COUNCIL on FOREIGN RELATIONS

Maurice R. Greenberg Center for Geoeconomic Studies

DISCUSSION PAPER

Geostrategic Implications of China's Twin Economic Challenges

William J. Norris

June 2017

The Council on Foreign Relations (CFR) is an independent, nonpartisan membership organization, think tank, and publisher dedicated to being a resource for its members, government officials, business executives, journalists, educators and students, civic and religious leaders, and other interested citizens in order to help them better understand the world and the foreign policy choices facing the United States and other countries. Founded in 1921, CFR carries out its mission by maintaining a diverse membership, with special programs to promote interest and develop expertise in the next generation of foreign policy leaders; convening meetings at its headquarters in New York and in Washington, DC, and other cities where senior government officials, members of Congress, global leaders, and prominent thinkers come together with CFR members to discuss and debate major international issues; supporting a Studies Program that fosters independent research, enabling CFR scholars to produce articles, reports, and books and hold roundtables that analyze foreign policy issues and make concrete policy recommendations; publishing *Foreign Affairs*, the preeminent journal on international affairs and U.S. foreign policy; sponsoring Independent Task Forces that produce reports with both findings and policy prescriptions on the most important foreign policy topics; and providing up-to-date information and analysis about world events and American foreign policy on its website, CFR.org.

The Council on Foreign Relations takes no institutional positions on policy issues and has no affiliation with the U.S. government. All views expressed in its publications and on its website are the sole responsibility of the author or authors.

For further information about CFR or this paper, please write to the Council on Foreign Relations, 58 East 68th Street, New York, NY 10065, or call Communications at 212.434.9888. Visit CFR's website, www.cfr.org.

This paper was made possible in part by a grant from the Carnegie Corporation of New York. The statements made and views expressed are solely the responsibility of the author.

Introduction

China's economic development is entering a phase in which its old growth model is reaching its limit. The Chinese government has embarked on an effort to reorient the economy from an investment- and export-driven model toward one predicated on a larger role for consumption and market forces. At the same time that Chinese policymakers are attempting this structural reorientation, China is also experiencing what many observers consider to be a new normal of much slower economic growth. Although both of these economic phenomena are likely to carry independent foreign policy and security considerations, they could also interact to uniquely affect Chinese foreign policy and security behavior. U.S. policymakers should carefully consider how China's foreign policy could be affected by those twin economic challenges.

The economic downturn and concomitant structural shift in China's economy has already begun affecting its foreign policy. Security, not economics, is becoming one of President Xi Jinping's—and China's—top strategic priorities. As China's economy reorients domestically and becomes less reliant on international ties, it will likely become less constrained. Moreover, the current economic slowdown and reorientation in China is uncharted territory for the country's rise; navigating this novel terrain could be more dangerous than is commonly realized.

To prepare for such eventualities, the United States needs to remain flexible in its strategic assessment of China's grand strategy. Some of the strategic assumptions that motivated a rising China's grand strategy may no longer weigh as heavily, and U.S. policy should be nimble enough to revisit those assumptions and adjust as necessary.

Links Between Economics and China's Grand Strategy

Economic development has been at the heart of China's modern strategic vision.[1] Deng Xiaoping, who launched China's economic reforms, drove a critical geostrategic reorientation away from Mao Zedong's obsession with perceived existential threats facing China. Deng's official reinterpretation of the international strategic situation allowed him to downplay military concerns and provided the ideological justification for prioritizing economic development.

Deng's Four Modernizations campaign invested heavily in updating China's agriculture, defense, science and technology, and industrial sectors, elevating economic development in each area over other strategic priorities, including traditional national security concerns.[2] Because the world was no longer perceived as hostile, China was free to focus on economics. Now, after decades of compounding growth have made China an economic great power and with its military modernization beginning to bear fruit, China's economic and security position enables it to revisit some of the strategic constraints under which it once operated. Given that so much of China's post-Deng grand strategy has focused on securing the country's integration into the global economic order, a secular shift toward low growth is likely to have a significant effect on China's foreign policy and strategic orientation.

Until the 2008 financial crisis, a distinctly economic logic drove China's foreign strategy. China relies on the ability to sell its products around the world much more than the United States does.[3] China has used an export-oriented model of economic development that entailed deepening ties to the globalizing world economy.[4] This model delivered near-double-digit annual growth for almost three decades.[5] To enable this economic exchange, China needed steady access to a relatively stable international environment.[6] Much of contemporary China's grand strategy and foreign policy has thus been focused on securing China's ties to the global system. For example, joining the World Trade Organization helped ensure steady access to markets abroad for Chinese exports. Japan's official development assistance, which Chinese foreign policy helped secure, provided an important early source of capital. After the government response to the Tiananmen Square protests of 1989 left China cut off diplomatically and economically, overcoming Beijing's isolation became an important foreign policy objective for subsequent presidents. Securing reliable supplies of raw material as China emerged as the world's workshop motivated many high-level official delegation visits abroad under Hu Jintao.

