

# STORMS AHEAD

THE FUTURE  
GEOECONOMIC  
WORLD ORDER



Johann **Strobl**  
Heiko **Borchert**



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# Contents

- |   |  |     |
|---|--|-----|
| 1 | <b>Introduction</b><br><i>Johann Strobl</i>  | 006 |
| 2 | <b>New Geoeconomics: A Primer</b><br><i>Heiko Borchert</i>   | 016 |
| 3 | <b>Systemic Divergence and the<br/>Future Economic Order</b><br><i>Thomas Wieser</i>   | 036 |
| 4 | <b>Austria's Open Strategic Autonomy</b><br><i>Margarethe Schramböck</i>   | 050 |
| 5 | <b>A tous azimuts? Russia's Balancing Act Between<br/>Resource Power, Economic Transformation, and<br/>Global Systemic Competition</b><br><i>Dmitri Trenin</i> | 064 |
| 6 | <b>Chinese Economic Statecraft:<br/>What to Expect in the Next Five Years?</b><br><i>Alicia García-Herrero</i>   | 082 |

- 
- 7** **With a Little Help from a Friend: A Geoeconomic Infusion for the Transatlantic Partnership** **104**  
*Daniel S. Hamilton*
- 8** **The Triangle Faces East: The Geoeconomic Power of Russian-Chinese-Arab Gulf Cooperation** **120**  
*Theodore Karasik*
- 9** **Global Supply Chain Management in a Fractured World: An Insider's Perspective** **136**  
*Ross Kennedy*
- 10** **Infrastructure Development and Geoeconomic Competition: A Framework for Analysis** **156**  
*Björn Fägersten and Tim Rühlig*
- 11** **Ensuring Access to Raw Materials Amid Geoeconomic Competition: An Austrian Perspective** **172**  
*Elisabeth Köstinger*
- 12** **Green New Deal: Europe's Geoeconomic Joker?** **194**  
*Kirsten Westphal*



# **Chinese Economic Statecraft: What to Expect in the Next Five Years?**

*Alicia García-Herrero*

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## China's Achievements After 100 Years of Single Party Rule

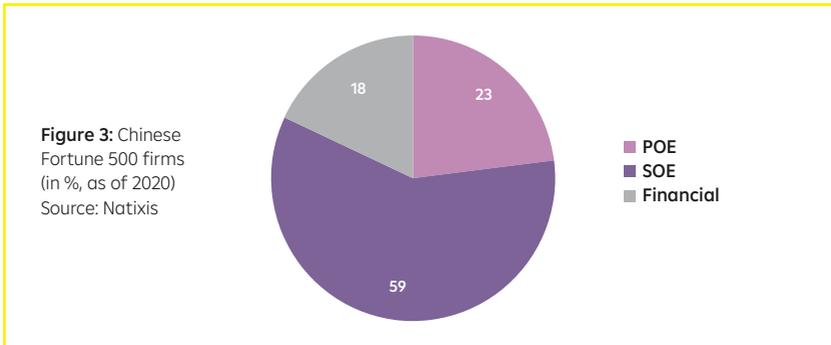
The start of economic reform under Prime Minister Zhu Rongji and President Deng Xiaoping in the late 1980s was widely seen as the turning point for the trajectory of Chinese economy. Key to the reform was the increased private ownership of the production of goods and services as well as the opening to trade and foreign direct investment.<sup>77</sup> The reason for the push toward private ownership is not so much ideological – China remains a socialist country – but pragmatic. Private-owned enterprises' (POEs) return on assets has remained stubbornly higher than that of state-owned enterprises (SOEs) – and not just centrally owned state enterprises but local state-owned companies, too.<sup>78</sup> More importantly, state-owned companies having undergone partial private privatization, and the so-called mixed ownership companies also tend to have high returns on assets. In other words, China's economic success cannot be understood without the dynamism of its private sector and its openness to the rest of the world.



77 Alicia Garcia-Herrero, "Will the Private Sector Save China's Growth Model?," *ZhongHua Mundus*, June 9, 2021, <https://mailchi.mp/648c2c1c032f/zhnghu-mundus-will-the-private-sector-save-chinas-growth-model>.

78 Alicia Garcia-Herrero and Gary Ng, *China's State-Owned Enterprises and Competitive Neutrality*, Policy Contribution No. 5/21 (Brussels: Bruegel, 2021), <https://www.bruegel.org/2021/02/chinas-state-owned-enterprises-and-competitive-neutrality/>.

