’s reelection come November. It would also weaken Xi on the eve of the Party’s centennial celebrations in 2021, not long before Xi has to secure support for an already controversial third term starting in 2022.

Each side says publicly that the trade war is hurting the other side more than itself. But the reality is that it is hurting both of them—destabilizing markets, destroying business confidence, and undermining growth.

So despite all the public political position taking by each government, the truth is that both Trump and Xi, for these basic political and economic reasons, both want and need a deal. They also need one by the end of the year to prevent further damage to their economies, particularly if the tariff hikes currently scheduled for

December 15 come into effect. These are big and run the serious risk of not only poisoning business sentiment further, but also delivering material and lasting damage to the real economy of each, not to mention the world.

Each side says publicly that the trade war is hurting the other side more than itself. But the reality is that it is hurting both of them—destabilizing markets, destroying business confidence, and undermining growth. Each side also claims that it has greater economic resilience to see the other side out if the trade, tech, finance, and economic war between them becomes entrenched. On that, the jury is still out. America is certainly less trade dependent than China. But Beijing has greater fiscal, monetary, and credit policy

tools at its disposal to supplement declining external demand with greater domestic investment. The bottom line, however, is that the hard heads on both sides recognize that they are holding an economic gun to each other's heads, and it is uncertain, at best, how it would all play out if the shooting were to start.

If, therefore, we have indeed now entered a new fourth phrase of the U.S.-China trade war as of this week, there is much damage to repair. The question for us all—not just Chinese and American firms, not just these two countries' governments, but the entire world, which looks on helplessly—is whether after all the carnage of the last 18 months, will there be sufficient political will and policy creativity left to produce such a deal?

Current Chinese Economic Policy Settings and Performance

A core factor impacting both Chinese and American negotiating behavior is their respective perceptions and conclusions concerning the current state of each other's economies.

In China's case, this includes the current and prospective impact of the trade war on employment, investment, and growth. It also includes the extent to which the trade war has compounded preexisting economic difficulties arising from China's previous political economy settings going back to 2015.

I have written before that China's economic growth performance began to suffer during 2016–2018 as a consequence of significant changes to China's domestic policies well before the trade war became a reality. This has roots in Beijing's deleveraging campaign in 2015, itself a response to concern over that year's stock market crash, ballooning debt to gross domestic product (GDP), and the realization that an unfettered shadow banking sector posed real risks to the stability of China's financial system. The result was that in many cases, unproductive state-owned enterprises were given more favorable access to credit at the expense of the private sector, despite the fact that China's private entrepreneurial class had long been the dominant driver of new employment and overall growth in China's economy.

By 2017–2018, private sector sentiment and investment had begun to suffer because of conflicting signals about how large private firms could grow; the growing status of Party secretaries within the management of private firms; the vagaries of the Chinese financial system, including access to credit; and an anticorruption campaign that made many China's entrepreneurs feel anxious for their future. As a result, China's private sector growth has slowed. As a further result, overall economic growth has slowed because of factors completely exogenous to the trade war of 2018–2019.

From November 2018, as the trade war began to bite, the Chinese Communist Party and government have actively tried to address these major challenges to growth with a series of policy responses. First, there was a political reembrace of the private sector by China's leaders. Second, there have been policy shifts aimed at opening up new lines of credit to private firms, including reduced reserve requirements for banks to encourage them to lend more, broadened definitions of collateral that banks could lend against, and a directive for large state-owned banks to increase their lending to small private sector firms by 30 percent. Third, financial sector reform has been accelerated with moves to liberalize interest rates and to encourage greater foreign participation in China's financial sector to drive down costs for borrowers. Fourth, there has been a reinvigoration of broad, systemic market-based economic reform, consistent with the content

and thrust of “The Decision” of the Third Plenum of the 18th Central Committee in 2013. This was underlined on September 9 in Xi’s reported remarks at a Politburo meeting on “comprehensive economic reform.” Finally, the same Politburo meeting issued a new guidance document on “better supporting the further development and reform of China’s private sector.”

The jury may still be out on how the private sector will respond to these measures, given the risk factors outlined earlier. Nonetheless, Liu He, one of the leading voices for sustained economic reform in Beijing, sees opportunity in adversity. He has publicly described the trade war as a positive opportunity to “improve innovation and self-development, speed up reform and opening up, and push forward with high quality growth.”

The central near-term challenge facing Chinese economic policymakers, given the combination of domestic and international factors now bearing down on their country, is how to stimulate growth while not recreating the systemic financial risk of the past.

Nonetheless, the central near-term challenge facing Chinese economic policymakers, given the combination of domestic and international factors now bearing down on their country, is how to stimulate growth while not recreating the systemic financial risk of the past. Central bank governor Yi Gang stated in June that “the room for adjustment is tremendous” in China’s fiscal and monetary policy toolkit, with “plenty of room in interest rates and in required reserve ratios.”

China has reduced the reserve requirements for financial institutions to encourage an expansion of their loan portfolios, including new relaxations announced in the course of the last week. Chinese regulatory interlocutors also tell me that they have considerable room to move on this score as well. One further area in which credit reform is under way is the People’s Bank of China’s new policy on benchmark interest rates, which would move toward aligning the

cost of borrowing for firms and households with interbank lending rates, improving the transmission of central bank rate decisions to the broader economy. The implementation of such a reform should lower borrowing costs for firms and households, independently of lowering benchmark rates.

Further pathways for easier access to capital for domestic tech companies have also recently been announced with the establishment of the Shanghai Stock Exchange’s Science and Technology Innovation Board, which began trading at the end of July. Companies can list on STAR, as it is known, by registering with the exchange, without any need for further government approval. Profitability and minimum capital requirements are also lower if a company shows strong technology or innovation potential

Fiscally, Beijing has reembraced economic stimulus to support growth, albeit using more subtle levers than previously, such as cuts to the value-added tax, targeted consumption stimulus packages to the electronics, communications, auto, and constructions sectors, as well as renewed infrastructure investment in urban rail projects—a long-favored stimulus lever. There are also ongoing discussions in Beijing on allowing provincial governments to issue more debt for infrastructure development. Premier Li Keqiang’s comments on September 4 seem to indicate that this will come soon. There is also some capacity for

renewed housing stimulus to bolster China's property market should prices begin to sag, notwithstanding Beijing's anxiety about a creating a new class of asset bubbles.

On international economic policy, China has followed a two-track strategy: escalating tariffs in response to U.S. actions while simultaneously reducing tariffs on the rest of the world. By June 2019, China had increased its average tariff rate on U.S. imports to 20 percent while reducing its tariffs on the rest of the world's imports to an average of 6.7 percent. In January 2018, the average tariff rate on all imports to China stood at 8 percent. Furthermore, in July 2019, the Ministry of Commerce reduced the number of restricted sectors to foreign investment from 48 to 40. This includes the new ability for majority foreign ownership in subsectors such as value-added telecommunications. This year also saw a substantial increase in the Ministry of Commerce's "Encouraged Catalogue" for foreign investors, which provides preferential treatment by way of fast-track approvals, reduced land prices, and tax incentives. This list shows a heavy preference for attracting foreign investment in high-tech manufacturing, agriculture, health care, and artificial intelligence sectors. These are all preliminary steps, but they are positive when we contextualize how foreign investment and value chain participation have driven historical tech advancements in China.

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In apparent response to U.S. and broader international pressure, China has also begun to adjust its intellectual property regulations. In March, the State Council removed a number of provisions in the Technology Import and Export Regulation that had drawn the ire of the U.S. Trade Representative's office as proof of China's predatory practices on foreign intellectual property. These appeared to be welcome announcements for the U.S. Trade Representative who then dropped a related complaint against China before the World Trade Organization in June. The National People's Congress Standing Committee also amended the Trademark Law and Anti-Unfair Competition Law in April, which made it explicitly illegal for companies to secure trade secrets through electronic hacking. The legal burden of proof for trademark violations also shifted from the plaintiff to the defendant when evidence is strong. These amendments were fast tracked and made effective immediately.

It is difficult, of course, to separate the trade and nontrade policy factors currently bearing down on China's overall economic performance—just as it is difficult to assess at this early stage the likely effectiveness of the raft of policy measures outlined here. Nonetheless, the net impact of all of these factors—policy and market, foreign and domestic—has been a slowing of Chinese growth. But this is not a slowdown tantamount to economic collapse, as a number of American commentators seem to hope.

- China's second-quarter economic growth officially stood at 6.2 percent, down from first-quarter growth of 6.4 percent. This is the slowest growth rate for China since 1992, when official records were first published. Some analysts believe growth is actually lower than this, approaching the 6 percent threshold long believed to be crucial to sustain improved living standards and resist rising unemployment.

- Business sentiment in the manufacturing sector has been gloomy, with official manufacturing PMI reporting contracting output in six out of eight months from the beginning of this year. A recent survey of Chinese exporters was pessimistic, with 40 percent of respondents viewing the trade war as a “permanent state,” up 7 percent.
- Foreign capital is pulling back from China, with \$5.9 billion leaving China’s stock mutual and exchange traded funds in 2019. Around \$2.9 billion of this amount left in August, the greatest outflow since 2017. Both foreign and Chinese firms alike are increasingly looking to move parts of their supply chain offshore to countries such as Vietnam.
- Infrastructure development, long a reliable driver of economic growth has begun to decline, with fixed asset investment growth hovering just under 6 percent growth through 2019, well below the 7 to 8 percent growth regularly reported through 2017.
- Retail sales grew by 7.6 percent in July, down from a high 9.8 percent growth in June.
- There is a growing predilection for Chinese consumers to save more according to surveys, rather than spend their discretionary income. This undermines the effectiveness of economic stimulus designed to increase consumption, such as tax cuts. Household pressures are also building with rising pork prices—up by 25 percent in August. Pork represents 60 percent of China’s meat consumption.
- Official urban unemployment figures increased in July to 5.3 percent, equaling the highest unemployment rate on record of February 2019. Of particular concern are the growing proportion of China’s young, unemployed recent university graduates.

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Taking all these factors into account, the bottom line is that Chinese growth is considerably weaker than it was three years ago. It is on track to become weaker again because the combination of the trade war, recent domestic economic policy settings, as well as the lack of response so far from the Chinese private sector to the new policy signals that have recently been put in place.

However, a weakening economy does not mean the economy is on the verge of collapse. China’s economy is much more robust than that. It continues to have headroom for future economic growth through further

urbanization and a rising middle class. Furthermore, exports, while significant to China’s overall growth performance, are not as significant as they were historically.

But if natural growth in Chinese domestic consumer demands fails to offset the negative impact of declines in the traded sector of the economy, then the bottom line is that there are still sufficient fiscal and monetary policy tools available to the government, including future large-scale stimulus, should that prove necessary to sustain growth at or around 6 percent.

In other words, China's overall economic circumstances, as we head into the final quarter of 2019, are difficult but by no means dire. From Beijing's perspective, the trade war has also provided Chinese economic reformers to regain greater control over the policy agenda, enabling them to readjust economic policy direction over time in a manner more supportive of the private sector and the market. While it remains to be seen whether these measures will go far enough to have significant impacts on the substantive investment behavior of China's entrepreneurial class, they do represent some steps in the right direction.

For these various reasons, there seems to be little sign of panic among economic policymakers in Beijing. Concern, yes, but not panic. In the context of the trade war, U.S. policymakers need to be aware of that. At the same time, there is still sufficient concern in Beijing to cause Xi to conclude that, on balance, it is better for China to put the trade war behind it if it can—or at least to do so until the end of 2020, when a new set of American political realities may present themselves following the next election.

Current State of the U.S. Economy

The global economy at present, however, is the sound of two hands clapping, not just one. And that other hand is the United States itself. In trying to analyze the likelihood of an early conclusion to the trade war, we need also to have an objective understanding of the robustness of American growth as we approach the last quarter of 2019 and how it is seen in Washington and in Beijing.

President Trump, as he is given to do, has overstated the impact of the trade war on the Chinese economy. He has also understated its impact on the U.S. economy through the disruption of American global supply chains, the sectoral interruption of America's agricultural industry, declining business and consumer confidence, as well as the volatility of financial market reactions to the gyrations of the trade war over the last several months. As with China, however, it is difficult to clinically separate trade and nontrade factors impacting current and future U.S. growth.

We are familiar with the length of the current U.S. business cycle. It is already the longest since the war—10 years of continuous growth since America's recovery from the global financial crisis in 2009–2010. Markets, therefore, for some time have been factoring in their own assumptions of when this long-term business cycle will reach its natural conclusion.

On top of that, there is the rolling debate of the continued effectiveness of U.S. monetary policy. The stimulatory effect of Trump's 2017 tax cuts have already been delivered to the economy. Of themselves, they are no longer contributing to further growth. At the same time, the U.S. Federal Reserve has been reluctant to lower interest rates more rapidly than they have done, particularly given these are already sitting near historically low levels. Whether or not a further reduction is necessary, desirable, or deliverable, given the curious relationship between the chairman of the Federal Reserve and President Trump, remains to be seen. This includes whether any further monetary policy action can indeed extend the already long U.S. business cycle.

