

China's Future

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Let me begin by summarizing my theme: Xi Jinping is not going to enjoy his third term.

Let's start by looking at China's long-run economic prospects. There are some very common views on that. The most common, particularly in the national security community, is that China has demonstrated an exceptional ability to grow. Therefore, even if it slows some, it's certainly going to continue to grow faster than the U.S. and eventually will tower over us. As Larry Summers has often pointed out, we Americans tend to exaggerate the present and future prowess of anyone seen as a rival. We did it with the Soviets and we did it with the Japanese. We're doing it again.

There is an opposite argument that autocracies cannot sustain economic growth and therefore China can't. Autocracies, we are told, cannot promote officials based on merit, cannot do long-range plans, and in general cannot sustain growth. This argument is a triumph of modern political economy. It combines conceptual incoherence, two logical fallacies and a regression on an invalid database to come to a false conclusion that we like to hear. It's not helpful to understanding China. I'll be happy to elaborate if somebody triggers me in the question session.

So, what are the prospects for the Chinese economy? Slow, slow, slow after 2030. I'm not talking here about the current property and Covid slowdown, which has precipitated a stampede of new pessimists. China will cope and partially bounce back, but later the real problems begin.

China's rapid growth has been based largely on three drivers: property, infrastructure and urbanization. By the end of this decade those drivers will be mostly exhausted. The

property bubble is popping and is being managed partly by inflating an infrastructure bubble.

Two worsening drags on the economy exacerbate the problem of exhausted drivers. China will continue to need to service the debts that financed the property and infrastructure bubbles. Above all, an aging population is becoming a huge economic burden and that burden falls on a declining workforce.

A weakened private sector provides 90% of urban employment, 100% of net job creation, over half of all exports, and according to Liu He 70% of innovation. Under Xi Jinping private sector investment and credit have drastically declined. While the big private companies are taking market share from the big state enterprises, the private sector as a whole is being squeezed. The big banks cannot do creditworthy lending to local private companies and Xi Jinping's excessive reform of shadow banking eliminated too many of the institutions that could do such lending. Internet financial companies like Ant Financial provided a potential solution, but the government feared their control of data and their disintermediation of the banks. So the government has grabbed control of the data and assumes the big state banks can use it efficiently; more likely this will be like a merger of Twitter and Tesla.

Xi Jinping is not trying to curtail the private sector but he is trying to strengthen the state sector. This forces one to ask whether China will experience Japanification, which is stagnation that results from domination of the economy by a group of large conglomerates in cahoots with a government that thinks it can drive the economy forward by subsidizing and protecting those companies. China's companies are much more competitive and dynamic than Japan's. However, the Japanese experience does have two ominous implications for China. As happened in Japan, Beijing's industrial policies, designed to achieve dominance in every modern industrial sector, are likely to have some very expensive successes and even more very expensive failures. Second, as

China adopts its own industrial standards different from the West, it risks isolating itself the way Japan isolated its cell phone companies and thereby handed the global market to Apple and Samsung.

Services are and will be the dominant sector of China's economy. Services have exceeded half of the economy since 2015. But the modern services sector—finance, accounting, law, journalism, much of education—has been highly protected. Unlike manufacturing, whose efficiency has been hardened by intense international competition, much of the vital service sector remains stodgy, politicized, and corrupt. Modern financial and legal systems are vital for entrepreneurship and efficiency. For future Chinese growth this is an opportunity as well as a drag, but, except for a slow financial opening, policy is looking inward. It's a drag.

The breadth of Chinese growth owes much to governmental and Communist Party entrepreneurship. Early in the reform era, the leadership basically sought to turn its vast bureaucracy into Drexel Burnham with Chinese characteristics. They deprived local government of adequate fiscal resources but allowed them to start businesses. They gave officials at all levels strict goals but pointedly didn't ask questions about how they achieved those goals. Overnight town and village enterprises employed 110 million people. Up and down the bureaucracy entrepreneurship flourished. Teachers gave each student half a dozen eggs and taught them how to raise chickens in order to support the school. The Institute of Marxism-Leninism became a consulting firm. Everybody grew, at the cost of universal rulebreaking and risky financial management.