These diplomatic efforts largely succeeded. China's deep ties to the international economy propelled its growth to become the world's second-largest economy.[7] China now has greater economic sway in both its region and in the global system.[8] Beijing's maturation over the past forty years now permits it to revisit its grand strategic prioritization of economic growth and integration, and make greater use of its economic heft to pursue strategic objectives. Such a shift has been made even more likely by the advent of Xi Jinping.

The Effects of Xi Jinping's Leadership

Whereas Deng redefined China's grand strategy away from security and toward economic development, Xi has reemphasized security. Just as Deng's de-emphasis on security concerns played an important part in clearing the way for China's economic growth, Xi's perspective is fundamentally shaping China's grand strategy. Although Deng's successors Jiang Zemin and Hu Jintao largely maintained his grand strategy, which prioritized economic growth and regional stability, evidence is mounting that Xi is placing China on a different trajectory.[9]

There are several indicators that suggest such a shift is occurring. First, Xi seems more willing to take geopolitical risks to stand up for China's territorial interests, even if that means tolerating a higher degree of regional instability.[10] Second, Xi has argued that national security, not the economy, ought to supersede all other concerns.[11] Nonetheless, he recognizes that economic growth is critical to maintaining popular support for the Communist Party of China (CPC).[12] He has advocated for painful reforms that could result in slower growth in the next few years to ensure continued long-term economic growth. He seems to be willing to tolerate a lower level of growth if that is the price of maintaining the party in power.[13] Third, Xi's preoccupation with security—even at the expense of economic benefit—is also evidenced by recent legal measures. The National Security Law, which outlines the government's authority to respond to threats, is designed to support the party and protect against potential subversion.[14] Similarly, the law on nongovernmental organizations (NGOs), which regulates and effectively limits the work of foreign NGOs in China, could be construed as an effort to prevent external forces from undermining the party's dominance of civil society. The potential economic blowback—an exodus of multinational technology companies unwilling to provide source code to the Chinese government or of foreign NGOs that help fill holes in the social welfare net—from these efforts has not had much restraining effect.[15] Objections to such measures have not resulted in a moderation of these laws. Fourth, the Xi administration created the National Security Commission, a high-level coordinating body that elevated and centralized the internal and external security missions directly under Xi.[16] Fifth, the sweeping military reforms announced in November 2015, while partly designed to enhance war-fighting capabilities, also indicate Xi's desire to consolidate the party's dominance over the military. Implementing military reforms of this magnitude will require diverting top-level attention away from the considerable economic workload.

Risks of Moving Toward a "Moderately Well-Off Society"

By 2021 (the centennial of the CPC's founding), the Chinese government hopes to have completed the building of a "moderately well-off society," in which the gross domestic product (GDP) per capita is double the 2010 figure of roughly $4,400. To get there, Xi faces two distinct but related economic challenges: a slowdown in economic growth and a transition to a sustainable economic growth model. Specifically, China is attempting a three-part reorientation while managing a slowdown. According to the World Bank's quarterly economic update from June 2015, China is trying to move away from manufacturing sectors into service sectors, shift the composition of its GDP growth away from investment and toward consumption, and transition from export production to domestic spending. This would add up to a fundamental reorientation of China's economic growth model, and the path forward is not without risks.

DOMESTIC UNREST

Poorer economic growth prospects will likely exacerbate domestic unrest in China. Inequality has long been a source of concern and potential instability, and economic challenges could place additional stress on the system. Recent college graduates with dismal job opportunities, displaced migrant laborers, discharged military service members, the rural poor, and discontented pensioners, among others, have voiced their dissatisfaction with the economic situation. Despite Xi's efforts to decouple sustained economic growth from party legitimacy, people still expect the party to deliver economic performance; to that end, popular disenchantment could result in instability.

As the export-oriented coastal economy boomed, demand for additional low-wage labor drew millions to move from the countryside. The subsequent domestic migration to coastal cities has created a migrant worker population of roughly two hundred million people directly or indirectly dependent on export-oriented industries. Thus, a downturn in these industries could aggravate unemployment among a demographically volatile population.[17] If China is structurally shifting away from an export-oriented model, these lost jobs may not return. Economists have been finding increasing evidence that retooling such out-of-work labor forces to successfully transition to service-sector employment may not be a simple task, especially under slowing economic growth.[18] The Chinese government considers such unemployment to be a significant source of domestic unrest and a possible threat to regime stability; shifting China's growth model risks exacerbating domestic discontent that could easily be directed toward the party.

A further slowing of China's GDP growth rate is anticipated. After the 2008 financial crisis, China offset weak export demand with a massive investment stimulus; part of the most recent slowdown is the result of removing that stimulus. Decreasing investment in the next few years strongly incentivizes a return to reliance on exports, especially if consumption fails to take up the slack and there is considerable job displacement in export-dependent sectors. However, the leadership seems to genuinely desire a fundamental reorientation of the Chinese economic growth engine away from both exports and investment in favor of consumption. Whether this transition can happen successfully and smoothly remains to be seen. The Chinese economy has many politically powerful, vested interests that have grown up around the current model. A consumption-driven growth model would generate a new set of winners while challenging some of the interests that have benefited the most from high levels of investment.