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However, the most recent U.S. economic data reflects continuing, relatively strong growth. Annual GDP growth has remained above 2 percent since January. Unemployment continues to decline from its highs of 2010 to its current level of 3.7 percent. The Federal Reserve's most recent "Beige Book" is optimistic on wage growth.

But we are beginning to see some impact on the U.S. domestic economy and, indeed, on the wider global economy, as global trade takes a battering from not only the trade war but also the wider forces of global protectionism. These protectionist forces have been eating away at U.S. and global financial market sentiment for a long time, while eroding business and consumer confidence and substantive investment behavior by firms. Given the size of their economies, the U.S.-China trade war lies at the center of this. Some recent economic data is beginning to show this:

- Last week's job creation figures were below expectations.
- America's manufacturing sector contracted last month, for the first time in three years.
- Consumer sentiment figures compiled by the University of Michigan reported the lowest figure in almost three years, including the biggest one month drop since the end of 2012.

Economists estimate that existing tariffs are costing America 0.6 percent of GDP growth, or more than \$100 billion annually. President Trump's actions also seem to admit a growing sense of anxiety about the

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state of the economy as of the end of August, when he let slip that he was mulling further income tax cuts. His incessant calls for the Federal Reserve to lower interest rates belie a high level of concern.

In summary, while the United States is beginning to take a hit from the trade war, it would be wrong to say that its nonresolution would necessarily push the country into recession. Many of the economic indicators mentioned continue to be strong. But the

risk nonetheless remains, reinforced by declining business and consumer confidence indicators. These, together with the underlying headwinds noted earlier, should give the president sufficient pause for reflection about the state of economy in 12 months' time—that is, on the eve of next U.S. presidential election. For these reasons, President Trump, when looking at his own political destination in 2020, on balance is likely to prefer to bring the trade war to a negotiated conclusion by year's end, if possible.

How Could China and the U.S. Conclude a Trade Deal by Christmas?

Given all of the above, and the underlying political and economic assumption that as of now, it is still in both sides' interests to end the trade war, then what in practical terms must be done to help get such a deal agreed, and what might be a mutually acceptable landing point? Here are five things that might help.

First, China should provide the United States with its own draft text. It should be the same as the last 150-page text but include only the drafting changes necessary to satisfy China's "red lines" announced on May 13, and nothing more. These would be removing the U.S. provision to retain \$50 billion of tariffs

after the agreement is signed; removing the provision for the United States to unilaterally reimpose tariffs in the future if it decides that China is not honoring the agreement, as well as the prohibition on China taking retaliatory action; and inserting a provision in the text that China will give effect to the agreement consistent with its constitutional, legislative, and regulatory processes, rather than specifying the precise nature of these enactments. The details of how this could be done could be clarified in a side letter to the agreement.

The bottom line is that if the United States objects to China's actual behavior in the future, it will take action anyway. Why would the United States want to destroy the rest of the provisions already secured in the draft agreement by insisting on these three positions, which it could deal with by other means anyway in the event of any future Chinese noncompliance?

There are, of course, other views on how to handle the current U.S. negotiating requirement to maintain tariffs on \$50 billion of Chinese exports once a deal is signed. For example, Wendy Cutler, vice president at the Asia Society Policy Institute, is a veteran U.S. trade negotiator. She argues for immediately removing the majority of U.S. tariffs while leaving in place the original tranche of \$50 billion on the basis that these tariffs specifically targeted China's unfair intellectual property practices. This would be a substantial reduction from the existing U.S. tariff burden. She argues that with clear benchmarks and timeframes for lifting the remaining tariffs, Beijing could sell this to their people as a big and broad U.S. concession. But I am not so sure, given that China has publicly declared the removal of all tariffs when the agreement comes into force as a Chinese red line.

Second, China should improve on the original offer of a \$200 billion reduction in the bilateral trade deficit over time. This is lousy economics. But it is important to Trump personally and politically. China may not be able to meet Trump's May counterproposal on the quantum of the proposed bilateral purchasing agreement, but China might be able to find a number somewhere in between.

Third, China must retain the draft agreement's existing provisions on the protection of intellectual property and the outlawing of forced technology transfer. These are critical structural changes in China's trade and economic practices for the future. On the question of state subsidy for Chinese industry and enterprises, China will never outlaw this in the text of a bilateral agreement, not least because many countries around the world have similar practices. Look at U.S. agriculture, for example. But it may be possible to have both countries declare their respective positions on state industry policy for the future in a communiqué accompanying the release of the signed agreement. This should not be a blank check for China. China should also stipulate which domestic and international arbitral mechanisms will be applicable to place the quantum of any such subsidies in the future within fixed limits. This would mean complying with competitive neutrality laws and tribunals domestically, as well as those with come under the World Trade Organization internationally.

Fourth, none of the above will work unless both sides act now to create a positive political atmosphere for when the Chinese negotiators arrive in Washington early next month. This is not a feel-good question. It is about concrete actions. China could kick start this by placing a large order now for American soy beans and corn. That helps Trump's angry farmer problem in his Republican heartland. The United States could respond by deferring the currently scheduled 5 percent increase on October 1 on top of the 25

percent tariff already imposed on \$250 billion worth of Chinese exports. Failing to do this would further alienate the Chinese leadership, as it would fall precisely on the 70th anniversary of the founding of the People's Republic, a big event in the Chinese political calendar. The United States might also consider issuing permits for some of the more nonsensitive applications already received from dozens of U.S. firms wishing to sell their product to Huawei—applications that are currently languishing on the commerce secretary's desk.

Fifth, both sides should regard the November 16 Asia-Pacific Economic Cooperation Summit in Santiago as the last chance saloon for getting the deal signed. That would mean technical level meetings in Beijing in September. High level negotiations between Vice Premier Liu He and U.S. Trade Representative Robert Lighthizer in early October. With outstanding issues to be agreed at a 14th and final round of negotiations in Beijing in early November. Getting the deal done before Thanksgiving will be critical to undergirding U.S. business and consumer confidence going into the Christmas shopping season.

Conclusion

I have been among a small minority of analysts who have consistently argued that despite the public political fireworks over the last year or so, the underlying interests of both presidents make a deal more likely than not. But a failure to manage the next two critical months carefully could still cause the whole process to implode.

To be clear, both sides have already spent a lot of time preparing Plan B for 2020—namely, to let loose the dogs of economic war between the two countries, each appealing to underlying nationalist sentiment to blame their domestic economic woes on each other, all to secure their respective political futures. In that case, we should all get ready for the risk of recession next year.

Indeed, if a new negative spiral begins, deeper resentment and retrenchment sets in, precipitating a broader decoupling of the two economies. For example, a recent article in a People's Bank of China-affiliated journal defending China's recent actions in currency markets called on China's policymakers to prepare for the worst should bilateral relations fail to improve. This was a call to develop domestic autonomy from U.S. suppliers and capital, promote the renminbi more heavily in international transactions, and to support European efforts to develop independence from the U.S. dollar-dominated international financial system.

With each passing cycle of conciliation and then escalation, the political cost of granting concessions worsens, as the nationalistic impulses become harder to calm. With each passing month to November 2020, the political incentives for Trump to pivot the missteps of the once "easy" trade war and pin all blame on China grows stronger, and the temptation to tap anti-Chinese nationalism rises. The same will apply in China. And in the United States, the unwillingness of many Democratic candidates to recite anything but a blanket hawkish stance to China only pushes Trump further to the right.

We are now at a critical window of opportunity in this trade war. We must hope that economic and political self-interest prevails over some of the darker forces at work in the politics of both countries—for China's sake, America's sake, and the world's.

6. To Decouple or Not to Decouple? That Is the Question for U.S.-China Relations

**Robert F. Ellsworth Memorial Lecture
21st Century China Center
University of California, San Diego
November 4, 2019**

U.S. and China flags stand behind a microphone at the U.S. Embassy in Beijing, China. Frederic J. Brown. AFP. Getty Images. 2009.

THE CASUAL, INCREASINGLY NONCHALANT, and, for some at least, apparently satisfying deployment of the term “decoupling” to describe the current trajectory of the U.S.-China relationship reminds us of the classical wisdom that in foreign policy, words are bullets. Indeed, “decoupling” has become the “term du jour” of U.S.-China relations, reflecting for some the unfolding reality of the relationship, and for others, its desired destination.

This is despite the fact that regardless of the current fetid state of the relationship, neither the U.S. government nor the Chinese government, at least at this stage, is deploying the “d” word as part of its official vocabulary, despite the fact that the relationship is now in the worst shape it has been for nearly half a century.

Official reluctance, however, has not prevented the term being thrown around with abandon by the academy, think tanks, and the commentariat in both capitals—with varying levels of semiofficial enthusiasm, but, I fear, greater and greater levels of political contagion.

This has also happened with remarkable speed. It was only 18 months ago that we first became accustomed to the phrase “trade war.” By the end of 2018, this had happily morphed into a “technology war.” And by the early months of this year, these ideas had morphed, in turn, into a much wider economic war covering trade, technology, talent, foreign direct investment (FDI), capital markets more generally, and, as of last week, national currency strategy as well. A year is a long time in global politics. And a year and a half, it now seems, is an eternity.

“Decoupling” began appearing in the academic and think tank literature on U.S.-China economic relations last May. Six months later, it had become the battle cry of none other than President Donald Trump’s former chief strategist, Steve Bannon. Mr. Bannon, like all good propagandists, can spot a good marketing opportunity at a thousand paces.

This simplistic debate about decoupling reminds us afresh that geopolitical and geo-economic change is now so multidimensional, complex, and rapid that it defies the ability of political and policy elites to remain abreast of what is actually happening out there in the so-called real world, let alone working out what to do about it and then to explain it to their various constituencies. It also reminds us that in international relations, language can reflect realities just as easily as it can create realities. And it reminds us that sharp language like this, designed to cut through the dense fog of political and foreign policy debate, particularly when used ahead of the curve in advance of the reality that it seeks to describe, often produces unintended consequences.

For example, in the context of the “Great Decoupling” debate that now rages in both countries, it is resulting in the generation of contingency plans in both capitals against a range of economic scenarios in case a capital-D decoupling actually comes to pass. This, in turn, heightens the danger of these plans actually being activated in response to any evidence, however incomplete, of hostile actions from the other side, thereby creating a cycle of action and reaction which eventually spirals out of control.

It reminds me a little of the mobilization plans, schedules, and railway timetables of the great powers on the eve of the Great War, albeit today in the less lethal domains of the international economy. Less lethal perhaps, but comprehensively destructive nonetheless.

My purpose in this lecture is threefold:

- first, to analyze the domestic and foreign policy context in which this current debate on the “great decoupling” debate has taken off;
- second, to look carefully at trade, FDI, technology, capital, and currency markets to test whether we are actually witnessing a substantive economic decoupling, or indeed something much more mixed than that; and
- third, to begin reflecting on where all this takes us in the wider world of foreign policy, national security policy, and geopolitical stability for a future that affects us all.

My argument is simple: that those supporting comprehensive decoupling are seeking to create the conditions precedent for a substantive rather than a rhetorical second Cold War; that despite this, the present and prospective economic relationship is much more interconnected than the increasingly wild use of the term decoupling might suggest; and that policymakers in both capitals would be better advised to define afresh the terms of economic coexistence, within the framework of what the United States has now defined as this new era of strategic competition, rather than indulging in loose and inflammatory language that could well become a self-fulfilling prophecy.

In other words, we should be very careful what we wish for. A fully “decoupled world” would be a deeply destabilizing place, undermining the global economic growth assumptions of the last 40 years, heralding the return of an iron curtain between East and West and the beginning of a new conventional and nuclear arms race with all its attendant strategic instability and risk.

Policymakers in both capitals would be better advised to define afresh the terms of economic coexistence, within the framework of what the United States has now defined as this new era of strategic competition, rather than indulging in loose and inflammatory language that could well become a self-fulfilling prophecy.

Political and Foreign Policy Context

The current debate on economic decoupling between the United States and China occurs within a much wider political context. Much as economists would love to ignore politics, the reality is that it is the evolving nature of the domestic political economy of both the United States and China that will be the critical determinant of the relationship’s future. This goes to the heart of the so-called decoupling debate.

The reality today is that the U.S.-China relationship plays deeply into the domestic politics of each country. It is no longer a sacred space where only professional diplomats are allowed to operate. Politicians in both capitals, Republicans and Democrats in Washington, conservatives and reformers in Beijing, now rampage around the public debate on the relationship because it is now legitimately seen as central to everything: from soybeans to the South China Sea to climate change; from Huawei to the NBA to human rights; and almost all points in between.