Xi Jinping's highly politicized crackdown on corruption terminates this era. From the bottom of the bureaucracy to the top, everybody is afraid of being accused of corruption. If you act decisively on anything, a change in the political wind can knock you down permanently. When there are so many rules, and so many political requirements, any decision makes you vulnerable. In New York City, when the subway

workers want to shut the system down in protest, they declare a work to rule. Under Xi Jinping the Chinese bureaucracy has gone from Drexel Burnham with Chinese characteristics to a work to rule. This affects everything.

The least of China's problems is the activation of Party committees in every firm, public and private, as the ultimate arbiters of strategic business decisions. We don't know how this will work out across China. Likely the outcomes will be different in different regions and different sectors. We do know that, in many of the large companies in Beijing, the agenda of the Party Secretary is quite different from the CEO. Across China, this rule may mean a little sand in the gears or a lot of sand in the gears, but it is sand in the gears. Imagine if we Americans put a politician in every company as the ultimate arbiter of business strategy. Well, on reflection that's unfair to Chinese Party secretaries.

Finally, foreign investors are going to be far more careful what and how much they put in China. ~~Foreign direct investment has proved vital to China's economic success. When China joined the WTO its superior openness to foreign automobile companies, an openness unimaginable to Japan and South Korea, saved the American car industry. Foreign businesses rushed to China and they defended China against protectionist attacks. But now, if Huawei or CATL (the battery manufacturer) is given full access to the U.S. and European markets, while foreigners are held to a small share of the Chinese market, the Chinese giants will utterly destroy their foreign competition. Not through superior business but through unfair access. China now needs foreigners less than it once did, but it still needs them. Quite aside from Western national security actions, the resulting determination of foreign businesses to diversify their supply chains will have some negative effect on Chinese growth.~~

China will have economic wins. It is the world leader in every form of green energy and its exceptional success in reducing the carbon content of its energy use contrasts sharply with the pathetic record of the U.S. China will set the standard for good trains and, given

the current U.S. administration's protectionism, the U.S. will continue to have no Asian class trains. China's space program is, and will continue to be, world class. Beijing's focus on digitization and artificial intelligence in industry will generate some gains. I forecast that Biden's recent semiconductor decisions will circuitously lead China to triumphant success in semiconductors while U.S. protectionism degrades its own semiconductor industry. But the overall Chinese future will be slow growth.

Aside from overall growth, China is also experiencing an unsettling budget transition. At the turn of the century GDP was growing very fast and government revenues were growing twice as fast. The Chinese economy was monetizing and tax collection was improving. Extraordinary revenue growth created a bull market mentality. When Xi Jinping first took power, it seemed the Chinese government could do anything and everything—eliminate poverty, fund social services for an aging population, build the world's greatest infrastructure, grow a military to compete with the U.S., commit a trillion dollars or more to the Belt and Road Initiative, buy the world's great ports and its great technology companies... Now economic growth is slower and revenue growth has to converge with GDP growth. The transition from bull market mentality to sobriety is difficult. Sobriety hit hard in 2022. The emergent sobriety coincides with a new politics.

What is that new politics? The conventional wisdom is that Xi Jinping is China's most powerful leader since Mao Zedong and can do just about anything. That's nonsense. I'll begin with the context.

Leaders' greatest task throughout modern Chinese history has been to create stability out of chaos. Mao Zedong unified the country and Chinese opinion reveres him for that despite privation, starvation and millions of deaths. Into the 1990s, though, Beijing still confronted basic challenges of stability and unity. During that decade, under Jiang Zemin and Zhu Rongji, the government first became capable of vital government functions like controlling the money supply, suppressing inflation, replacing provincial

leaders as needed, and reassigning military commanders at will. These achievements culminated one of world history's most difficult tasks.

However, the early 21st century brought retrogression. Under Hu Jintao (2003-2012) ministers often defied the prime minister and private sector leaders often derided the prime minister's edicts. Local leaders flouted central government directives. Spectacular corruption undermined Party legitimacy. Private companies dominated growth, new employment, and innovation, and some were becoming politically assertive.

Demonstrations rose by an order of magnitude and an embarrassed government stopped publishing the statistics. Marxism was becoming a boring class required of resentful students. Party membership was largely opportunistic. Vice ministers were being sent to Harvard and Oxford and were returning with contaminated thoughts. Reform dynamism vanished. Communist Party leadership seemed to the leaders of that Party to be at risk. Faced with this, Hu Jintao, crippled by diabetes and committed to collective leadership, vacillated.