Another source of instability is China's growing inequality. When the economic transformation toward consumption happens, it will likely be quite uneven. China has at least three distinct socioeconomic strata that will drive a consumer-focused economy: the wealthy and upper-middle class, the lower-middle class, and the rural poor. The primary consumers in this "moderately well-off society" will consist of wealthy and upper-middle-class urbanites with significant disposable incomes. Their patterns of consumption will mirror, and in many instances, exceed, the patterns typically found among member countries of the Organization for Economic Cooperation and Development (OECD). Behind this consuming vanguard will be another group of urban and suburban residents with considerably lower levels of buying power. This group will nevertheless be a significant influencer of Chinese mass consumption patterns due to its sheer size. Finally, the rural poor will make up an important segment of China's emergent consumers. Public awareness of these unequal economic divisions could aggravate a distinct source of domestic instability.

DIVERSIONARY NATIONALISM

Populist pressures might tempt the party leadership to encourage diversionary nationalism. The logic of this concern is straightforward: the Communist Party might seek to distract a restless domestic population with adventurism abroad.[19] The Xi administration wants to appear tough in its defense of foreign encroachments against China's interests. This need stems from a long-running narrative about how a weak Qing dynasty was unable to defend China in the face of European imperial expansion, epitomized by the Opium Wars and the subsequent treaties imposed on China in the nineteenth century. The party is particularly sensitive to perceptions of weakness because much of its claim to legitimacy—manifested in Xi's Chinese Dream campaign today—stems from the party's claims of leading the restoration of Chinese greatness. For example, the May Fourth Movement, a popular protest in 1919 that helped catalyze the CPC, called into question the legitimacy of the Republic of China government running the country at that time because the regime was seen as not having effectively defended China's territorial and sovereignty interests at the Versailles Peace Conference.

Diversionary nationalist frictions would likely occur if the Chinese leadership portrayed a foreign adversary as having made the first move, thus forcing Xi to stand up for China's interests. An example is the 2012 attempt by the nationalist governor of Tokyo, Shintaro Ishihara, to buy the Senkaku/Diaoyu Islands from a private owner.[20] Although the Japanese central government sought to avert a crisis by stepping in to purchase the islands—having them bought and administered by Ishihara's Tokyo metropolitan government would have dragged Japan into a confrontation with China—China saw this move as part of a deliberate orchestration by Japan to nationalize the islands. Xi seemingly had no choice but to defend China's claims against an attempt by Japan to consolidate its position on the dispute.[21] This issue touched off a period of heated tensions between China and Japan, lasting more than two years.[22] Such dynamics are not limited to Japan. Other possible areas of conflict include, but are not necessarily limited to, Taiwan, India, and the South China Sea (especially with the Philippines and Vietnam).

The Chinese government will use such tactics if it believes that the costs are relatively low. Ideally, China would like to appear tough while avoiding material repercussions or a serious diplomatic breakdown. Standing up against foreign encroachment—without facing much blowback—could provide Xi's administration with a tempting source of noneconomic legitimacy. However, over the next few years, Xi will probably not be actively looking to get embroiled abroad. Cushioning the fallout from slower growth while managing a structural economic transition will be difficult enough. Courting potential international crises that distract the central leadership would make this task even more daunting.

Even if the top leadership did not wish to provoke conflict, a smaller budgetary allotment for security could cause military interests in China to deliberately instigate trouble to justify their claims over increasingly scarce resources. For example, an air force interested in ensuring its funding for a midair tanker program might find the existence of far-flung territorial disputes to be useful in making its case. Such a case would be made even stronger by a pattern of recent frictions that highlights the necessity of greater air power projection. Budgetary pressures may be partly behind a recent People's Liberation Army reorganization and headcount reduction. A slowing economy might cause a further deceleration in China's military spending, thus increasing such pressures as budgetary belts tighten.

CHALLENGES TO XI'S LEADERSHIP

Xi Jinping's efforts to address economic challenges could fail, unleashing consequences that extend well beyond China's economic health. For example, an economic collapse could give rise to a Vladimir Putin–like redemption figure in China. Xi's approach of centralizing authority over a diverse, complex, and massive social, political, and economic system is a recipe for brittleness. Rather than designing a resilient, decentralized governance structure that can gracefully cope with localized failures at particular nodes in a network, a highly centralized architecture risks catastrophic, system-level failure. Although centralized authority offers the tantalizing chimera of stronger control from the center, it also puts all the responsibility squarely on Xi's shoulders.