China in U.S. Domestic Politics

In the United States, the president tries to sit above it all, maintaining his own definition of political and strategic ambiguity, claiming his Chinese counterpart as his best buddy, while in the next breath declaring that China has now become America's public enemy number one. Underneath the president, following the removal of National Security Advisor John Bolton, the center of gravity on China policy has now moved to Secretary of State Mike Pompeo, who has made it plain, through the first of what he intends to be a series

of thematic addresses on China, that “China is truly hostile to the U.S. and [its] values.” The Pentagon voice on China under new Secretary of Defense Mark Esper at this stage remains largely unknown. Meanwhile, Treasury Secretary Steven Mnuchin seeks to pour oil on the troubled waters of the trade war wherever he can to try to calm markets, reenergize global growth, and sustain the American economy through election year 2020. U.S. Trade Representative Robert Lighthizer is doing as professional a job as he can, staying carefully within his negotiating remit, to try to bring the trade war to a satisfactory conclusion—one that maximizes Chinese trade and economic policy change while also minimizing the future bilateral trade deficit, and recognizing, reluctantly, that the latter remains his president's principal

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Of course, in Washington, the Republicans represent the sound of only one hand clapping on China. The Democrats have doubled down just as much—in fact, probably more so. Democrats have always exhibited greater skepticism than Republicans on China, on both trade and human rights. To this they have now added the intersecting domains of technology and national security, as well as a political determination, mindful of the presidential election campaign that lies ahead, to depict any deal the president may make with Xi Jinping in trade, technology, or the rest of the economic relationship as insufficient and, by definition therefore, a political sellout.

Beyond these political postures, however, three years into this administration, it is still not clear what the actual content of America's China strategy is. America is angry about China because it believes China has cheated in adopting World Trade Organization (WTO) rules in its international trade and wider economic practices. America is frustrated with China because of what it sees as repeated broken promises to reform. And America feels betrayed by China because, in Washington's view, the United States extended WTO membership to Beijing on trust, only to see that trust largely dishonored when China decided instead to set out to eat America's economic, technological, and strategic lunch. While America clearly has an *attitude* toward China, it is not clear at this stage that Washington has an agreed *strategy* for dealing with China.

In thinking through what U.S. strategy might be, it is important to look at the National Security Strategy of December 2017, the National Defense Strategy of 2018, and other recent policy speeches by both Vice President Mike Pence and Secretary Pompeo. The National Defense Strategy defined China for the first time a peer competitor of the United States. The National Security Strategy concluded that 40 years of strategic engagement with China had not caused Beijing to adhere to the global rules-based order, let alone become its effective advocate as a responsible global stakeholder, and therefore a new period of outright strategic competition was the inevitable consequence. In other words, no more “Mister Nice Guy,” always giving China the benefit of the doubt. But while both documents represent significant departures from the past, they nonetheless represent the *analytical* conclusions of the U.S. national security establishment rather than outlining a detailed new policy *strategy* for the future.

Three years into this administration, it is still not clear what the actual content of America’s China strategy is.

Secretary Pompeo’s address to the Hudson Institute on October 30, 2018, provides greater insight into the likely direction of such a strategy in the future. It is a remarkably blunt speech. Indeed, strategic hard heads in Beijing may welcome its bluntness as a clarification of the depth and breadth of the administration’s strategic intent. The heart of Pompeo’s speech is an explicit American rejection of China’s ideological system. Indeed, he states that China’s Communist Party is a Marxist-Leninist party “focused on struggle and international domination.” This language has not been used by a U.S. administration in relation to China in half a century. The secretary stops short of calling for regime change, although when he goes on to say that America wants to see a “liberalized China,” “regime change” is how it will be read in Beijing. Pompeo says he is not seeking confrontation with China. But he underlines that administration policy is now that Chinese economic practices that contravene competitive neutrality are being confronted; so, too, must China’s efforts through its bilateral and multilateral diplomacy to change the international rules-based system. So too should China’s domestic human rights practices now be taken on directly. Secretary Pompeo admits that the administration is still “trying to work out the right strategy and tactics to deliver against these objectives,” but this task will be the central task of the United States “for the next 50-100 years.”

This is a hard-hitting speech. Indeed, it embraces much of the language of the Cold War from a previous era. But for the purposes of my topic today, what is important is that Secretary Pompeo does not embrace any form of decoupling of the two economies. Indeed, this is made crystal-clear in Vice President Pence’s Malek Memorial Lecture the week before when he states, “We are asked whether the Trump administration seeks to decouple from China—the answer is a resounding no.”

The Chinese may note from all this that economic decoupling is not on the administration’s agenda, at least for now. But the open question, of course, is whether Beijing accepts these assurances at face value given that there has been a complete collapse in political and strategic trust in bilateral undertakings of all hues between the two sides over the last year and a half.

The Chinese Political Context

This brings us to the prevailing political context in China, where the Communist Party has just concluded the long-awaited Fourth Plenum of the 19th Central Committee. The only credible way to interpret the

Plenum communiqué is that Xi Jinping continues to reign supreme. Despite multiple rumors about the possible elevation of would-be replacements for Xi at the 20th Party Congress in 2022, nothing happened at all at the Plenum on this score, thereby conveying a clear message that Xi intends to remain in harness for the long term. This was reinforced by the fact that the communiqué was almost an exclusively political and ideological document, reinforcing Xi's determination to reassert the Party's control over everything in China. Indeed, I would not be surprised if we soon see a dramatic resuscitation of the anticorruption campaign of recent memory to remind wavering comrades of what may await them should they be tempted to stray from Party discipline and challenge his continued hold on the leadership. There has certainly been grumbling within the Party about Xi Jinping's overreach—on the concentration of individual power; on the alienation of the Chinese private sector and the resultant slowing of economic growth; on the U.S.-China trade war; on the South China Sea; on China's 2025 strategy for dominating high technology in the decade ahead; on the cost of and reaction to the Belt and Road Initiative (BRI); and most of all

on the elimination of term limits for the presidency. But none of this has reached critical mass. And Xi, as a political dialectician from central casting, who prides himself on his well-honed ability to anticipate action, reaction, and further reaction three steps ahead of anybody else, seems to have anticipated the emerging criticism of his leadership and has begun acting decisively to deal with any difficulties well in advance. While continuing for a third five-year term in 2022 will not be without its difficulties, at this stage, it remains the most probable outcome.

Xi's principal vulnerability remains the economy. Growth is slowing. Private sector business confidence remains low. Private entrepreneurs still see little reason to invest in the future because of uncertain signals on the future of the market economy, how big they will

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be allowed to grow, their ability to expatriate profits, the continued impact of the deleveraging campaign, and an unlevel playing field with state-owned enterprises both in market share and in credit allocation. Despite efforts 12 months ago to change course in an important speech to the nation's leading entrepreneurs on November 1, 2018, there is little evidence to date that the tax and credit policies announced since then have flowed through to the private sector to the extent of restoring business confidence, let alone returned to pre-2015 levels. Sustaining 6 percent national economic growth therefore remains a real problem. And Xi's critics will note carefully that the Fourth Plenum document paid scant attention to the real elephant in the national living room—the economy. Indeed, it will be read by some as a triumph of politics over economics at critical time for the country.

This is the domestic political and economic context in which Xi Jinping now confronts the rhetoric and/or reality of economic decoupling from the United States. Xi therefore faces three broad strategic alternatives for the economy in the future given the current fragility of global, regional, and national growth. First, he could revisit his November 1, 2018, speech encouraging the private sector and double down on policy measures to enhance new private investment and employment. Second, he could make

even greater recourse to fiscal and, to a lesser extent, monetary policy stimulus to fill the growing economic growth gap. China has headroom to do so—but not infinite headroom without generating other asset bubbles, financial imbalances, and systemic risks for the economy at large. Third, he could seek to limit his exposure to additional, externally generated threats to the economy by adopting a general strategy of trying to prevent the economic rift with the United States from widening further; greater international economic diversification in trade, investment, and technology markets beyond America; together with greater national economic self-reliance. The evidence to date suggests we are likely to see a combination of the second and third of these approaches.

Xi Jinping has learned not to trust what Donald Trump says. That is likely to mean not believing the recent assurances of his vice president and secretary of state that the administration has no interest in pursuing a decoupling strategy with China. Indeed, Xi Jinping believes the United States has fundamentally changed course toward China since 2017. He reportedly told his Politburo colleagues in closed session earlier this year that the Party should prepare itself for 30 years of sustained struggle with the United States and that this will involve multiple American provocations over that time. If this analysis is true, where it leads us is a conclusion that Xi Jinping has now embarked on an accelerated strategy seeking to insulate China to the greatest extent possible from possible American coercive action against Beijing across the full breadth of the country's economic armory. As we will explore in the sections that follow, we are already beginning to see some evidence of this in trade, FDI, technology, talent, and capital markets. But these are still early days. The patterns are far from even, particularly when it comes to capital markets and certain technology markets, where unscrambling the U.S.-China economic omelet would be no easy feat, not to mention mutually destructive.

The irony of this thesis is that whereas the Trump administration may indeed be genuine when it says it does not want to embark on economic decoupling with China, it may well be Xi Jinping's administration that initiates and accelerates the process in the name of national self-reliance. China has a long and celebrated tradition of what is called *zili gengsheng*. Those of us who follow China closely have noted with a little alarm that this old slogan from pre-reform and opening days has made a loud reappearance since the first shots were fired in the trade war some 18 months ago. It is a separate question, of course, whether going down the self-reliance road would be in China's national economic interests. Most of us, together with most Chinese economic reformers, would answer with a resounding no. But a sense of vulnerability does strange things to people, just as it does to states. This is particularly if China were to combine greater self-sufficiency, on the one hand, with a radical new and accommodating international posture toward its non-American friends and partners around the world, as China also sought to offset its vulnerabilities in export, technology, talent, FDI, and where necessary capital markets by seeking new strategic economic alliances in Europe, Japan, Korea, India, Southeast Asia, as well as with some of its more significant BRI partners.

To test the decoupling proposition properly, whether it is being initiated by the United States or by China, or whether there is no substantive decoupling evident at all, it is important to look at what is actually happening in each of the economic domains referred to previously. To some extent, this will be a superficial analysis given that each of these domains generates its own formidable complexities. But I believe it is time to draw these disparate threads together to see what aggregate picture, if any, may be emerging—beyond the reflections of the commentariat and more in the nuts and bolts of the real bilateral

economy. It might also give policymakers in both Beijing and Washington pause for thought based on the general principle of “be careful what you wish for.” The law of unintended consequences is as much alive in the dismal science as it is political science and international relations.

The Decoupling of U.S.-China Trade?

At this stage of its economic development, China’s vulnerability to the United States restricting its markets to Chinese goods and services remains significant. The United States has long been China’s largest export market—and by a massive margin. By contrast, China is less significant to overall U.S. exports. Whereas the United States, on average over the last decade, represented 19 percent of Chinese exports, China represented only 8 percent of total U.S. exports, consistently coming in as America’s third-largest market after Canada and Mexico. Furthermore, China in aggregate is a more trade-exposed economy than the United States. As of 2019, China’s exports and imports combined represented 36 percent of total Chinese gross domestic product (GDP). By contrast, the traded sector of the U.S. economy in the same year made up only 26 percent of U.S. GDP. Therefore, while trade remains important to both economies, it is much more important to China at this point of its economic evolution than to the United States. For these reasons, China’s leadership, in framing its overall policy response to the United States, is acutely aware that the United States can inflict more economic damage on China through trade than China can inflict on the United States. The U.S. market as of 2019, notwithstanding the trade war, still represented 17 percent

of total Chinese exports significantly contributing to China’s overall economic growth. America, therefore, for the time being at least, remains the key.

But because of the declining role of Chinese exports to overall GDP over the previous decade, China is less vulnerable now than it was on the eve of the global financial crisis a decade or so ago. In 2006, Chinese exports to GDP had risen to 36 percent, whereas by 2019, they had almost been halved, to 19 percent. Second, Chinese household domestic consumption has been steadily increasing, replacing exports as the principal driver of economic growth. Boosting household consumption will therefore become an even more important part of Xi Jinping’s strategy to reduce his

Xi Jinping’s challenge, therefore, is to manage the U.S. relationship in a manner that prevents a major collapse in growth from declining exports while seeking to insulate China, to the greatest extent possible, from further punitive American action via the continuing trade war.

country’s overall vulnerability to international economic forces. Furthermore, China is acutely aware that the United States is China dependent for a range of consumer goods that cannot be readily replaced in the near term without producing an American consumer revolt. For example, 2018 U.S. Census Bureau data showed that 82 percent of mobile phones and 94 percent of laptop computers imported to the United States were from China. In other words, America does not have all the cards in this game, and China knows it.

Xi Jinping’s challenge, therefore, is to manage the U.S. relationship in a manner that prevents a major collapse in growth from declining exports while seeking to insulate China, to the greatest extent possible, from further punitive American action via the continuing trade war. This will include taking whatever

measures may be possible to reduce the impact on Chinese manufacturing as third countries seek to reduce their exposure to growing U.S.-China geopolitical risk by moving their global supply chains offshore.