China's reform and opening has moved in zigzag in the last few years, however. On the one hand, private ownership has continued to increase, when measured as the share of listed assets (Figure 2), but POEs are not yet as big state-owned companies. In fact, the number of Chinese private companies in the Fortune 500 is much smaller than that of SOEs, all the more so if we consider that the largest Chinese financial institutions are all state owned (Figure 3).



In addition, the regulatory environment faced by private companies has become much more complex since the 13th Plenum in November 2013, the first under the new chairmanship of President Xi Jinping. Since that Plenum, and especially since the modification of China's Communist Party (CCP) Charter in 2017, several measures have been announced to increase the control of the state in private companies.<sup>79</sup>

Regarding China's opening process, China has signed a number of important trade deals in the past few years, the most important one being the Regional Comprehensive Economic Partnership among ASEAN countries and Japan, South Korea, and China. On the investment front, China has finally moved to a negative list for inward foreign direct investment (FDI) at the national level, with 33 sectors remaining closed for foreign investors.<sup>80</sup> Furthermore, and

79 On September 15, 2021, the General Office of the Central Committee of the Chinese Communist Party (CCP) issued the *Opinion on Strengthening the United Front Work of the Private Economy in the New Era*, calling on the nation's United Front Work Departments (UFWs) to increase CCP ideological work and influence in the private sector. In the same vein, in 2020 hundreds of Chinese SOEs amended their corporate charters to codify a role for the Party in corporate governance. See: [http://www.gov.cn/zhengce/2020-01/05/content\\_5466687.htm](http://www.gov.cn/zhengce/2020-01/05/content_5466687.htm).

80 "2020 National Negative List," National Development and Reform Commission and Ministry of Commerce, July 23, 2020, [http://www.gov.cn/gongbao/content/2020/content\\_5532623.htm](http://www.gov.cn/gongbao/content/2020/content_5532623.htm) (in Chinese).

partially as a response to the U.S. import tariffs for Chinese products, China has also embarked on an array of protectionist measures on the trade side, such as import tariffs or export controls on some key technologies where China is strong (e.g., drones and components of 5G).<sup>81</sup> More recently, export tariffs have also been introduced on iron ore to protect its domestic use and avoid a further escalation of iron ore prices.

Against a backdrop of much slower reform and a zigzag strategy for opening up, the question is how much China can grow in the next few decades, and what the main sources of growth will be in this new stage of development.

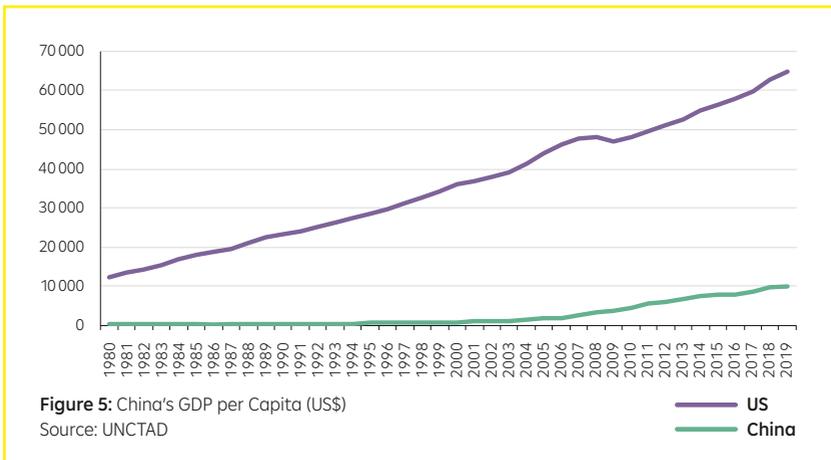
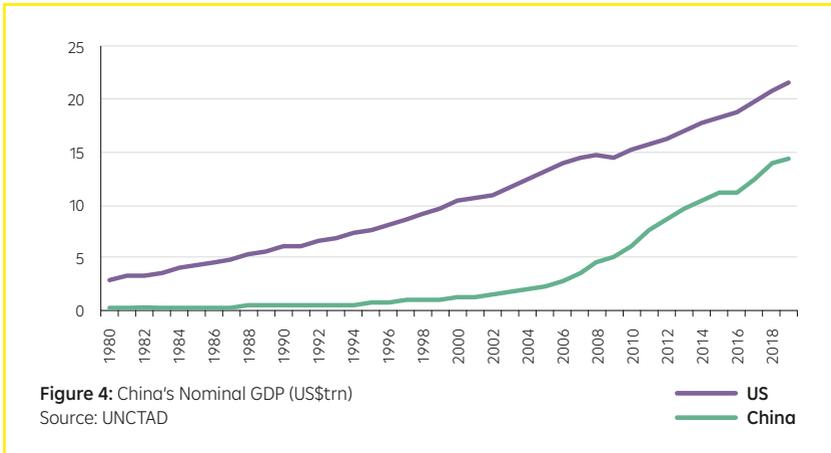
## Where Is China in Terms of Growth and Where We Should Be Heading