With China's ascension to great power status, the consequences of internecine domestic political battles are increasingly playing out on the world stage. The international significance of China's domestic politics is a new paradigm for the Chinese leadership, and one can expect an adjustment period during which the outcome of what had previously been relatively insulated domestic political frictions will likely generate unintended international repercussions. Such dynamics will influence Chinese foreign policy and security behavior. Domestic arguments over ideology, bureaucratic power struggles, and strategic direction could all have ripple effects abroad. Many of China's party heavyweights still employ a narrow and exclusively domestic political calculus. Such behavior increases the possibility of international implications that are not fully anticipated, raising the risks of strategic miscalculation on the world stage. For example, the factional power struggles that animated the Cultural Revolution were largely driven by domestic concerns, yet manifested themselves in Chinese foreign policy for more than a decade. During this period, China was not the world's second largest economy and, for much of this time, did not even have formal representation at the United Nations. If today's globally interconnected China became engulfed in similar domestic chaos, the effects would be felt worldwide.[23]

WEAKENED FETTERS OF ECONOMIC INTERDEPENDENCE

If China successfully transitioned away from its export-driven growth model toward a consumption-driven economic engine over the next four or five years, it could no longer feel as constrained by economic interdependence. To the extent that such constraints are loosened, the U.S.-China relationship will be more prone to conflict and friction.[24]

While China has never been the archetypal liberal economic power bent on benign integration with the global economy, its export-driven growth model produced a strong strategic preference for stability. Although past behavior is not necessarily indicative of future strategic calculus, China's "economic circuit breaker" logic seems to have held its most aggressive nationalism below the threshold of war since 1979. A China that is both comparatively strong and less dependent on the global economy would be a novel development in modern geopolitics.

As China changes the composition of its international economic linkages, global integration could place fewer constraints on it. Whereas China has been highly reliant on the import of raw materials and semifinished goods for reexport, a consumption-driven China could have a different international trade profile. China could still rely on imported goods, but their centrality to the country's overall economic growth would be altered. Imports of luxury goods, consumer products, international brands, and services may not exert a significant constraining influence, since loss of access to such items may not be seen as strategically vital. If these flows were interrupted or jeopardized, the result would be more akin to an inconvenience than a strategic setback for China's rise. That said, China is likely to continue to highly depend on imported oil even if the economic end to which that energy resource is directed shifts away from industrial and export production toward domestic consumption.

A consumer-oriented China would not automatically become self-sufficient. China is deeply embedded in the international economic system today, and it would be difficult for China to make a complete break with these ties. Rather, a consumption-driven China would simply not depend as much on these international links as China does today. An approximate reference could be the level of U.S. dependence on foreign trade and investment, which, although quite large, hardly drives U.S. economic performance. The bulk of U.S. GDP is driven by consumption.

As China embarks on its economic reorientation, close attention should to be paid to the type and extent of China's ongoing integration into the global economic system, which will raise questions surrounding whether China continues to be deeply embedded in global supply chains as its labor costs rise; whether the Chinese economy refocuses on meeting the needs of domestic Chinese consumers, producing tailored goods and services that are largely detached from international markets; and the extent to which Chinese energy needs are met by international supplies as opposed to domestic sources. Analysts concerned about the erosion of the pacifying effects of interdependence ought to closely track the extent to which the emerging Chinese growth model will continue to be tied to the rest of the world economy and the extent to which China's economy becomes decoupled.[25]

SHIFT FROM COMPLEMENTARITY TO COMPETITION

A consumption-driven Chinese economy would be a significant shift away from what has been a largely complementary U.S.-China macroeconomic relationship. Although the U.S.-China economic relationship has seen its fair share of tension over trade deficits, exchange rate policies, and unfair competition, since the 1990s, the U.S. and Chinese economies have worked complementarily: Chinese savers tended to save too much as American consumers tended to spend too much. While the United States imported and ran large trade deficits, China exported and ran trade surpluses.[26] The United States was a highly advanced, capital-rich, industrialized economy, and China was a large, labor-rich, emerging economy. Despite its downsides, such an arrangement provided considerable benefits to both societies.[27] But as China's economy matures to resemble the U.S. economy, frictions could increasingly come to replace mutual interests.[28]

The aggregate demand from a consumption-driven Chinese economic growth engine may, at least partially, displace the United States as the dominant export market for the Asia-Pacific region. Today, many of the goods produced by disaggregated supply chains throughout Asia are ultimately bound for the U.S. consumer market. As China shifts to a consumption-driven model, such producers could rely on Chinese rather than American consumers, leading to a reorientation around the Chinese economy. Numerous analysts have raised concerns about the long-term security considerations such economic alignments might pose for U.S. allies such as Australia, Japan, and South Korea.[29] Because of clear treaty commitments, such crosscutting economic attraction is unlikely to cause much concern among these states. But others, such as Indonesia, Malaysia, or Taiwan—which are seen as regional partners of the United States—could gradually distance themselves from the United States and become more deferential toward Chinese strategic preferences even if those ran counter to U.S. interests or to the maintenance of the existing regional order and norms.

The Future of China's Economic Statecraft

As China navigates its transition, it has also embarked on a challenging effort to build a new regional institutional economic architecture centered around itself over the next decade or two. Such international institutions are difficult to build and will only succeed when there is a need that is not adequately being met by current multilateral regimes or when China can capitalize on broad discontent among a critical mass of states that are dissatisfied with elements of the existing order.