China's national interest, for at least the decade ahead, is to de-escalate the trade war until such time as China's dependency on the U.S. export market is less critical. This will likely mean yielding to American pressure on intellectual property protection, forced technology transfer, further access to the Chinese market, and administratively decreeing a major increase in Chinese imports from the United States to reduce the bilateral trade deficit, particularly in agriculture. Xi Jinping is nonetheless unlikely to accept U.S. demands for cutting Chinese state subsidies for Chinese firms active in the global market. This is because in the Party's view, the role of the state is inseparable from the general economy without fundamentally changing the entire nature of the Chinese system. For these reasons, a phase one trade deal is highly likely this year. And a phase two deal remains probable for next year. Beyond the immediate effect on the traded sector, these agreements would also assist in returning confidence to markets in what is a critical election year for President Trump and an important period for Xi Jinping, given the weakened state of Chinese growth caused by nontrade war factors arising from poor domestic economic policy settings.

Xi is also likely to expand Chinese export opportunities in third-country markets in Europe, Japan, Korea, India, Southeast Asia, and BRI countries across Eurasia to reduce export dependency on the United States over time. This will be implemented in tandem with a new diplomatic offensive in these states as China seeks to widen its penetration of global markets. In the meantime, China will continue to promote the Regional Comprehensive Economic Partnership among Asia-Pacific Economic Cooperation economies, with a view to bringing it into force in 2020. Similarly, China is in the process of examining whether it should become a member of the Trans-Pacific Partnership (TPP), already agreed to by 11 regional economies and from which the United States has now withdrawn. Such an approach from Beijing would present the TPP-11, led by U.S. allies Japan and Australia, with a major dilemma, particularly if China did not seek to renegotiate the agreement in order to gain access to this high-quality trade agreement. China is also likely to use its widening political influence in the WTO to prevent any U.S.-led multilateral action in the future, led by a U.S. Democratic administration, against China's global economic and trading practices.

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In summary, Xi Jinping recognizes the significant tactical threat to his economy from the U.S.-China trade war for the coming years. His short-term strategy is to manage the trade war by offering sufficient concessions to prevent further escalation while not compromising on what he regards as core national economic and political interests. In the meantime, he is also pursuing a long-term, two-pronged strategy of trying to boost domestic private consumption as a major driver of economic growth, on the one hand, while rapidly diversifying Chinese export markets, on the other. Neither of these strategies is necessarily guaranteed success. But both are designed to reduce China's long-term economic dependence on the United States, reinforced by a Chinese view that by the end of the coming decade, the United States will be less significant to both the Chinese economy and the global economy. In Xi Jinping's view, the economic

danger for China from the trade war lies in the immediate decade ahead, when trade decoupling needs to be avoided at all costs because of the major dislocation this would create for overall Chinese growth.

Foreign Direct Investment

FDI flows between China and the United States represent a relatively recent development in the overall bilateral economic relationship, only registering significant numbers over the last 20 years, and in the case of Chinese investment in the United States, only the last 10. Indeed, it was for these reasons that both sides began negotiating a draft Bilateral Investment Treaty in 2009 to enhance the overall investment relationship and deal with China's historically restrictive approach to investment in multiple sectors of its economy that it deemed to be sensitive. But amid the continuing travails of the trade war, these negotiations have stalled. As of 2019, the total stock of U.S. FDI in China had reached \$269 billion,

with annual flows averaging around USD \$15 billion. Meanwhile, Chinese FDI in the United States had reached an accumulated stock of \$145 billion, but with annual flows dropping by 80 percent in 2018, reflecting a number of recent political and regulatory changes, both in Beijing and Washington.

To put this into a wider context, total U.S.-China bilateral FDI flows in 2018 represented approximately 1.4 percent of the total global FDI flows. By contrast, total U.S.-China trade in the same year represented approximately 3.3 percent of total global trade. As for total foreign investment coming to the United States,

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Chinese FDI in 2018 represented 1.4 percent of the stock of overall global investment into America and 2 percent of total 2018 flows. As for total FDI into China, U.S. FDI made up just over 9 percent of global FDI 2018 flows to the Middle Kingdom. Therefore, unlike trade, where U.S.-China trade dictates the overall global trade in goods and services, in addition to representing a major component of each countries total trade, the same does not apply to the U.S.-China FDI relationship. The reality is that it represents a much smaller share.

Nonetheless, from China's perspective, FDI has been an important means of securing access to advanced technology. This applies both to China's domestic FDI strategy as well as the types of firms it has sought to acquire or invest in abroad, including in the United States. China in the last several years, however, has begun to encounter new and significant resistance to its approach to U.S. investments. Washington has tightened the procedures of the Committee of Foreign Investment in the United States (CFIUS), introduced the Foreign Investment Risk Review Modernization Act, and reactivated the Export Control Reform Act, all of which have imposed new levels of scrutiny and control on inbound Chinese investments, as well as what U.S. firms may be allowed to collaborate on with Chinese partners in China itself. These new measures have the potential to reduce not just FDI between the United States and China but also portfolio investments, including venture capital activity between the two countries. This is particularly significant given that as of 2019, venture capital investments in both countries had not been affected by the general downturn in bilateral FDI. That may now change as well.

For these reasons, from China's perspective, the investment door to the United States is now closing. Just as Beijing anticipates that U.S. technology firms will face increasing resistance from Washington regulators to continue collaborating with Chinese companies and institutions in China. Furthermore, Xi Jinping's administration has limited expectations that the restrictions put in place under the Trump administration will be reduced under a successor Democratic administration. As with trade, China is now seeking to improve its foreign investment environment for other potential investors from third countries, as well as improving reciprocal arrangements for Chinese investors in those countries. This includes the introduction of China's new Foreign Investment Law with new provisions for intellectual property protection, as well as rendering forced technology transfer illegal in China. China has also removed foreign equity caps for investors in the Chinese finance and insurance sectors. And the country is now seeking to advance its overall investment relationships with Japan, India, and Europe in an effort to offset the prospective loss of American FDI, venture capital, and possibly the full range of portfolio investment opportunities as the overall geopolitical climate continues to deteriorate.

In summary, decoupling from each other's FDI markets may be happening more rapidly than we may all think, particularly from the China end, although this has obviously been compounded by capital export controls imposed by the Chinese government for other reasons.

Technology

For Xi Jinping's China, the struggle for technological primacy over the United States has become a central factor in Beijing's overall relationship with Washington, as well as in China's national security and national economic strategy more generally. China's ambition is to achieve national autonomy in all critical technology categories in the decade ahead and, where possible, to then achieve technological dominance over its economic and geostrategic competitors. This applies, in particular, to the principal drivers of the artificial intelligence (AI) revolution, next-generation mobile telecommunications, and quantum computing. These ambitions are made clear in the "Made in China 2025" strategy of April 2015, which identified 10 core technologies in which China would need to prevail. The list is led by information communications technology (ICT) but includes all other major technology categories as well. The strategy sets targets for China to be 70 percent nationally self-sufficient by 2025 and globally dominant in all technologies by midcentury.

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"Made in China 2025" was supplemented in July 2017 by the State Council's "New Generation Artificial Intelligence Development Plan," which states explicitly that AI is a major area of international economic and strategic competition in which China has a "major strategic opportunity" and Beijing could achieve a significant "first-mover advantage." China's leadership believes that collectively these AI technologies represent the principal next-generation technologies that will determine China's future global competitiveness. They also represent the engine room of a much broader "Fourth Industrial Revolution," following earlier

revolutions driven by paradigm-shifting technologies in fossil fuel combustion, electricity generation, and, most recently, digital electronics. This fourth revolution, driven by profoundly disruptive technologies clustered around breakthroughs in AI, the convergence of human and machine capabilities, and its multiple applications through the “internet of things,” is seen by Chinese leaders as fundamentally transforming the structure of the global economy and determining the future distribution of global economic power. It is also seen as deeply instrumental in the ongoing “informationization” of warfare, including the deployment of new forms of autonomous offensive and defensive weaponry in remotely controlled battle spaces.

Given the revolutionary, game-changing nature of these emerging technologies, China sees a combination of threat, opportunity, and urgency. China, having lagged behind the West badly in the first three industrial revolutions, is determined not to do so again. Indeed, Beijing sees an opportunity to dominate and deploy these technologies to leapfrog the United States and the rest of the West economically and, if possible, militarily. China has also concluded that the United States and its allies are now embarked on a strategy to deny it access to these technologies in the future. From Beijing’s perspective, this leaves China with little alternative other than to achieve national self-reliance as quickly as possible. China has therefore embarked on a centrally coordinated strategy embracing an unprecedented national scientific research effort, the large-scale acquisition of targeted foreign firms, technology transfer from foreign joint ventures in China, the rapid development of national and global product champions, and, according to the U.S. authorities, large-scale technology theft.

In this rapidly unfolding technology war, the stakes have become very high indeed, dwarfing the traditional domains of trade, investment, foreign policy, and even classical security policy in its overall significance. In many respects, it has become the central terrain of the relationship. Therefore, for anybody seeking to navigate the already complex domain of U.S.-China relations—past, present, or future—the failure to incorporate the significance of this rapidly developing yet still undeclared technology war will render any conclusions reached on a way forward as radically incomplete.

AI has many definitions, but fundamentally it describes systems that interpret information, make decisions based on that information, and adapt and learn from the outcomes of these decisions. In recent years, advances in AI have accelerated with the ability to process big data through improvements in semiconductors and interconnected computing power. China now sees itself as being in a highly competitive race with the United States across the full spectrum of artificial intelligence.

Within this field, China has a range of strengths and weaknesses. First, there is the availability of pure data. China, at least at this stage, has great advantages over the West given the vast size of its population and the volume of collectable data from the existing Chinese network of digital communication, economic, and social transactions and other personal information, with few privacy restrictions inhibiting effective access. Because this access to data represents a major first-mover advantage over competitors, China has limited the cross-border flow of its own data banks to other countries. It has mandated under its own Cyber-Security Law that foreign firms like Apple must build data storage facilities in China rather than using any offshore facilities. Nonetheless, there is a real debate as to whether China’s current data advantage will be permanent as digital governance regimes in the United States, the United Kingdom, and Europe become more settled and greater access to individual data becomes more feasible at scale. For the time being, however, China’s raw data advantage is real.

Second, in the race to produce the most effective and efficient semiconductors and computer chips, a significant advantage is still held by U.S. and a limited number of other non-Chinese firms. On semiconductors, as of 2018, China was only manufacturing 5 percent of total global supply, while the United States provided 45 percent, primarily through its major corporate leader in the field, Intel. The other two global leaders in semiconductor technology are Taiwan's TSMC (China's largest supplier) and Korea's Samsung. Indeed, as of 2019, the U.S. semiconductor industry collectively represented about 50 percent of total U.S. exports to China. China's vulnerability to U.S. domination of the field was demonstrated by the 2018 decision by the Trump administration to ban all U.S. semiconductor sales to the Chinese national AI champion ZTE (subsequently temporarily lifted), which came close to collapsing ZTE altogether. This followed a 2017 decision by the administration to block the purchase of a U.S. semiconductor firm by a Chinese state-owned enterprise on CFIUS grounds. Taiwanese law also does not allow any Chinese equity in TSMC. Similar provisions apply to Samsung's semiconductor operations. Part of the reason why China has remained vulnerable in this sector, despite massive efforts to buy technology and talent or just copy, is that the microscopic size of semiconductors has made classical reverse-engineering approaches a near technical impossibility. As a result, the U.S. industry believes that China, as of 2019, is at least five years behind the most recent advances in semiconductor technology. This has been reinforced by some Chinese industry analysts who argue the gap is even greater. While Chinese efforts to close this critical gap will continue, the degree of difficulty should not be underestimated.

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Third, on the technology that integrates semiconductors or integrated circuits into a single computer chip, a more complex and competitive picture is emerging. China has made more rapid progress in the development of specialist computer chips, particularly focusing on 3D images, voice, and text recognition. This is in contrast to more generic computer chips targeted on the general computing market that are repurposed for AI-algorithmic purposes, which have been the long-standing strength of the American industry. China's own significant indigenous AI state research and development effort has focused on high-powered specialist chips where the gap with the United States and the rest is narrower than for generalized chips and semiconductors.

What China is seeking to do is to overcome its natural deficiencies in specific AI technologies and systems by directing a massive state research effort across the industry at large. For example, as of 2019, 48 percent of all AI start-ups globally were listed as Chinese, while 38 percent were American. It remains to be seen the extent to which these Chinese start-ups represent effective individual claims to new, free-standing technologies, or whether their numbers have been inflated because many are dealing with almost identical patents. The truth, however, is that from a near-zero base only a decade ago, Chinese firms have become, at minimum, significant big data and AI innovators. They have also become the leading adapters of emerging technologies developed elsewhere (for example, in digital payment systems), thereby providing massive cash flow for reinvestment into primary research. Indeed, in the commercial adaptation of AI technologies, China on an economy-wide basis now leads the United States in many fields.