As mentioned in the previous section, China has successfully defied the convergence trend with still meteoric growth thanks to the adoption of reform and openness measures that lift the productivity growth rate. However, China's growth rate has been on a downward trend for the last decade in what is generally considered to be a structural trend, which will continue for decades to come. In this section, we review the forces behind China's structural deceleration but also possible ways to counter the process, especially through human capital investment and "effective" innovation.

Thanks to the positive overall population growth rate and the rural-urban population migration, the size of China's Gross Domestic Product (GDP) grew massively even before its accession to the World Trade Organization (WTO), with the GDP expanding from US\$0.3trn as of 1980 to US\$1.2trn as of 2000 (Figure 4). Since stepping into the 21st century, China has sustained its growth at a rapid pace boosted by international trade. The convergence with the United States in terms of GDP per capita has been obvious. The GDP per capita of China has increased by more than three times from less than US\$1,000 to over US\$3,000 (Figure 5). But the situation seemed less favorable after the global financial crisis, based on which one would point to a consistent slowdown of the Chinese economy. This seems not hard to understand, as it reflects a wealthier China. Although lower growth as a consequence of "eco-

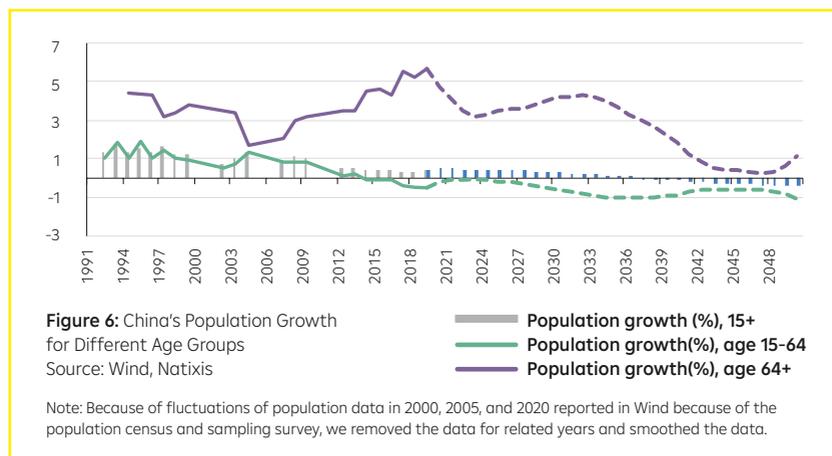
81 "Revision of the Catalogue of Technologies Prohibited or Restricted from Export," Ministry of Commerce and Ministry of Science and Technology, August 28, 2020, [http://www.gov.cn/zhengce/zhengceku/2020-08/29/content\\_5538299.htm](http://www.gov.cn/zhengce/zhengceku/2020-08/29/content_5538299.htm) (in Chinese).

conomic convergence" is a given phenomenon, the question is whether China's structural deceleration might be faster than one would expect because of China's fast aging but also a lower return of assets stemming from a too rapid increase in fixed asset investment.



Against the backdrop, most of the existing quantitative estimates of China's future growth point to much lower growth, especially after 2035. This is even more the case for those projections assuming limited reform, which is argu-

ably where we are today. For example, the World Bank<sup>82</sup> predicts average growth below 4% from 2021 to 2030. This echoes an earlier study by Albert et al. that points to a steady deceleration to 4.5% up to 2025 and a much faster one thereafter (2.3%).<sup>83</sup> The IMF's World Economic Outlook seems more optimistic, but it only covers the next five years, and it has already incorporated the likely massive rebound in 2021 after COVID-19. Bai and Zhang are much more optimistic, with expected growth above 6% and at 8%, respectively.<sup>84</sup> Still, Justin Lin et al.<sup>85</sup> make it clear that this is more an aspiration than a baseline projection, as favorable conditions are needed to achieve it, which might have been the case at the time of their publication, when China was blessed by a very favorable external environment, which radically changed in 2018 with President Trump.