China's One Belt, One Road (OBOR) efforts are explicitly designed to facilitate regional economic activity by deepening China's infrastructure and transportation links with its neighbors and beyond. If the links work as envisioned, China will enjoy unprecedented structural economic power, which can be used both for coercion and to gradually realign other countries' self-interests to be more in line with China's. The mechanics of coercion are already well known. Less theorized is how economic interaction can gradually foster the emergence of actors in other countries that, over time, help shape and define the interests of their country.[30] This is a powerful form of economic statecraft that promises long-lasting strategic benefits for China.[31] Although economic statecraft can be a notoriously difficult tool, when effectively wielded it provides attractive avenues for exercising power.[32] Despite slowing economic growth, China will likely continue to seek to use economic power to prevent unfavorable strategic developments on its periphery. However, with a consumption-driven growth model and a slowing economy, some aspects of China's grand strategy will likely change.

China's double-digit growth rates are a thing of the past, and they will continue to decelerate given China's demographic challenges, especially as the country shifts to a consumption-driven economy. More mature economies tend not to grow at 7–8 percent per year. A more sustainable GDP growth rate for China would likely fall in the 3–6 percent range. This figure is highly speculative and serves only as a directional indicator of a consumption-driven economic growth model. Less robust growth will diminish the attraction potential of the Chinese market and reduce the ability of the state to use the market to woo potential partners. This would make the type of "win-win" diplomacy that was so effective for China in its relations with Southeast Asian partners twenty years ago significantly less attractive.

Unfavorable economic conditions will also likely lead to enhanced state control over commercial actors. Under conditions of economic duress, the state's ability to determine commercial success—also known as the Chinese state's king-making capabilities—will become even more highly prized by struggling firms.[33] In China, the state has demonstrated an ability and willingness to help tilt the competitive commercial landscape in favor of preferred firms or against firms it wishes to target. This king-making capacity should result in greater state control over the direction and behavior of firms under difficult economic circumstances, because firms will become even more sensitive to the opportunities that could be granted or closed off to them. [34] This condition makes economic statecraft easier by facilitating state control over the behavior of commercial actors.[35]

Currently, it seems that OBOR initiatives will be sustained through the transition to a slower-growth, consumption-driven economy. These regional integration efforts can serve a useful Keynesian stimulus role for absorbing some excess Chinese construction and engineering capacity.

Although China has a long record of state financing for such endeavors, the scale and scope of this initiative is unprecedented. An important indicator will be the extent to which funding actually follows announced initiatives. OBOR comes at a time when China's banks and other financial entities are still coping with the post-2008 credit expansion that was part of the massive investment stimulus. Considerable debt still looms over municipal and provincial balance sheets. Even so, China continues to possess foreign exchange reserves well in excess of what is needed to finance its trade activity.[36] Much of this foreign-denominated wealth is difficult to spend in China without stoking inflationary pressures, thus making OBOR an attractive way to realize some liquidity while potentially absorbing a small portion of China's excess engineering and construction capacity.[37] OBOR efforts suggest another potential evolution for China's economic statecraft. Financing trade deficits in Europe as well as in Central and South Asia with Chinese investment could foster greater integration of these economies with the Chinese economy. The strategic ramifications of such economic ties warrant additional exploration.

A fundamental shift away from investment and exports would likely reduce China's need for massive quantities of raw materials and semifinished goods, which currently constitute a significant portion of China's imports. In a consumption-driven economic model, securing such raw materials would become less of a strategic priority for the government, noticeably altering a foreign commercial strategy that had been premised on securing raw materials.

One enduring feature of a consumption-driven China would likely be the continued need for imported energy. A significant portion of China's current energy demand is tied to export-oriented industries; this demand would likely shift to the consumer sector, leaving China with a continued need for imported oil. For instance, as more Chinese households purchase automobiles, the demand for gasoline will continue to rise. The United States might provide an example of what a mature, consumption-driven energy demand profile looks like (with obvious consideration given to population and demographic differences, among others).

There are several areas in which China is likely to depend more on imports as a result of a shift to a consumption-driven economy. The food sector has been an emerging area: as Chinese consumers have expanded their wallets, consumption of meat has spiked. At the same time, domestic food safety concerns have driven additional demand for imported products seen as more reliable. Such desirability helps command premium prices. Moreover, China's domestic agricultural capabilities have historically under-produced relative to the needs of its population. As a result, China's dependence on international sources of food will likely grow as it shifts toward a more consumption-driven economy. Of course, consumer imports more broadly would also become more important. If Chinese economic developments to date are indicative, such imported consumer goods will be particularly skewed toward international brands and luxury items that have strong brand awareness among Chinese consumers.

Even under a domestic consumption-driven economic model, the Communist Party is unlikely to lose its paramount role in leading China and determining its strategic interests. This perspective has become a fixture of contemporary China strategic studies, and there is little evidence to suggest that the party's power will diminish even in the face of a reorientation of China's growth model. For the foreseeable future, the party will continue to set China's strategic priorities, control the leading elements of society, and govern China.

Conclusion: Implications for U.S. China Strategy

As the United States responds to the geopolitical risks likely to arise as by-products of China's response to its economic challenges, it needs to maintain flexibility and avoid defaulting into a strategy that is misaligned with a rapidly changing China. Specifically, two forms of strategic inertia are likely to bedevil U.S. strategy regarding China.