Parallel with this debate on the nature of the Chinese challenge on AI is the escalating dispute between China and the United States on next-generation mobile telecommunications. Fifth-generation or 5G data networks can transmit data at 20 times the speed of current 4G networks, drawing on the combination of mid-band and high-band radio frequencies used by those networks. The macro-significance of 5G is that it becomes a major new enabling platform for the deployment of future AI applications globally. China has become the undisputed leader in 5G technologies, infrastructure, and systems, both within China and in

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a growing number of countries around the world. The Chinese state is estimated to have invested some \$180 billion between 2014 and 2015 in the development of 5G technologies. This was based on a specific state plan agreed in 2013 aimed at making China a global 5G leader—including the generous allocation of high-band spectrum, the building of 350,000 mobile towers across the country, as well as the direct support of national champions such as Huawei. China’s plan is to launch its global 5G network in 2020. Domestically, the rollout is already under way, with three major telecom firms unveiling 5G packages on November 1. Ten million users were already registered prior to its launch.

As the U.S. Defense Innovation Board has stated, “China is on track to repeat in 5G what the United States did with 4G.” China’s subsidy of its domestic 5G program also extends offshore through the rollout of the “Digital Silk Road” across a growing number of BRI participating states. These 5G networks, including mobile telephone, internet, and other digital services, are also likely to be subject to Chinese digital governance frameworks, including the potential accessibility of local data holdings to China’s security and intelligence services.

China’s leadership resents the U.S. campaign against the rollout of Huawei’s global 5G network. China has argued, credibly, that neither the United States nor its allies have developed an alternative to Huawei’s 5G technology. Nor do they have the intention or the capability of laying out a global system of under-sea cables and mobile terrestrial towers necessary for supporting such a network. China, however, has a more limited response to the American counterargument that Beijing, for similar national security reasons, has never allowed foreign providers into the Chinese domestic telecommunications market. Similarly, China is unable to provide assurances that U.S. global military, security, or intelligence communications would remain sacrosanct as a result of China owning, operating, and regulating a 5G network relied on by them, particularly at a time of crisis. The American decision in May 2019 to formally “list” Huawei as an entity whose activities are contrary to U.S. national security interests meant that in the absence of specific, case-by-case approvals by the commerce secretary, U.S. firms were banned from selling microprocessors to Huawei—essential for the further rollout of its global network. Other Chinese entities have also been listed. The Huawei listing has complicated China’s ability to set the global industry standard for 5G, despite the fact that Huawei is the market leader in what remains a limited field of only two Chinese, two Nordic, and zero American firms. In many respects, the May 2019 entity list represented the formal commencement of hostilities between China and the United States in the new technology war.

Xi Jinping is aware of the significance of all this. He has chaired two Politburo committees with overlapping responsibilities in this area: the Central Commission on Internet Affairs and the Leading Group on Internet Security and Informationization. China's information and communications technology (ICT), AI, and overall high-technology strategy washes across the full spectrum of the Party's priorities: iris, facial, and gait recognition technologies in support of the Party's domestic political surveillance efforts; social credit scores to underpin political compliance; combined AI and ICT capabilities enabling the Party to better communicate its propaganda to its members and to the people with more tailored messaging; enhanced cyber capabilities for offensive and defensive security operations; support for greater economic growth through new market applications of AI; potential improvements in education, health, aged care delivery, and the general effectiveness of Chinese governance; reinforcement of the BRI; enhancement of China's military capabilities; and use of China's new technological leadership to underpin its role in the future determination of industry and international governance arrangements. Xi Jinping's China sees the battle for technological primacy as the single greatest determinant of the country's and the Party's future competitiveness. Overall, Xi Jinping would be pleased with the pace of China's progress so far. In 2019, a report was prepared by the U.S. Information Technology and Innovation Foundation examining 36 different measures of China's progress in catching up with the United States in cutting edge technologies. It concluded that "China has made progress in all indicators, and in some areas now leads the United States."

The reality is that a significant degree of technological decoupling between the United States and China is already under way. Of course, this began nearly two decades ago when China decided to embark on internet sovereignty to restrict the free flow of information to its citizens. It is now likely to occur with 5G because of U.S. and allied national security reasons. And on AI, a combination of U.S. national security requirements, as well as China's pre-existing strategy of achieving national self-reliance, places this sector on a decoupling trajectory. This is to the great despair of the U.S. semiconductor industry, for which China is the single largest market and whose profits are redeployed into next-generation research to guarantee continued U.S. technological leadership in the field. It does not mean that future sales of American semiconductors and chips to China are likely to be totally banned. It does mean, however, that the regulatory restrictions on the trade will become greater. While U.S.-China collaboration in other fields of emerging technology may well continue (for example, in biotechnology) for some time to come, new restrictions are beginning to emerge in this sector. Decoupling will also have a profound impact on future global industry standards, regulation, and governance arrangements as a range of unilateral, plurilateral, or multilateral regulatory worlds begin to emerge.

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Capital Markets

The prospects for decoupling the two countries' capital markets, however, are considerably less likely. The reason is that the current degree of mutual interest and exposure is simply too great. The current U.S.-

China bilateral financial relationship stands at just over USD \$5 trillion. This includes Chinese listings on U.S. stock exchanges (USD \$1.9 trillion); USD \$1.5 trillion in Chinese stocks and bond holdings on Chinese and Hong Kong exchanges intermediated by U.S. firms; USD \$200 billion in Chinese holdings of U.S. corporate stocks and bonds; USD \$100 billion in U.S. cross-border lending to Chinese firms; as well as USD \$1.1 trillion in Chinese official holdings of U.S. Treasuries; and a further USD \$200 billion in other U.S. government bond holdings. The bottom line is these are very large numbers indeed.

By and large, whatever strategic difficulties these two governments may have with each other, it continues to be in each country's interest to maintain these arrangements. From China's perspective, there is no ready alternative to the diversity, depth, and liquidity of U.S. capital markets. Second, China as of 2019 will, for the first time in a quarter of a century, run a modest current account deficit. This is likely to become a long-term structural deficit, consistent with China's overall economic development and not inconsistent with other countries experience at this point of their economic history. China will therefore face a net financing requirement, which means that continuing access to global capital markets will be

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necessary to balance the current account. Of course, China could look to European and other financial markets to meet these needs, just as it could look to these markets, or its own domestic capital markets, if Chinese firms suddenly no longer were able to list in the United States. Indeed, China has contingency plans for both scenarios should the decoupling contagion begin

to infect capital markets. But at present, because of the large-scale mutual interests at stake in keeping capital markets open, the prospects of that happening still seem remote.

There are, however, two proposals currently before the U.S. Congress that could change this equation. The first is the so-called Equitable Act, which threatens to delist from U.S. exchanges any firm that fails to provide regular audited reports to the Public Company Accounting Oversight Board. This directly affects Chinese listings in that many are state-owned enterprises that have routinely failed to comply. There are around 230 Chinese firms currently listed on U.S. exchanges. If the Equitable Act passes the House and the Senate, failure to comply would result in their delisting. However, because of the impact of such a significant measure on U.S. firms benefiting from these listing arrangements, not to mention the New York Stock Exchange itself, it still seems unlikely that the proposed legislation will become law. Those who oppose the legislation further argue that a failure to provide the exchange with full audit reports will generate its own penalties, through lower share prices as investors mark these stocks down. This, it is argued, is a more effective means of dealing with noncompliant firms than the drastic step of compulsory delisting.

A second legislative proposal is being introduced by both Republican and Democrat lawmakers seeking to restrict U.S. public pension funds, particularly the Federal Retirement Thrift Investment Board (FRTIB) from investing in certain Chinese firms which are alleged to be complicit in human rights offences. At least three Chinese firms are under particular scrutiny by the initiating senators: AviChina Industry and Technology, which is alleged to be associated with the Chinese People's Liberation Army; Hikvision, which has supplied surveillance equipment to China for use in the crackdown against Uighurs in Xinjiang; and China Mobile, which has an alleged relationship with Chinese security services and is already banned from operating in the United States. The FRTIB currently manages a total fund of USD \$600 billion. Were this

to be given effect, it would have a significant effect on the investment decisions of U.S. portfolio managers. It would also generate an inevitable Chinese reaction.

While U.S. legislators consider imposing these new restrictions on Chinese access to U.S. listing opportunities and portfolio investments, China for the last 12 months has been moving in the reverse direction by opening up its own capital markets more. In September 2019, China removed all quotas on Qualified Foreign Institutional Investors to purchase domestic A shares on the Shanghai and Shenzhen exchanges. At present, foreigners only hold about 2 percent of Chinese equities. This is now likely to rise (industry predictions suggest rising to 10 percent by later this decade) as institutional investors seek to increase their China exposure as part of a balanced global portfolio. These developments have been enhanced by recent decisions to include Chinese equities in MSCI and Barclay's indexes—the very indexes that are drawing the attention of U.S. lawmakers and the FRTIB. Similar liberalizations are occurring in Chinese bond markets where at present foreigners hold about 8 percent of total bonds issued by Chinese firms. That percentage is likely to rise as well. Changes allowing fully owned foreign companies to become majority participants in the Chinese domestic insurance, brokerage, and other financial service industries also point in a liberalizing direction.

Therefore, despite certain proposed legislative activity in the United States (where the prospects of passage remain unclear because of major opposition from the U.S. financial services industry), the sheer scale of the mutual interests at stake linking U.S. and Chinese capital markets, combined with China's domestically driven decisions to internationalize its own domestic financial services sector to help service its emerging current account deficit, means that the prospect of any significant decoupling of capital markets is a long way away.

Currency Markets

As for the future of currency markets, three sets of issues arise. The first is the long-standing debate between the United States and China on the proper valuation of the yuan. The second concerns the yuan's role as a future global reserve currency. And the third is China's recently announced determination to launch its own international digital currency, in part to reduce its future exposure to the risk of dollar weaponization against Beijing if the bilateral political relationship progressively collapses. Of these, the latter is the most recent, and potentially the most controversial.

On the first of these, despite episodic rhetorical fusillades between the two countries, including President Trump's recent declaration that China is a currency manipulator, China is likely to maintain its current "managed float," whereby the yuan is allowed to move within a defined band each trading day. Trump has indicated phase one of the proposed trade deal between the two countries is to conclude a new currency agreement. It is unclear what this is likely to include, although the yuan has depreciated by 10 percent since the beginning of the tariff war 18 months ago. If the trade war were to deteriorate further, economic decoupling to gather pace and the political relationship to grind into the dust, then a further round of exchange rate wars would be possible. China might be attracted to using the exchange rate to mitigate against the impact of future tariff increases. However the problem is that it would result in an exchange rate war between China and all its trading partners, generating political frictions on every front. This represents a significant political disincentive for Beijing.

Second, the internationalization of the yuan has long been a project for the People's Bank of China. Yet China's political leadership, mindful of the lessons of the Asian financial crisis, has long resisted floating the currency and opening the country's capital account. China's long-standing fear has been its potential exposure to international hedge funds and the possible political manipulation of currency markets to destabilize China's political system. These decisions, on both the yuan and the Chinese capital account, have long constrained China's ability to turn its currency into a significant international reserve currency, thereby lessening China's dependency on the dollar intermediation of its global financial transactions.

China has succeeded in having the yuan accepted as part of the International Monetary Fund's special drawing rights reserve basket of currencies. China has initiated some 36 separate bilateral currency swaps with its trading partners, although the proportion of global trade settlements concluded outside the dollar-denominated system remains small. China has even initiated with Russia an alternative to SWIFT, the dollar-based international financial settlement system. But as of 2019, the dollar remains dominant. The yuan is still a marginal player at best in the international currency system, with 62 percent of global reserves held in U.S. dollars, 20 percent in euros, 5 percent in Japanese yen, 4 percent in sterling, and less than 2 percent in yuan—about the same as global reserve holdings of the Australian dollar. Furthermore, the U.S. dollar is used in 88 percent of all foreign exchange transactions, compared with 4 percent for the yuan. Because of the long-standing depth, liquidity, and reliability of U.S. global debt markets, in contrast to China's continued reluctance to open its capital accounts and float its currency, China has limited

China has limited options to reduce its own global dollar dependency, despite its paranoia that it will one day become victim to the weaponization of the dollar against it.

options to reduce its own global dollar dependency, despite its paranoia that China will one day become victim to the weaponization of the dollar against it, as it has witnessed with other U.S. geopolitical adversaries including Russia, Iran, Venezuela, and Iran.