There are two key variables for China's growth potential in the future. The first is aging. China's labor force is bound to grow less over time (from 0.5% from 2011 to 2019 to 0.4% on average from 2020 to 2030 (Figure 6). Although this

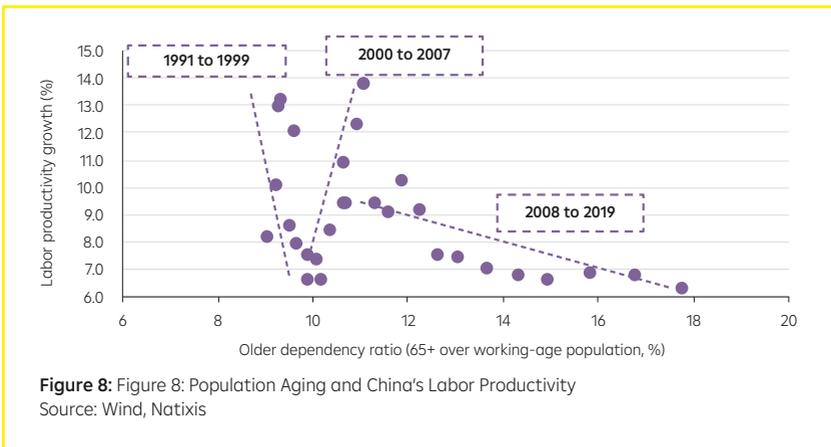
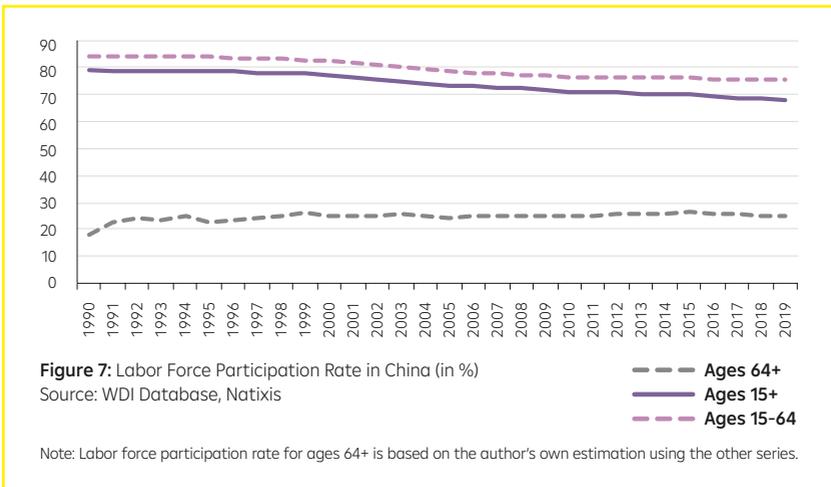
82 *Innovative China: New Drivers of Growth* (Washington, DC: World Bank, 2019), <https://openknowledge.worldbank.org/handle/10986/32351>.

83 Marie Albert, Cristina Jude, and Cyril Rebillard. *The Long Landing Scenario. Rebalancing from Overinvestment and Excessive Credit Growth. Implications for Potential Growth in China*. Banque de France Working Paper No. 572 (Paris: Banque de France, 2015), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2671760](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2671760).

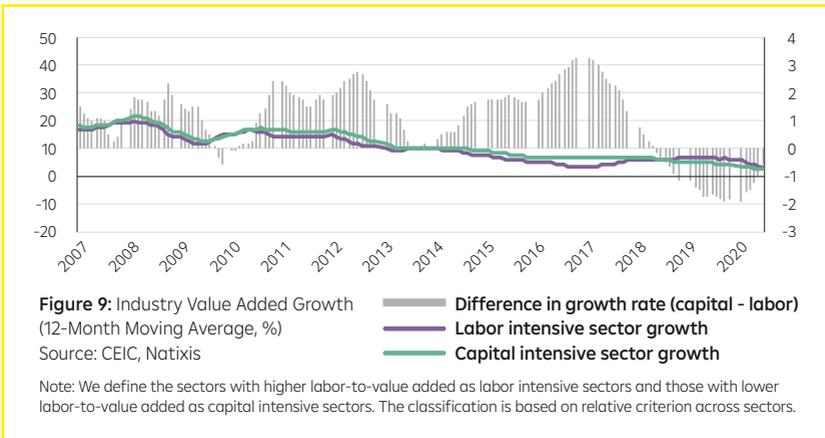
84 Chan-en Bai and Qiong Zhang, *A Research on China's Economic Growth Potential* (London: Routledge, 2020).