This backsliding reflected a weak Party leader and a corrupt prime minister's family, but more fundamentally Chinese society had passed a threshold of social complexity. Economic success turned a simple economy into an immensely complex one, and each segment had education, resources, organizational skills, political interests, and expanding cosmopolitan connections to the outside world. This was the point in social development when China's developmental dictatorship predecessors in South Korea and Taiwan had acknowledged social changes and responded with more market-oriented economics and more market-driven politics.

Xi Jinping's mandate was to resolve the crisis of complexity: ensure order, restore central control, reignite economic reform, save the Party. This immense assignment seemed disproportionate to Xi's limited domestic political base, which peers expected to render him controllable. Until very late in the selection process he had a formidable

opponent, Bo Xilai, Party Secretary of Chongqing, whose charisma and similar leadership strategy--anti-corruption campaign, Maoist slogans, populist songs, successful infrastructure development, attentiveness to the rural poor--had cultivated a more extensive popular and elite base than Xi's. After Bo fell, much of the Party still preferred Li Keqiang, who became prime minister only to be crushed like other rivals.

Despite a narrow political base, Xi did not vacillate. Corruption had to be conquered, potential challengers routed, civil society atomized, government and economy centralized, Party control rendered absolute, Marxism reimposed, regrettable history erased, nationalism inflamed, foreign ideas filtered.

The threat was omnipresent: corruption everywhere, civil society and cosmopolitan ideas everywhere, personal vulnerabilities raw. So Xi sought personal control of everything. His multiple titles put him in charge of the Party, the government, the military and eight powerful "Leading Small Groups" that manage everything from "comprehensive deepening of reform" to economic and financial management, internet security and informatization, military reform, and national security coordination. With remarkable efficacy, he banished all potential challengers. He broke established norms such as the two-term limit and the requirement to groom successors. He wrote himself into China's constitution.

Numerous titles and totally suppressed opposition do not, however, evidence confident, absolute power. Xi is accountable to the Communist Party, whereas Putin's party is an entourage supporting his accumulation of power and money. For another perspective, imagine a U.S. conglomerate CEO who appoints himself managing director of every important business unit; he would be perceived as insecure and unskilled at delegation. In contrast, preeminent leader Deng Xiaoping could have destroyed his ideological opponent Deng Liqun and his market reform opponent Chen Yun, but he had the confidence and wisdom not to do so. Indeed, Deng's leadership team (the "Eight

Immortals”) comprised immensely powerful figures with conflicting ideas and momentous power scheming. Likewise, China’s success under Jiang Zemin resulted from Jiang’s wise balancing of personalities as different as reformist Zhu Rongji and conservative Li Peng. The ultimate confident leader of modern Chinese history was Deng Xiaoping in his later years, leading China with one title: Honorary Chairman of the Chinese Bridge Players Society.

To assert central, and specifically Party, authority, to attack corruption, and to acquire the clout to impose his will on the economy, Xi took on every elite group at once. The anti-corruption campaign jailed over 100,000 officials of the Party, the government, the military and business, including top generals and the Politburo Standing Committee member managing security. State enterprise leaders lost half their compensation. Private sector credit and investment collapsed. Giant conglomerates disintegrated. Tech sector executives and investors lost \$2 trillion in the recent regulatory crackdown. Clean energy leaders personally lost \$140 billion. Provincial and local leaders have found their jurisdictions in a financial squeeze and their personal incomes slashed. Simultaneously they lost their innovative freedom of action. Central and local officials, formerly notable for their innovative energy, are demoralized, fearful and immobilized. Wealthy and middle class parents seek to get their money and children out of the country, forcing Xi to enhance capital controls and restrict officials from having family and property abroad. The crackdown on companies hurt the bankers and Xi’s reforms decimated the enormously important shadow banking sector. To demolish any potential civil society resistance, Xi has repressed teachers, tutors, lawyers, journalists, feminists, homosexuals, Christians, Muslims, Falun Gong, NGOs. Many enemies.