China, however, has begun to look at more unconventional ways in which it can deal with its continuing strategic concern over the country's dollar exposure, as well as expand its overall global financial

footprint. Chinese commercial platforms Alipay and WeChat Pay are already two of the world's largest digital payment platforms, generating some USD \$8.4 trillion in payment transactions in the first quarter of this year alone. China wants to build on this strength by developing its own international digital currency. It also wants to prevent other potential international competitors, like Facebook's Libra, from securing serious first-mover advantage in the international marketplace. Indeed, Mark Zuckerberg warned Congress in his recent testimony that unless the United States backs commercial efforts like Libra, America risks ceding the global ground to China in this new, rapidly unfolding global domain. China does not want its own international digital customers becoming tethered to a digitized currency within the regulatory control of the United States. China's new cryptography law was just passed by the National People's Congress, coming into effect on January 1, 2020, which will support the release of the new digital renminbi. This latest development has some potential to challenge the dollar over time as the global payments system becomes progressively digitized. These are very early days. The precise impact on the dollar remains uncertain. But China clearly senses a serious opportunity to reduce its global dollar dependency by leapfrogging the United States as an early adapter of international digital currency innovation.

Education, Research, and Talent

One final area to examine is what is happening with education, research, and the free flow of talent between the two countries. This is perhaps what concerns me most of all. I fear we are slowly entering a new McCarthyism in which increasingly Chinese Americans in general, not just Chinese students studying in America, are under a veil of suspicion. I begin to sense the same may be emerging in China, where Americans may increasingly become the targets of the Chinese security agencies. The refusal rate for Chinese government-sponsored visas went from 3 percent in the first quarter last year to 13.5 percent in the same period this year. For the 2017–2018 academic year, there was a 6.6 percent decline in the number of new international enrollments in general at American universities. This followed a 3.3 percent decline from the year before. This is the first time there have been year-on-year declines.

This follows a decision announced in the U.S. National Security Strategy in 2017 to review visa arrangements for foreign science, engineering, technology, and mathematics students from designated countries. It also follows a statement from the State Department in June of this year that it would begin reviewing the visas of existing Chinese students in these areas. Visa renewal times for Chinese students have also now been considerably lengthened. These changes also impact the perceptions of Chinese students. According to a 2019 survey conducted by the Beijing Overseas Study Abroad Association, for the first time, the United Kingdom has passed the United States as the preferred destination for Chinese students.

Meanwhile, on the Chinese side, Beijing has shut down more than 200 higher education programs run in conjunction with foreign, including American, universities. China has its own security-related reasons for doing this—although it would be analytically flawed to claim this was just in response to these most recent American actions. Beyond all the above, there are also many reports of visiting American and Chinese scholars, think tankers, and even officials across multiple fields increasingly experiencing visa restrictions, delays, and outright rejections.

Has the great decoupling begun in the field of human talent? The early data is not encouraging. It is possible we are now in an adjustment period as new visa-related administrative arrangements are put in place. The numbers may then stabilize. But we would be foolish to ignore the early trends. If these trends become sustained, then this would become the greatest decoupling of all.

National security concerns in both countries are real. Let us not pretend they are not. But there is a danger that the normal operation of our security and intelligence operations in safeguarding the integrity of national research, scientific, and technological institutions triggers a tidal wave of exits from both countries as personal safety concerns rise to the fore.

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We seem to have lost sight of how far we have come over the last 40 years. Back then, at the beginning of the period of reform and opening, Chinese students in America and American students in China were relatively rare, almost exotic. We have come a long way since then to the extent that extensive travel, engagement, and personal experience of each other's countries has become normal. Are we on the cusp of reverting to an earlier, atavistic age?

We seem to have lost sight of the fact that more than 3 million Chinese students over the last 20 years have been educated at American universities—many more if we add the United Kingdom, Canada, and Australia. They also constitute the biggest voice of moderation and understanding of the United States and

the West across China's vast political and economic system. It would be deeply counterproductive to our interests for this to be decoupled as well.

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Conclusion

As we can see from this survey, the emerging picture across these various domains of economic engagement and/or decoupling is mixed.

- In trade, there will be new restrictions in technology exports, but China's overwhelming interest for the decade ahead is to maintain its export markets in America. American industry, from semiconductors to agriculture, albeit for different reasons, shares many of these interests.
- FDI represents a different story: some level of decoupling of sorts has begun in Chinese investment flows to the United States, although these have driven by a range of other Chinese policy considerations, not just U.S. regulatory changes.
- Decoupling is likely to become more acute in technology markets, product regulation, and industry standards, in part because of American national security concerns and in part because of China's desire to maximize its own national self-reliance.
- The story is quite different in capital markets, where the sheer magnitude of mutual self-interests appear to be militating against any significant decoupling.
- Where a more complex form of decoupling may emerge is with currency, as the full implications of China's recent announcements concerning its proposed new international digital renminbi are yet to be seen; we would be prudent to watch these developments very carefully indeed.
- And then there is talent, where the early signs are not encouraging at all.

After an 18-month-long trade war, it appears that both sides have stopped, stared into the abyss, concluded that it is a very long way down there, and a lot of people on both sides could get seriously

hurt—and without any real lasting benefit to anybody. That is why I have argued for the last 12 months that mutual economic interest would eventually kick in and that we would see an imperfect, negotiated outcome by year's end. Given that both presidents have an interest in strengthening their economies in the year ahead (President Trump for re-election, and President Xi to reduce the self-induced economic headwinds he currently faces in China), we will see a phase one deal by the end of 2019, probably involving a deferral or cancellation of the proposed December 15 new tariffs, and possibly some reduction in existing tariffs. As for a phase two deal, it is more probable than not that it will be agreed next year. If so, it would need to be accompanied by the elimination of all tariffs as this is China's bottom line for any concessions it will make on outstanding policy disagreements. Removing all tariffs may be difficult in a presidential election year, in which case negotiations may also continue through until the end of 2020. But the bottom line is there seems to be limited appetite to do further damage to the trading relationship, an interest in repairing it somewhat, as well as sustaining a process for resolving the rest over time.

Resolving or reducing the scope of the trade war is one thing. But that will not of itself mean the end of the technology war, the “talent” war, the declining flows of FDI or the new, emerging uncertainties on currency. These “wars” are likely to continue in response to political and regulatory toughening in both countries. The danger of a negative spiral remains. Some decoupling is now unavoidable. But full-scale decoupling does not at this stage seem probable. Although China's contingency plans for such an eventuality are being developed, with self-reliance and global diversification beyond America being the key.

Beyond the economic relationship, foreign and security policy tensions will continue to grow between Beijing and Washington. Military competition in East Asia and the West Pacific will intensify. Taiwan tensions will grow both in the lead-up to and in the aftermath of the 2020 Taiwanese presidential elections. Hong Kong will be unlikely to resolve itself in the near term, although skillful management from Beijing *may* assist in reducing tensions over the next year or two, particularly as China has no interests in militarily intervening. The South China Sea is likely to see sharper incidents between China, the United States, and its allies although these are also likely to fall short of direct confrontation or conflict. Strategic competition between China and the U.S. will expand in the Indian Ocean, the Gulf, Africa, and Latin America. Europe will become increasingly contested ground in trade, investment, and technology between Beijing and Washington. And across the multilateral system including the United Nations, the WTO, the United Nations Framework Convention on Climate Change, and other institutions, China will continue to make inroads at America's expense as the current U.S. administration continues to walk away.

We are unlikely to witness a complete collapse in the U.S.-China relationship. Instead, we are likely to muddle through to the end of 2020. But the long-term trend line is heading south, given that structural nature of the geopolitical rivalry between the two counties will only intensify. What happens under a

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reelected Trump presidency on U.S.-China relations is uncertain. China fears that without the discipline of a subsequent election to contain him, Trump will let loose those within his administration who have yearned for real decoupling but have so far been kept on a short leash during the trade war. How this would play out after a Trump win is unclear. Furthermore, what a President Joe Biden or President Elizabeth Warren may do on China remains an equally open question. Their administrations would likely be staffed by a coterie of serious China hands. They are likely to develop a systematic, hard-line strategy on China. But they are unlikely to see any real policy benefit or leverage in fueling a wide-spread economic decoupling in the overall relationship.

In the midst of all this uncertainty, both in Washington and Beijing, it would be wise for both governments to look afresh at how they might navigate the difficult decades ahead. Full-scale strategic competition, without any effective rules of the road, can be a dangerous and destabilizing thing. The alternative, which I advocate, is a form of “managed strategic competition.” This would mean a mutually agreed framework with defined areas of fundamental strategic disagreement (which might be managed

according to agreed protocols to prevent unnecessary escalation); areas of major disagreement where strategic dialogue is possible, both to manage and to narrow such areas of potential escalation; as well as areas where collaboration and cooperation are not only possible but mutually desirable. This is difficult work. But it is more productive than simply standing idly by, watching, waiting, and, in some cases, hoping for one form or another of economic or strategic decoupling to unfold, all as a product of political and diplomatic inertia. And then just hoping for the best. Hope is not a strategy. Nor is anger.

Managed strategic competition might also provide a framework for third countries to work with. If decoupling unfolds over time, and an

Rather than the “great decoupling,” therefore, perhaps we are seeing something more approximating the “great unravelling” of the global rules-based order so painstakingly constructed in the decades following the last world war. And that would be a tragedy for us all as we enter a new era of the law of the jungle.

increasingly binary international system unfolds, third countries will come under increasing pressure to make strategic choices. The Huawei matter may be the first of many such choices to come, and not all in technology. It is often assumed that a bipolar world is primarily a problem for third countries. That is not necessarily so. It may also be as big a problem for China and the United States themselves because if choices are forced on the world, Beijing and Washington may not be entirely delighted by the choices that are then made. This is why some of us have been lifelong advocates of multilateral orders because they reduce the conscious or subconscious binary imperative.

Beyond U.S.-China, we may have already passed “peak globalization” as we move into the third decade of the current century. Not just because of the unfolding strategic competition between the two great powers of the twenty-first century. Not just because of the steady emergence of competing regulatory systems between them in the internet, mobile telephony, and artificial intelligence. But also because of the new forces of protectionism, populism, and nationalism now at work across the world. These forces have

become increasingly legitimized over the last several years. They have moved from the margins to the center of the politics of many countries in the developed world, and elsewhere as well. Rather than the “great decoupling,” therefore, perhaps we are seeing something more approximating the “great unravelling” of the global rules-based order so painstakingly constructed in the decades following the last world war. And that would be a tragedy for us all as we enter a new era of the law of the jungle.

A photograph of Donald Trump wearing a red "KEEP AMERICA GREAT" cap and a dark suit with a red tie, standing in the center of a large crowd of Naval Academy cadets. The cadets are wearing dark uniforms and white officer-style hats with gold anchors. Trump has his right fist raised and is speaking. The background is filled with many other cadets, some looking towards the camera and others looking away.

7. The Avoidable War

John F. Kennedy Jr. School Forum
Harvard Kennedy School, Institute of Politics
Cambridge, Massachusetts
December 5, 2019

Interview with Graham T. Allison, Douglas Dillon Professor of Government at Harvard Kennedy School and the author of *Destined for War: Can America and China Escape Thucydides's Trap?*; and Jane Perlez, former China correspondent for the *New York Times*.

Edited and abridged for brevity.

GRAHAM ALLISON: What we want to do tonight is explore the China challenge. Kevin is now writing a book called *The Avoidable War*. So I thought we would start with a game plan where Jane and I would ask a couple of questions to Kevin to get started, then have a conversation, and at some point we'll go to the audience for questions. I'm going to start at the top with the title, *The Avoidable War*, and the book that you're writing. Give us the elevator brief. When are we going to get a chance to read it?

KEVIN RUDD: Thanks for having me back at the Kennedy School and the Kennedy Forum. Graham, it's good to be here with you and Jane. To all of the students here at the Kennedy School and Harvard University, to echo what Graham said before, if public policy is what lights up your life, if that's what animates your soul, go for it. Because all of our countries need your expertise—and this country, the United States, in particular.

As you asked me about the book that I'm working on at the moment, *The Avoidable War*, well, I suppose someone had to write the response to the Graham Allison book *Destined for War!* We also worked together here at Harvard in 2014 just after I left political office in Australia, and Graham offered me political exile here. I'm still a senior fellow here at this illustrious institution.

Graham's book *Destined for War* is an excellent read because it points to a range of historical probabilities. As you all know, those of you familiar with the literature—rising powers, established powers, changes in the balance of power between them, and what states are observed to do under those circumstances in history. And what they may be doing now, in the case of China and the United States. I'm not a historical determinist. I think agency—what we do as political leaders and as political elites within countries—actually matters and changes the course of history. But what we have with Graham's book is a solemn reminder of the structural forces at play.

When I look at this China-U.S. relationship, I see two or three things at work. Observably, there are objective changes in the balance of power between these two countries, whichever barometer you use—the military, the economy, technology, hard power, soft power, at least to some extent. Second, what we see in the case of China under Xi Jinping is an infinitely more assertive Chinese leadership across all the domains of global policy. It's quite clear that this is happening. And third, we also are observing, under the current U.S. administration, the trajectory of an America that is uncertain about its future role in the region and in the world. When you put those three things together, what I see is dangerous terrain ahead—one that can either be left to the “forces of nature,” so to speak, and we'll see what happens, or, alternatively, you think through how this new era of so-called strategic competition can be navigated.