85 Justin Yifu Lin, Guanghua Wan, and Peter J. Morgan, "Prospects for a Re-Acceleration of Economic Growth in the PRC," *Journal of Comparative Economics* 44:4 (November 2016), pp. 842-853, <https://ideas.repec.org/a/eee/jcecon/v44y2016i4p842-853.html>.

change is tiny, China's aging implies that the overall labor participation rate will also shrink beyond what is already has. In fact, China's labor force participation rate has decreased significantly over the past decades from nearly 79.0% in 1990 to 69.4% in 2019 (Figure 7). Still, technology upgrading could enable more room for the elderly to work and push up the labor participation rate. In that regard, China is likely to raise retirement age from the current very low level compared to international standards (60 for men at 50/55 for women, depending on whether they are blue or white-collar workers).



Second, the slow-down in labor productivity is much more significant than aging when explaining the rapid deceleration of the Chinese economy. One of the key reasons for this trend might be aging, as both aging and labor productivity have decelerated in tandem in the last few years, although this was not the case in previous decades (Figure 8). There are other important factors behind the rapid slowdown in labor productivity. An important one is China's turn towards more labor-intensive sectors in the past few years, as the growth model turns to services – which require more labor at a time of relatively larger labor scarcity (Figure 9). Another potential and perhaps even complementary reason for this is whether China's push for technological upgrade through research and development (R&D) and investment in human capital can stop, or at least mitigate, the slowdown in productivity. To date, these efforts have not yet been fruitful, as neither labor productivity nor total factor productivity growth are showing signs of a lift. Beyond the counterintuitive push for labor-intensive innovation, there is a more general issue – the rather inefficient allocation of resources, which drags down total factor productivity.



## Beyond the Baseline Scenario: Geopolitics Is Increasingly Important

The U.S.-China relationship has shifted dramatically since late 2017, when the Trump administration officially labelled China a strategic competitor. The Biden administration does not seem to have changed that rhetoric regarding

China. As such, geopolitical risks, especially the confrontational relationship with the United States, may also push China's medium-term perspective lower, the more the two economies bifurcate their path from the still important economic relations, whether we look at trade or investment.<sup>86</sup> In this section, we zoom into where we stand with the U.S. administration's efforts to contain China, especially as regards bifurcation in their trade, technology, and financial relations. We also investigate China's actions, some of which started even before the U.S.-led trade war in 2018. For trade and technology, dual circulation seems to be China's main strategy. For finance and the extraterritorial role of the dollar as reserve currency, a renewed effort to internationalize the RMB, possibly with the help of China's Central Bank Digital Currency (CBDC), seems key.

### *U.S.-Led Bifurcation*

Since the announcement of the seemingly untargeted measures in early February 2018 for solar panels and washing machines, the United States has moved to increasingly targeted action against China, with trade flows between the two contracting massively (Figure 10). The most obvious case in point was the announcement of 25% additional import duties to be applied to US\$50bn equivalents of imported goods from China on the basis of China's infringement of intellectual property rights (García-Herrero, 2018a). The speedy introduction of the announced import tariffs by the United States, without allowing for much time to negotiate a deal between China and the United States, shows the U.S. resolve to move away from the status quo in terms of the functioning of the global trading system, at least as China is concerned.<sup>87</sup> China retaliated with equivalent import tariffs on U.S. goods. In that regard, even with a truce reached on the sidelines of the Buenos Aires G20 summit in late 2018, the U.S.-China trade war re-escalated soon in May 2019 with former U.S. President Trump's unexpected announcement to ramp up tariffs from 10% to 25% on products covered by the September 2018 action. In January 2020, right before the outbreak of the COVID-19 pandemic, the Phase 1 deal was finally reached as an interim agreement between China and the United States. This, together with the United States' massive need for imports

86 Alica García-Herrero and Junyun Tan, *Deglobalisation in the Context of the United States-China Decoupling, Policy Contribution 21/2020* (Brussels: Bruegel, 2020), <https://www.bruegel.org/2020/12/deglobalisation-in-the-context-of-united-states-china-decoupling/>.