One is a reliance on the comfortable and familiar strategic logic of a rising China where economic considerations are dominant. If the United States relied on the same logic to explain how a consumption-driven, post-rise China might see the world, it would fail to recognize the shift in strategic conditions and the need to adjust U.S. responses accordingly. U.S. officials should ensure that important U.S. strategic assumptions about the causal logic motivating China's grand strategy are appropriately revisited as the role of economics within China's strategic calculus shifts.

Another type of strategic inertia would be to mistake a post-rise China for the Soviet Union. The future U.S.-China relationship is not predestined to become a new type of Cold War. Policymakers should resist organizational tendencies to return to the days when a single, clear-cut, state-based adversary dominated U.S. strategic planning. As China faces its twin economic challenges of slowing growth and a transition to a more sustainable growth model, the United States continues to have a significant interest in China's success. The United States should continue to support a successful, smooth transition to a more open, consumption-driven economic model that remains deeply integrated in the global economic architecture and should work cooperatively with China to help move that country toward a more sustainable growth path. Having China on a productive and sustainable economic trajectory would be a win for China, the United States, and the world.

But how China navigates these challenges in the coming years matters. It matters for the United States and regional stability, as well as for China and the regional strategic environment in which it needs to operate. The United States should make it clear that, although it encourages further economic liberalization and is willing to support such efforts, it fundamentally disagrees with restricting political and social activities in the name of regime security. Successfully navigating these economic challenges will be tricky for China, and today's choices will generate geopolitical consequences with effects far beyond China and its immediate economic environs. As China confronts this coming period of rapid change, the United States needs to periodically revisit its China policy to ensure that the policy remains optimized given the continuing strategic and economic developments in China.

About the Author

William J. Norris is an associate professor of Chinese foreign and security policy at Texas A&M University's Bush School of Government and Public Service, where he teaches graduate-level courses in Chinese domestic politics, East Asian security, and Chinese foreign policy. He is also a nonresident associate with the nuclear policy program at the Carnegie Endowment for International Peace. Norris has been a postdoctoral fellow in the Princeton-Harvard China and the World Program. He is the author of *Chinese Economic Statecraft: Commercial Actors, Grand Strategy, and State Control*. Norris completed his doctoral work at Massachusetts Institute of Technology, where he specialized in the confluence of economics and security, focusing on the role of economics in contemporary Chinese grand strategy.

Endnotes

1. Wang Zhengyi, “Conceptualizing Economic Security and Governance: China Confronts Globalization,” *Pacific Review* 17, no. 4, (2004): 523–545.
2. The Four Modernizations were agriculture, industry, national defense, and science and technology. While military modernization was still one of the national priorities—particularly after the 1991 Gulf war, as evidenced by decades of double-digit spending increases that typically outpaced China’s annual GDP growth—Deng’s modernization efforts rested squarely on an economic, rather than a military, prioritization. Incidentally, this de-emphasis on security also facilitated Deng’s consolidation of power over the post–Cultural Revolution People’s Liberation Army, which had permeated almost all aspects of the society, economy, and governing spaces.
3. While exports in the United States represented only 14 percent of GDP in 2012, China’s exports were 30 percent of its GDP. Trade represents only 23 percent of the United States’ GDP, in stark contrast to China’s 42 percent. These figures, based on 2014 data from the World Bank, reflect the structural differences between the U.S. and Chinese economic engines.
4. By 2009, the magnitude of the U.S. financial crisis made it clear that China would likely suffer some economic setbacks as a result of slack demand for Chinese exports. With the financial crisis, China faced the dangerous prospect of a steep decline in demand abroad that directly affected China’s exports, which had been the cornerstone of its growth. To counter this decline and prop up GDP growth, China accelerated its planned investment projects and opened the investment spigots both through its monetary policy and its banking system. Effectively, China was offsetting and substituting investment for the export decline so that the top-line GDP number remained relatively stable.
5. Between 1978 and 2005, China’s GDP grew at an average annual rate of 9.6 percent. See Carsten A. Holz, “China’s Economic Growth 1978–2025: What We Know Today About China’s Economic Growth Tomorrow,” *World Development* 36, no. 10 (2008): 1665–1691. For official data, see the China Statistical Yearbooks from the National Bureau of Statistics of China. Even if growth slows, China is already the world’s second-largest economy and a massive regional actor in Asia.
6. This access to the international economy has been critical for China’s success. With China’s accession to the WTO, China’s trade and overall GDP grew rapidly throughout the early part of the twenty-first century, further propelling China’s rise. By 2003, trade comprised more than half of China’s GDP. See “Merchandise Trade (% of GDP),” World Bank, http://data.worldbank.org/indicator/TG.VAL.TOTL.GD.ZS?page=2.
7. In 2007, China surpassed the United States to become the world’s largest trading nation in both total imports and exports.
8. For more on how China actually employs its economic power, see William Norris, *Chinese Economic Statecraft: Commercial Actors, Grand Strategy, and State Control* (Ithaca, NY: Cornell University Press, 2016).
9. Elizabeth C. Economy, “China’s Imperial President,” *Foreign Affairs*, November/December 2014, 80–91.
10. Most visibly, this tendency has been evidenced in some of China’s territorial disputes in the East and South China Seas. For more on the domestic political forces at work in China’s East China Sea dispute, see William Norris, “Explaining Recent Senkaku/Diaoyu Tensions: The Domestic Dimension,” *Education About Asia* 19, no. 2 (Fall 2014): 43–44.
11. At the first meeting of China’s new National Security Commission on April 15, 2014, Xi presented his “holistic” concept of national security. In that speech, he noted that “[the] Party should make national security its top priority.” See Xi Jinping, “A Holistic View of National Security,” *The Governance of China* (Beijing: Foreign Languages Press, 2014), pp. 221–222. For a helpful, early discussion of Xi’s ideas regarding national security priorities, see David M. Lampton, “Xi Jinping and the National Security Commission: Policy Coordination and Political Power,” *Journal of Contemporary China* 24, no. 95 (2015): 759–777. Also see Yiqin Fu, “What Will China’s National Security Commission Actually Do?” *Foreign Policy,* May 8, 2015, http://foreignpolicy.com/2014/05/08/what-will-chinas-national-security-commission-actually-do. Note that Xi’s understanding of security primarily revolves around maintaining the current regime in power.
12. Specifically, rising individual incomes, rather than general economic growth, seem to be an important source of party legitimacy. For recent survey work to this effect, see Bruce J. Dickson and Mingming Shen, “They Have Issues: Do Public Goods Produce Public Support in China? Performance Legitimacy and Popular Support in China” (working paper, 2013, https://gwucpw.files.wordpress.com/2011/10/dickson-and-shen-they-have-issues-cp-workshop.pdf).
13. Here, Xi seems to have been deeply influenced by his interpretation of how Mikhail Gorbachev mishandled challenges facing the Soviet Union.
14. National Security Law of the People’s Republic of China, July 1, 2015, http://www.cfr.org/homeland-security/national-security-law-peoples-republic-china/p36775.
15. See, for instance, Paul Mozur, “New Rules in China Upset Western Tech Companies,” *New York Times*, January 28, 2015, http://www.nytimes.com/2015/01/29/technology/in-china-new-cybersecurity-rules-perturb-western-tech-companies.html?_r=0.