Some would say that under these circumstances, war might be seen as inevitable. I don't have that view. It might be seen by some as probable. I don't actually share that view either. But I do think it's possible through mutual mismanagement as we go through a very difficult decade ahead. We have to be frank about some of the lessons from history, particularly in 1914, to understand how crises arise, how they can be mismanaged, and how they can end in absolute catastrophe. I'm aware of the fact that this relationship is different from any of the 1914 relationships, not least because you've got a level of nuclear deterrence at work. But that doesn't resolve everything.

What I seek to do in the book is to say, “Here are the things working against us, but also how this might still possibly be navigable into the future.” What I find now in the literature in both the United States and Beijing is that you’ve got two giant cheer squads. One in the United States is urging America, “Go, go, go! USA, USA, USA! And here is how you can ultimately stop those Chinese from taking over the world.” But I’ve got to say to my Chinese friends that it’s basically the same in China. You see a whole bunch of people, with various levels of bias from across the Chinese policy establishment, talking about

I’ve tried to...identify a third way on how these two mature states, which between them have much historical wisdom, could navigate a peaceful but nonetheless competitive future between them. I argue this can be done through what I call “managed strategic competition.”

how China can ultimately prevail in this contest, in this great strategic competition, against America. What I’ve tried to do in the book is identify a third way on how these two mature states, which between them have much historical wisdom, could navigate a peaceful but nonetheless competitive future between them. I argue this can be done through what I call “managed strategic competition.” That’s essentially what the book is about. We can go into a little more detail later on, but enough from me on the prospective book promotion. It will come out sometime next year if the publisher has sufficient patience with me.

because you combine an understanding of both China and the United States over a long period of time without being captured by either, to offer a serious analytic capability for thinking about options. Which is what we try to teach about and learn about here at the Kennedy School. But also you’ve been in the real arena of politics, where the abstractions of the academy are translated into something more practical.

ALLISON: This is an arena that I’ve been searching in fairly desperately for the past three years since I sent my book to the publisher. I think you’re likely, particularly

RUDD: The virtue of being in office, when you’re in the political process, is what you learn experientially about “agency.” What we discuss in the international relations and political science literature is real. The decisions of political leaders matter. We’re not simply some kind of puppet of anonymous structural forces out there somewhere. What leaders decide, and those who advise them shape, actually determines the future course of history. And so, what is reinforced for someone who’s long had an interest in international relations, but also someone who has been a practitioner as prime minister and foreign minister, is that what you decide in office fundamentally matters. It changes the course of things.

JANE PERLEZ: We’ve got to assume that in your book you’re going to be tackling one of the big questions, which is, “How is the big tussle in the Indo-Pacific region going to be resolved?” So you could look at it this way: you could say the United States is going to concede its 70 years of military and economic dominance in the region. You could say that China is going to back off its goal of dominating the region. Unlikely in both cases. So that leaves you with some kind of negotiated deal. What would that look like without each side losing strategic advantage? And in that situation, wouldn’t the United States have to give up a lot on Hong Kong, Taiwan, the South China Sea, and the East China Sea?

RUDD: I accept some of the premises of the question, although not all of them. If you look at the wider region, there's one set of scenarios about China, which is what I describe as the "CIA optimism scenario"—which is that China will just kind of internally implode. I've been reading various versions of this for the last 35 years that I've been in public policy. It hasn't quite happened yet. So I'm not convinced of this one myself. There are certainly structural questions within China. The political economy questions are real: the forces of left control within a party-controlled state, and an economy, which is a market economy, that is also now being pulled to the left. There are plenty of things that can go wrong in the China model. But it's prudent for everyone to assume that this model, which has been around for 40 years or so, is going to bump along and, on balance, continue to work into the future. I don't think it's prudent to base policy on assumptions that China will fall apart.

Then you've got another set of assumptions—that the United States will get its strategic act together. Right now, in my own judgment, it doesn't have its act together. I think what passes for high policy in Washington at the moment is a strategic shambles.

And I've seen a lot of the U.S. administrations over the years, worked with a lot of them, Republican and Democrat. But this one's right out there. But there's a big caveat to that, which is people assuming the inevitability of the reelection of Donald Trump. If the Democrats are elected, under a candidate able to assemble a professional team, they would be capable of constituting afresh a viable long-term strategy for dealing with China's rise. This, too, must form a critical part of our assumptions for the future. It's not inevitable, but it must be a credible part of our assumptions for the future.

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And finally there are assumptions about China itself. What I think is reasonably credible is that we are still going to have a coherent China, continuing to grow, albeit with an imperfect model. As well as an America that doesn't simply degenerate, but in fact rebuilds and reconstitutes itself. So there are my premises for what we are looking at in the future.

I do not believe that you can credibly have a grand strategic bargain, which in the tradition of Spain and Portugal and the post-medieval popes draws a line down the center of the map and says "yours" and "yours." It's not going to be like that. But I think what you can do is go back to my notion of "managed strategic competition." This is something with four or five core points to it.

First, I'm a realist in the sense that, ultimately, the behavior of states is determined by the realities of both an objective and a perceived balance of power. It may be an old-fashioned view in various parts of the world. But my observation of states' behavior is that this is a critical determinant. At present, there is an assumption that this is all just drifting in China's direction. But if the United States acts militarily, economically, and, to some extent, technologically, that is no longer simply an assumed reality. The balance of power could continue to be in America's favor for quite a long time into the future. That's the first element in the equation: strategic realism. And on this, the ball is very much in America's court. It's doing a very bad job of it at present—the fracturing of alliances is just one example. But this could change. The balance of power, however, remains the fundamental element in any effective framework for what I call "managed strategic competition."

The second element requires a definition of the core national interests of each side—that is, interests that at this stage are *non-negotiable*. Here we need to take a lesson from the nadir of the Cold War and what can be learned from the evolution of the U.S.-Soviet relationship when things went radically wrong over

Cuba. The international authority on Cuba and the missile crisis is sitting to my right (Graham Allison), and his seminal text is *Essence of Decision*. A mature reflection on the Cuban missile crisis, and what then happened in the period of détente that came sometime afterwards, is instructive. Both sides looked into the abyss and said, “that is indeed a very deep hole which we should not fall into.” So on the fundamental, core national interests you’ve mentioned—Taiwan, South China Sea, East China Sea, and one or two others besides—lines need to be drawn. At the high point of détente, drawing on a culture of absolute strategic realism, in the private diplomacy of the United States and the Soviet Union, certain red lines were indeed drawn. Both sides knew where not to go. These may have been contested red lines, but they were clear red lines nonetheless. The problem at the moment is a lack of clarity on similar red lines between China and the United States. And a lack of clarity can cause you to fall

If you have the rest of the conceptual architecture...for this overall framework of “managed strategic competition”—anchored first in the balance of power, and based then on a set of non-negotiable and negotiable national interests across the rest of the relationship—then the final principle should be “may the best man, or woman, win” in this ultimate contest of ideas.

into the abyss. Thus, in the logic of “managed strategic competition,” there is a category in which I would try to define the national interests that are core to each side and where negotiated resolutions are at this stage impossible.

Third is what I’ll describe as *negotiable* national interests. That’s where, for example, under a future Democratic administration, the common interests of both sides for a global compact on climate change are self-evident. This was certainly the case under the Barack Obama administration.

The final element of what I describe as “managed strategic competition” is this: we’d be blind not to recognize the fact that at present, we also have an emerging contest of ideas. It’s not as sharp and as stark as it was during the Cold War between the Soviet Union and United States. But we have, in effect, liberal capitalism versus authoritarian capitalism. These are the two models progressively on offer. And you all know the subdetails of each.

So if you have the rest of the conceptual architecture, which I’ve just described, for this overall framework of “managed strategic competition”—anchored first in the balance of power, and based then on a set of non-negotiable and negotiable national interests across the rest of the relationship—then the final principle should be “may the best man, or woman, win” in this ultimate contest of ideas. If China is confident in the ultimate integrity, utility, and effectiveness of its body of ideas about how to organize a country’s political economy for the future (not just for itself, but more broadly around the world)—well, fine, let’s see who prevails. If, on the other hand, it’s a combination of liberal democracy and liberal capitalism, as those from the West would argue, being the most effective set of ideas for the world, then

these will prevail instead. So let's have an ideological or an ideation contest—but one that doesn't help throw us all over a cliff into irreconcilable conflict, or even war.

PERLEZ: If I could just follow up for one second, we had an interesting class on reasoning from history just last week. Fred Logevall put out five indicators of what the old Cold War was like, and one of the indicators was the absence of diplomacy in the early years. But then there was diplomacy, as you said. So if a new administration comes in, you're saying we can start some diplomacy, modeled after (maybe not necessarily modeled after, but somewhat similar to) that used to manage the problem with the Soviet Union?

RUDD: Yes. I think if you look at the evolution of the Cold War, it unfolds in at least a couple of phases, for which the most critical learning experience was the missile crisis. The missile crisis was in the early 1960s. Détente began to emerge by the late 1960s. Détente was the product of deep institutional reflection both in Moscow and in Washington. If you stand back and look at the balance of power, or what the Soviets and the Chinese would describe as the correlation of forces, this represents, if you like, the *structure* shaping the international environment today—whereas *agency* lies in good-old-fashioned diplomacy and how you actually shape things. Diplomacy matters. It's not just having a chat. Frankly, in high diplomacy, it's about having a set of strategic understandings along the lines of what I was running through before—if you wish to *manage* strategic competition. The alternative is that you roll the dice every morning and see what happens. I'm a little more cautious than that.

ALLISON: Kevin, you're one of the few people—maybe the only person in the room—who knows Xi Jinping, the leader of China. You talked with him the other day in a small group with Henry Kissinger. When Xi was vice president of China, he went and visited you in Australia. And you took him around for, I don't know, a week or whatever. You've studied him for a long time, talked to him many times. So you're talking to him last week: if you were telling him something like what you just said, how do you think he would react to that? And second, what else from that conversation are you prepared to share with us?

RUDD: The honest answer is that I don't know how Xi Jinping would respond to what I just said. But when I was here working with you, Graham, several years ago, I put together at the Belfer Center [at Harvard University] a paper titled “Constructive Realism” as a possible framework for the future of U.S.-China relations under Xi Jinping. We put that into Chinese and we circulated it into the Chinese system. My understanding from our Chinese friends and colleagues, who at that stage were dealing with the Obama administration, was that they found it “useful” in its realism and “positive” in its embrace of constructive diplomatic alternatives. So I do not think, from my own observations and engagements with Chinese think tanks, that this sort of conceptual approach is automatically ruled out at all. That's because it tries to bridge two realities. One is the realist factor in international relations concerning state power. You can't walk away from that. But simultaneously, it's the constructive diplomacy part that enables you to navigate or negotiate the imperatives of state power. I think at that level, I don't think the door has been shut, at least in Beijing, on these sorts of ideas. I'm pretty confident the door would be shut in Washington right now. But maybe, in the future, that will change.

As for Xi Jinping the other day, what I observed with the Chinese president in the hour or so we had with Henry Kissinger and Hank Paulson and a few others in the Great Hall of the People was a

Chinese president completely on top of his game. He fielded happily any question from the floor, without any notes, for more than an hour—on the future of the market in China’s long-term economic reform program, on the future of the U.S.-China trade war, as well as interesting observations about the future relationship between China and Japan. I’ve observed Xi Jinping many times over the years. For a guy who should be under a lot of political pressure at present, because the Chinese domestic economy is weakening, he struck me as remarkably comfortable in his own skin—and confident, at least in dealing with our band of foreign barbarians.

ALLISON: For those of you who don’t follow China carefully, that’s quite a big takeaway, because politicians can understand things about politicians better than the rest of us—and certainly better than analysts like me. They can feel the vibes and watch a lot of the body language and see what’s going on. I should say, objectively, if I were just reading the newspapers, I would also imagine Xi would be under considerable pressure. And certainly for many previous Chinese leaders, and many American leaders, they wouldn’t answer questions of any sort unscripted with such confidence. So that is an interesting take.

RUDD: There’s a huge contrast between Xi and Hu Jintao. Hu Jintao’s style was to read you his talking points. I’ve never seen Xi Jinping use a note in all of my engagements with him. This is quite unique in the evolution of Chinese political leaders. The guy has his own deep intellectual and policy framework. He is very much his own leader. He is not being led by those around him. And I think it’s very important for Americans to understand that.

PERLEZ: I want to ask an Australia-specific question. But before I do it, I can’t resist asking, what did Xi say about the future of China-Japan relations? This is very important, because he is going to Japan in the spring. He’s going to meet with the emperor.