87 Alica García-Herrero, *Europe in the Midst of China-US Strategic Economic Competition: What Are the European Union's Options?* (Brussels: Bruegel, 2019), <https://www.bruegel.org/2019/04/europe-in-the-midst-of-china-us-strategic-competition-what-are-the-european-unions-options/>.

during the pandemic explains the return to massive trade flows between the two countries in 2020. It should be noted, however, that neither the Phase 1 deal nor COVID-19 have resulted in the United States eliminating its import tariffs for Chinese goods. All the more worrisome, the Biden administration has passed legislation to enhance the resilience of U.S. supply chains for key strategic sectors, including semiconductors and rare earth metals.<sup>88</sup> Such legislation ultimately aims at reshuffling some critical U.S. value chains away from China in the light of heightened geopolitical tensions and the risk of China retaliating. China's recent anti-sanction legislation, making retaliation against any target legally feasible, has only increased the concerns of the U.S. and other Western countries' governments but also the private sector.



**Figure 10:** China's Trade in Goods with the United States (YTD, YoY %)  
Source: Natixis, Wind

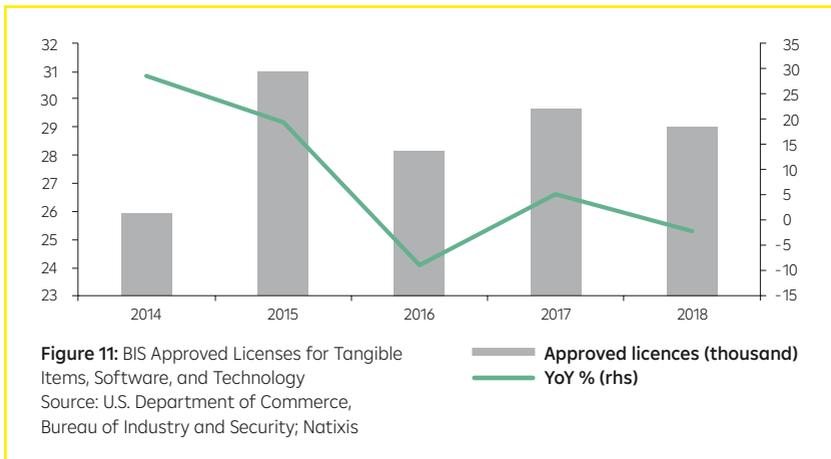
— Export  
— Import

Beyond trade, the Trump administration stepped up the measures for China's containment, but they were not fully unexpected, especially as concerns the tech side. In fact, the Obama administration had already increased the scrutiny through stricter export controls, especially after China announced the adoption of Made in China 2025, its landmark industrial policy. This long-term plan made it increasingly clear that China would be aggressively pursuing rapid technological upgrade and ambitious objectives in terms of substituting key imports with domestic components. In other words, the idea of self-reliance being a desirable objective for China does not really start with

88 "Executive Order on America's Supply Chains," *The White House*, February 24, 2021, <https://www.whitehouse.gov/briefing-room/presidential-actions/2021/02/24/executive-order-on-americas-supply-chains/>.

the dual circulation strategy but earlier, especially since Made in China 2025 was launched in 2015 as President Xi came to power.<sup>89</sup> Against that backdrop, the transfer of technology has become increasingly restricted by tightening exports control on high-end technology products (Figure 11). In turn, China has recently introduced export licenses for key technologies, such as drones and artificial intelligence.

One important measure taken by the Trump administration to contain China's technological rise is the expansion of the "entity list."<sup>90</sup> This tool effectively forbids U.S. companies to conduct business with the Chinese companies on the list. In fact, the U.S. Bureau of Industry and Security (BIS) had published such a list of entities deemed risky to U.S. national security as early as 1997. But the names on the list have expanded quickly since 2019 with the addition of Huawei as well a couple of its affiliates and more Chinese corporations. In 2020, China also announced the release its own entity list as retaliation,<sup>91</sup> but it only offers a framework, with the names of the targeted companies not yet being made public.