16. Creating a national security council was something that previous administrations unsuccessfully tried. National security, particularly a renewed focus on internal security, has been a priority for Xi. Additionally, the propaganda apparatus and censorship efforts have both enjoyed a resurgence under him.

17. So far, the brunt of the effect on migrant laborers seems to have come in the form of wage reductions rather than job eliminations. See *Quarterly Report on China's Economy,* World Bank, June 2015, p. 12.

18. See, for instance, Richard McGahey and Jennifer S. Vey, eds., *Retooling for Growth: Building a 21st Century Economy in America's Older Industrial Areas* (Washington, DC: Brookings Institution Press, 2008); Ian King and Arthur Sweetman, "Procyclical Skill Retooling and Equilibrium Search," *Review of Economic Dynamics* 5, no. 3 (2002): 704–717. A successfully rebalanced economy may well bring the type of long-needed social welfare reform in China that, if realized, would help alleviate some of the stresses highlighted.

19. Jack S. Levy and Lily I. Vakili, "Diversionary Action by Authoritarian Regimes: Argentina in the Falklands/Malvinas Case," in *The Internationalization of Communal Strife*, ed. Manus I. Midlarsky (London: Routledge, 1992), pp. 118–146; Frederick Solt, "Diversionary Nationalism: Economic Inequality and the Formation of National Pride," *The Journal of Politics* 73, no. 3 (2011): 821–830; and Jessica Chen Weiss, "Authoritarian Signaling, Mass Audiences, and Nationalist Protest in China," *International Organization* 67, no. 1 (2013): 1–35.

20. Kaori Kaneko, "Tokyo Governor Seeks to Buy Islands Disputed With China," Reuters, April 17, 2012, http://www.reuters.com/article/us-japan-china-islands-idUSBRE83G0C020120417. China disputes Japan's sovereignty over these small islands while Japan maintains the territory is not in dispute.

21. Some might argue that once it became apparent that China was paying an economic price in the form of declining new Japanese investment in China, Xi began to improve ties with Japan. I believe this overstates the ability of economic interests to trump more narrow nationalist calculus. Such economic costs can act as a ceiling on the tensions, but they did not dissuade Xi from pursuing a more aggressive position when he found that position to be expedient from a domestic political perspective. In that respect, these economic links failed to deter a more aggressive posture, even if they may have limited the extent to which either party was willing to escalate the friction.

22. It should be noted that Ishihara's attempt to buy the islands in the spring of 2012 predates Xi's official assumption of the party leadership in November 2012. Although this timing suggests that Xi merely inherited already souring Japanese relations, given his rapid assumption of the Central Military Commission's chairmanship (attesting to his stature and consolidated position among military and security forces), his formation of the Central Maritime Rights and Interests Leading Small Group, and the subsequent escalation of Chinese incursions, Xi may have already had a significant influence on China's activities during this period, even before the party congress officially conferred the title of general secretary on him.