Xi’s anti-corruption campaign is enormously popular with the masses. Likewise, his assertion of Chinese global leadership and his blaming of problems on America was as seductive in China as Trump’s similar blaming of Muslims and foreigners was popular in

America. Cracking down on what he saw as the spoiled, pampered people of Hong Kong and the separatists and terrorists of Xinjiang also garnered mass support. The elite honors Xi for saving the Communist Party but is very skeptical about his retrograde economics and politics.

Xi's political strategy contrasts with Turkey's founding leader, Kemal Ataturk, who, facing many groups that needed reform, sequentially amassed powerful coalitions, then confronted resistant groups one at a time. Xi has a devoted mass base comprising the overwhelming majority of the population, but alienating so much of the elite is risky and the mass base could start to dissolve if the economy continues to falter.

Xi's control of propaganda, the security apparatus, the Party, and economic management ensure that he can maintain mass support and, for now, suppress overt manifestations of elite discontent. He will almost certainly be able to maintain this stability through his third term. Nonetheless his actual policies and power are at risk.

Successful pushback limits further crackdown on internet platforms. The umbrella phrase for his social goals, "Common Prosperity," barely made it into important recent policy documents. The Belt and Road Initiative is downplayed. Propaganda organs intensely spread pro-Russian propaganda, but from May the majority of WeChat users have been pro-Ukraine. Xi spent so much of his first decade in the top job consolidating power that he had to rush to notch important accomplishments in year ten. But year ten has not been a good year.

Xi's protectionism deprived Chinese of access to effective vaccines and necessitated lockdowns of hundreds of millions of people. With the lockdowns and bursting property bubble as catalysts, the once-triumphal mood in China changed drastically. For years consensus opinion held that China was rising, the U.S. declining, and that the superior wisdom of technocratic Chinese leaders ensures constant success. The atmosphere resembled the earlier American triumphalism of George W. Bush and Dick Cheney—

until financial crisis and failing wars imposed American sobriety. Something like the resultant sobriety has now flooded China.

China's 2013 excitement over a new era of reform, when the market was going to be the primary determinant of the economy, political unity was going to be reinvigorated, and corruption was going to be banished, has become grim doubling down on Covid policy, Russia policy, infrastructure overinvestment, and propping up the housing market by inflating the infrastructure bubble.

Xi's signature foreign policy of Belt and Road now has a gastric belt. Xi's signature domestic goal of "Common Prosperity" would require a property tax, an inheritance tax, highly progressive income taxes, and abandonment of hukou controls on internal migration, but resistance is intense. The country has been trying unsuccessfully for 11 years to experiment with a desperately needed property tax. "Common Prosperity" may be stuck with campaign symbolism (decapitating the wealthy leadership of major private companies, extracting large charitable contributions, nationalizing their data, and hampering their stock market listings) rather than actually reducing inequality.

Notwithstanding a fierce campaign against corruption, Xi's hierarchical polity and more statist economy will nurture corruption as a wet log nurtures mushrooms.

New policies will have to pass through layer after layer of officials resentful of reduced pay and authority and fearful of taking initiative. Xi will not be a lame duck but he will be a slow duck swimming through mud.

While all Chinese leaders want China to be a rich and powerful global leader, Xi's domestic and foreign policies are not the inexorable culmination of a decades-long Chinese strategy. Quite the opposite. His extreme repression is a sharp break from the trend of his reform-era predecessors. His Hong Kong and Xinjiang policies are a sharp

break. His economic policies reverse key predecessors' moves promoting openness, market orientation and diverse competition.

Each post-1949 Chinese leader has remedied his predecessor's errors. Xi Jinping's overruling of the decadal change of generations hampers that adaptability but does not eliminate the possibility of change. Because Xi's core political policies seek to push back the tides of increasing social diversity and the globalization of knowledge, repression must either relax or worsen, not remain the same, a choice that could divide China's elite. We could see change five years hence and we could see a mammoth succession struggle.

While confronting some current policies, Western foreign policy leaders need to be prepared for sharply different future Chinas rather than ossifying today's relationship.

While one can confidently predict the slowing of China's growth, a slower China does not ensure superior U.S. growth. That would require U.S. stability and competent management. While we can hope for continuation of the U.S. history of resilience, the years of Trump and Biden are sobering.