RUDD: China-Japan has been a less than solicitous relationship in recent history. Effectively, Japan was put into the Chinese “sin bin” (a term from Australian football—you get sent to the “sin bin” for foul play) for many years. After the crisis following Japan’s nationalization of the Senkaku/Diaoyu Dao Islands in 2011–2012, we had an effective freeze in high-level political contact between the two countries—until a year or so ago. Interestingly, the “unfreeze” began to happen very soon after the Trump administration declared the end of strategic engagement between the United States and China, thereby beginning this new period of strategic competition. So my own view, not disputed by my contacts in Beijing, was that the Chinese concluded that as the U.S.-China relationship was entering a new period of fundamental structural friction, you could observe a decision in Beijing to reduce tensions at the political level with both Tokyo and with Delhi. And frankly, you see the same with Europe as well on Beijing’s part. So the Japan relationship has been taken out of the freezer. And, as you have said, we have a full state visit in March of next year.

This is relatively new in the “unfreeze.” A whole lot is happening economically in the China-Japan relationship, which hadn’t been happening until a year or so ago. Security tensions remain sharp in the East China Sea. The intensity of, let’s call it, Chinese military and coast guard deployments in and around the Senkakus continues. But in the framework of all that, I was fascinated to hear Xi Jinping’s reflections,

which were along the lines of, “Look, there’ve been some difficult times in the China-Japan relationship. But for the bulk of this history of the relationship between the two of us, it has been much better than that. And geography can never separate us.” He was reflecting an optimism that, structurally, this relationship with Japan could seriously improve. And so I was taken by the forward-leaning, positive nature of his presentation on Japan. And I’m sure it’s been conveyed back to the Japanese side as they look forward to next March.

PERLEZ: So on the Australian position, we are closer to China than the United States is. But we have had a very, very solid alliance with the United States. If I can frame it a little bit, Australia’s first independent diplomatic mission was in Washington in 1940. Am I correct? And ever since, for 70 years, Australia and the United States have enjoyed a very, very strong strategic alliance. But in the last 30 years, Australia has enjoyed a basically recession-proof economy. Why? Because Australia has been digging minerals out of the desert as fast as it can to sell to China and selling other goods to China. Australia has become very dependent on China economically. So the question is, what if something happens in the South China Sea? What if a plane is shot down accidentally? What does Australia do? Is it prepared to sacrifice its economic relationship with China for the long-term defense umbrella relationship with the United States?

RUDD: On the background, you’re right: the relationship with the United States is deep and long, goes back a hundred years. Australians and Americans first jumped into the trenches with each other in 1918. Interesting for our American friends here, U.S. forces were first deployed on the Western Front under an Australian general at the Battle of Hamel. And since then, the relationship, strategically and militarily, has been very close. It’s currently articulated through the ANZUS (Australia, New Zealand, and United States Security) Treaty of 1951, which is a mutual defense pact, like the NATO Treaty, with mutual obligations. If I recall the text of the treaty, it’s that if either of the treaty partners—the United States or Australia—suffers an attack on their metropolitan territory, they shall, according to their constitutional processes, consult and then act to meet the common danger. There’s only one time they’ve ever invoked that clause. And that was straight after September 11, when, surprisingly, it was the United States that was attacked. Obviously, the assumption on the part of the treaty drafters was that it would be those of us closer to the firing line in Asia that would be invoking that alliance obligation. The second provision is that if the armed forces of either treaty partner are attacked in the Pacific area, then, according to their constitutional processes, they shall also act to meet the common danger.

So you go to the hypothesis of the South China Sea—although the usual one that’s thrown up is Taiwan. The attitude of successive Australian governments is never to speculate on any particular scenarios that might arise in the future. And similarly, if you look at the traditional American posture on the Taiwan question, for many decades, the United States maintained a level of strategic ambiguity as to what it would do under the scenario that Taiwan was militarily attacked, or other military action was taken against Taiwan. I think of ourselves as a responsible ally, like the Japanese. And we adopt the same position. Even though I’m not in office at the moment, I never think it’s positive or productive to comment on what any Australian sovereign government should do should the treaty be invoked.

If I can just look at the world from a Beijing perspective for a moment. When China looks at future scenarios in the East China Sea (the Senkakus/Daiyou Dao), the South China Sea, as well as Taiwan, the

Chinese leadership, with greater or lesser degrees of anxiety and concern, always have to factor in a future variable of one form or another of common allied action. That is, in the event of a crisis arising, it would not just be the United States they would face. It could well be the United States plus its allies, depending on the scenario. And beyond that, in terms of other forms of action, including economic action, China could also face a response well beyond America's Asian allies. You will note, for example, the recent NATO communiqué listed China for the first time as a country of both concern and opportunity for America's European allies. This is a first for the transatlantic partners. So do the NATO partners or other Asian allies specify what they would do under individual circumstances? No. That's called diplomacy.

ALLISON: Let me ask one more question. To stay with Australia for a little bit, whenever I introduce Kevin, usually I remind people that Australia has been the firmest ally of the United States for the last hundred years. They've fought side by side with Americans in every war, sane or insane. And Kevin usually reminds me that is all true, except that the Americans showed up a couple of years late for the First World War and then again for the Second. That's also correct, because the Australians were there fighting before. The other thing is that when the Australians show up, they don't come to ask for help. They show up and they're ready to fight. That is another extremely impressive thing about Australia's role throughout all of this.

So Kevin, in terms of the comparison, China is your most important trading partner. But if the Americans come to you and say you have to choose between your security relationship with us, on the one hand, and your economic relationship with China, on the other, what do you do? As you've written in a number of things recently about economic decoupling, most of this discussion of an absolute binary choice is nonsense. And for the most part, leaders, when told to make such a choice, say, "Forget about it, we're not choosing. Let's have a relationship with both." But Australia has been squeezed by this in the Huawei case. Help us understand that, because I think that's going to be a dynamic for many countries. And especially for Australia, where there is such a deep relationship in security terms with the United States. But, as Jane points out, a country that hasn't had a recession for 30 years, in part because of China, has a challenge on its hands. And a prime minister who puts the country into recession in making such a choice probably won't be prime minister for very long.

RUDD: I think the first thing to reflect on in response to that question is that Australia is not Robinson Crusoe. If you look across the rest of Asia, most of the rest of Asia has China as its dominant trading partner. In fact, if you begin to look across Europe, a similar pattern begins to unfold as well. There is often a lot of focus on the Australian example. But frankly, this is a dilemma for all American allies in Asia and in Europe who have a security relationship with the United States but now a dominant economic relationship with China—more so in trade. Although in terms of capital markets, it's much more ambiguous. America remains the major source of global capital flows. So we should bear that in mind. It's not just heading in one direction. But the first point I'd make is that we are not alone in this dilemma.

Second, when I was prime minister, the Rudd Doctrine on this issue was very, very complex. It was this: "We walk and chew gum at the same time." That is, "We'll have an alliance with the United States, and we'll do whatever we need to do in the economy with China, thank you very much." In my meetings with Chinese leaders, they usually went along these lines. "Good morning. Number one: we're American

allies. There are reasons for that. It's called the Second World War. That is why we have an alliance. And if you're 25 million people sitting on a continent that is the same size as the landmass of the United States (minus Alaska) in the middle of nowhere, you would probably seek an alliance with a powerful friend with whom you have shared interests and values. Particularly when you have one of the longest coastlines in the world and the world's third-largest exclusive economic zone." That's point one. And then you say, "Friends, that's not going to change." Point two: I then say, "We also believe in universal human rights, because that's who we are. Why? Because we're from the West. That is the tradition we come from. We can't change the way we think. That is just us. That is part of our essential being." Point three, I conclude by saying to our Chinese counterparts, "Now, within those constraints, how do we make a whole lot of money together?" I have found in my dealings with my Chinese counterparts that this sort of brutal realism is reasonably effective. They don't like one and two, but they recognize the reality of it. And then we get to focus on part three. It's when you start dancing around one and two and pretending that they don't exist, or only partly exist, that you often get into trouble.

Now you have legitimately gone to the current dilemma around Huawei. I will make an example here of Japan, which is as strong an ally of the United States as Australia. Japan has currently got a policy on Huawei and 5G that, in substance, is identical to the Australian policy. It's simply in their diplomatic communication that they have executed it with what I would describe as "high-level Japanese finesse." Almost like a tea ceremony. They say, "Ah! Huawei, 5G. For the future of 5G, we would like a system with the following characteristics. We're not sure whether Huawei will meet those characteristics or requirements. Perhaps not. But that's a matter for the future." Then on the Belt and Road Initiative, they say, "Ah! The Belt and Road Initiative. Now, if the Belt and Road Initiative in the future is conducted through full transparency, sustainability, etc., then of course Japan would like to collaborate in the future. What a great idea! But until that time, we will probably be doing our own thing, so no offence." Whereas in Australia we say, "Nah! Go away." That is what I describe as a lack of finesse. I think we need to study the Japanese tea ceremony model a little more closely.

ALLISON: Let me take us to the audience. Let me start by taking advantage of the fact that we have among our audience Professor Nick Burns, a colleague and friend who was Under Secretary of State for Political Affairs when Kevin was the prime minister, and so had some time working with him. Kevin said something about "diplomacy matters." Nick heads up a project here at Harvard on diplomacy.

NICK BURNS: Kevin, I think the thing that we're struggling with in the United States is what you're struggling with in Australia. I just spent three weeks in Australia this autumn as a fellow at the Lowy Institute. Thirty-four percent of your trade is with China. You've had 28 years of uninterrupted economic growth because of that relationship. Twenty-five percent of the students at the University of Sydney are Chinese nationals. There's a relationship there where you're very vulnerable to Chinese action should they decide that you've taken actions that are unfavorable to them. How do you both cooperate with China and yet balance it with competition? We're facing the same problem here. We're in a highly competitive phase of the U.S.-China relationship. China is a strategic adversary for our country. I get that, and you and I were together this summer talking about this. We need them on climate change and on stabilizing the global economy. It seems to me that both Australia and the United States, from different vantage points, have to find a way to achieve this balance with this extraordinary country.

RUDD: Well you're absolutely right, but a point in parentheses on the way through. Yes, we're into our 29th year of consecutive growth. Jane mentioned this as well. But it's not just because of China. During the global financial crisis, we engaged in a 5.6 percent of GDP stimulus package, deployed along intelligent Keynesian lines, which uniquely among OECD member states helped keep us out of recession. So it was China plus domestic policy action. But that's a marginal point against the central question that you asked, which is how do we deal with the dilemma.

We seem to think that the U.S.-China gap is without historical precedent. I don't necessarily think that's the case. There are other examples in history of vastly divergent cultures and civilizations which, upon encountering each other, did not simply degenerate into conflict. And remember in the evolution of the Cold War, the Soviet Union and the United States managed to come out of that without blowing each other's brains out.

I think we just need a little bit of historical perspective and say this is not Mars and Venus. This is China and the United States—two sophisticated political systems with highly evolved political cultures, highly rational individuals within those cultures, who are capable of negotiating common outcomes.

I cannot think of two more disparate strategic cultures than those two. So I think we just need a little bit of historical perspective and say this is not Mars and Venus. This is China and the United States—two sophisticated political systems with highly evolved political cultures, highly rational individuals within those cultures, who are capable of negotiating common outcomes.

So my response to your question, Nick, is to go back to the principles of “managed strategic competition” that I sought to outline before. I do not see an alternative, which is why I'm writing a book titled *The Avoidable War*. It's not just a pious aspiration in hope. It's a piece of diplomacy that recognizes that China ultimately respects power. I know enough about Chinese Marxism, Leninism, and traditional views of

Chinese statecraft to know that power matters. And therefore, China, when it looks at the United States, is not just attracted by the scenery. It's not simply admiring the fact that at Harvard, you've got some nice buildings. They are deeply respectful of the fact that this is enormously powerful country when they aggregate all the elements of national power. So when I said the first principle of what I describe as “managed strategic competition” is for the United States and China to both recognize that this balance of power can be managed in a manner that is stabilizing and not destabilizing, this is the foundation for the future.

In America's case, this will require a revolution in this nation's investment in its basic science and research. This is fundamental to the sustainment of American power into the future. Otherwise, others will form an even deeper conclusion that America is sliding its way out of history. The rest is as I described before. And that is an arrangement based on the balance of power. One that recognizes the core interests of each side and the protocols necessary for managing those core interests through high diplomacy. One that also accepts that each side has significant interests that are nonetheless negotiable and therefore navigable, that there are also self-evident, common interests, such as climate. Together with a recognition that if we're going to have a big ideological debate about liberal democracy and state capitalism, then let a hundred flowers bloom and a hundred schools of thought contend, and see who ultimately prevails. I'm sure each side will be backing their own set of ideas.

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COVER IMAGE: U.S. President Donald Trump (R) and China's President Xi Jinping (L) along with members of their delegations, hold a dinner meeting at the end of the G20 Leaders' Summit in Buenos Aires, on December 01, 2018. (Photo by Saul Loeb/Getty Images)