23. This outcome is only one of several potentially dangerous consequences. Others include a rebellious military, destabilizing foreign policy, outright civil war, renewed military conflict with Taiwan, virulent anti-Americanism, and financial collapse and contagion.

24. Indeed, it is not coincidental that the most recent period of Chinese assertiveness in the region dates back to the aftermath of the 2008 financial crisis, during which time China substituted investment stimulus to offset an anticipated decline in export demand. With China's declining reliance on exports came more aggressive behavior in its territorial disputes.

25. This is another area in which China's slowing economic growth and structural economic reorientation are likely to interact and generate strategic consequences. For instance, a structural shift away from international economic ties might make conflict appear less costly, even as a slowing rate of economic growth encourages diversionary nationalism.

26. Some economic commentators have pointed out that such long-term, structural imbalances were unhealthy and unsustainable; see Martin Wolf, "Martin Wolf on Why Trade Imbalances Matter," *Financial Times*, January 22, 2015, http://video.ft.com/4000123703001/Martin-Wolf-on-why-trade-imbalances-matter/Editors-Choice. But the truth remains that both societies had their preferences regarding marginal propensity to consume versus save. The United States and China found, in each other's economy, a natural complement or enabler—depending on one's normative perspective.

27. There were at least two major costs to bringing the United States and China closer together economically. First, the United States had little regard for the domestic distributions of the gains or losses from trade (e.g., offsetting significant employment losses in U.S. manufacturing industries). For more on the employment impact of U.S.-China trade, particularly the concentrated local impact in manufacturing-based communities, see David H. Autor, David Dorn, and Gordon H. Hanson, "The China Syndrome: Local Labor Market Effects of Import Competition in the United States," *American Economic Review* 103, no. 6 (2013), pp. 2121–2168, and Daron Acemoglu et al., "Import Competition and the Great U.S. Employment Sag of the 2000s," NBER Working Paper No. 20395 (August 2014), http://www.nber.org/papers/w20395. Second, the payments and savings imbalance may have contributed to the global financial crisis. See Ben S. Bernanke, "The Global Saving Glut and the U.S. Current Account Deficit," remarks at the Homer Jones Lecture, St. Louis, Missouri, April 14, 2005, http://www.federalreserve.gov/boardDocs/Speeches/2005/20050414.

28. The relationship was not without frictions previously, with legislation such as the type proposed by Senator Charles Schumer (D-NY), WTO disputes, antidumping concerns, and Committee on Foreign Investment in the United States reviews, but these tended to be exceptions to an otherwise productive economic relationship.

29. Robert D. Kaplan, "The Geography of Chinese Power: How Far Can Beijing Reach on Land and at Sea?" *Foreign Affairs*, May/June 2010, 22–41; Evan S. Medeiros et al., "Pacific Currents: The Responses of U.S. Allies and Security Partners in East Asia to China's Rise," RAND Corporation, 2008; David C. Kang, "Getting Asia Wrong: The Need for New Analytical Frameworks,"

International Security 27, no. 4 (2003): 57–85; Scott Snyder, *China's Rise and the Two Koreas: Politics, Economics, Security* (New York: Lynne Rienner Publishers, 2009).

30. Rawi Abdelal and Jonathan Kirshner, "Strategy, Economic Relations, and the Definition of National Interests," *Security Studies* 9, no. 1–2 (1999): 119–156.

31. For more on the various forms of economic statecraft, see William Norris, "Security Externalities in U.S.-China Relations: A Theoretical Framework for Understanding the Relationship Between Economics and National Security" (working paper).

32. For instance, there has been a backlash against the practices of Chinese people and Chinese multinationals, particularly with regard to corporate social responsibility, in Africa, Latin America, and Southeast Asia.

33. For more on the state's "king-making" capabilities, see Norris, *Chinese Economic Statecraft,* pp. 35–36, 124–125, 157.

34. Unless, of course, the economic crisis prompts the state to more fully embrace liberalization and deep market reforms as an antidote to its economic malaise. In that case, state power would shrink in favor of less easily directed market forces.

35. For more on the relationship between state control and successful economic statecraft, see Norris, *Chinese Economic Statecraft*, especially chapters one and two.

36. The extent to which China will be able to fund Xi's OBOR strategy is open to debate. One option would be to redeploy its "excess" foreign exchange reserves. Some economists question whether China has the $100–$300 billion of excess reserves to adequately fund the ambitious initiatives. In addition, China might redirect some of the returns already earned on its reserves to be redeployed toward such initiatives, rather than compounding the foreign exchange reserves.

37. David Dollar has shown that the proposed scale of something like the Asian Infrastructure Investment Bank is unlikely to have much of a material impact, given how large China's overcapacity problem is. See David Dollar, "China's Rise as a Regional and Global Power: The AIIB and the 'One Belt, One Road,'" *Horizons*, no. 4 (Summer 2015): 162–172, http://www.brookings.edu/research/papers/2015/07/china-regional-global-power-dollar.