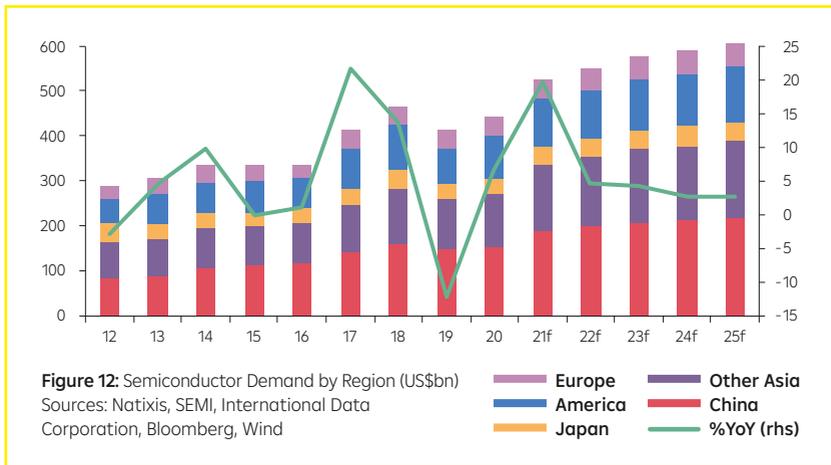


89 Alicia Garcia-Herrero, "US Tariffs Aim to Contain China's Technological Rise," *Bruegel*, April 10, 2018, <https://www.bruegel.org/2018/04/u-s-tariffs-aim-to-contain-chinas-technological-rise/>.

90 "Entity List," *Bureau of Industry and Security*, undated, <https://www.bis.doc.gov/index.php/policy-guidance/lists-of-parties-of-concern/entity-list>.

91 "Provisions on the Unreliable Entity List," *Ministry of Commerce*, September 19, 2020, <http://english.mofcom.gov.cn/article/policyrelease/questions/202009/20200903002580.shtml>.

A key sector where the impact of technology bifurcation might be most serious is the semiconductor industry, which has become apparent with the ban on sourcing semiconductors to Huawei. In fact, it affects not only American producers but also Taiwanese producers, among others. Furthermore, the U.S. entity list has expanded further from Huawei to SMIC, the largest producer of semiconductors in China. Targeting semiconductors is all the more understandable as China alone has consumed 35% of the global demand, up from 29% for the same period (Figure 12), whereas it hardly produces final semiconductors and certainly not at the highest end, which is what is needed for new technologies such as electric vehicles and the like. In fact, China imports more semiconductors by value than oil.



Interestingly, the U.S. containment on Chinese technological expansion is also moving into software. Before the 2020 U.S. election, the Whitehouse published an executive order targeting Chinese owned social media platforms TikTok and WeChat. The measures have threatened penalties on U.S. residents or companies engaging in any transactions with these firms after the order is in effect. Although the Biden administration has revoked Trump's order seeking to ban TikTok and WeChat, the new order requires Chinese apps to take stricter measures to protect private information if they want to stay in the U.S. market.<sup>92</sup> In other words, the Chinese apps could still

92 "Executive Order on Protecting Americans' Sensitive Data from Foreign Adversaries," The White House, June 9, 2021, <https://www.whitehouse.gov/briefing-room/presidential-actions/2021/06/09/executive-order-on-protecting-americans-sensitive-data-from-foreign-adversaries/>.

face bans for the data practices. One should not forget that China was the first to create a great firewall to block the free flow of information back in 2009.<sup>93</sup> But as the United States follows China's lead, the Internet and thus the exchange of global information will become increasingly divided. Taking as an example China Standards 2035, the country's push to enhance its independence in standard setting, one can already envision that the creation of two major – but rather independent – ecosystems might not be as far off as some may think. This could include hardware and software and possibly other technologies.

The increasing constraints for the free flow of investment, especially as regards Chinese acquisitions of companies in key technology sectors, points in the same direction. This is particularly the case for the United States, after the granting of increased powers by Trump to the Committee on Foreign Investment in the United States (CFIUS) in 2018. The EU also set up its own investment screening process at the EU level in April 2020 to beef up the coordination among national investment screening agencies. These moves show the unease in the West about China's technological upgrade. One should also realize that, beyond the containment of technology, the lack of reciprocity as regards Western companies' still very limited access to the Chinese market, is another factor pushing for bifurcation. In fact, although China has finally approved a negative list for inward foreign direct investment, as many as 33 sectors remain on the negative list, which means that no foreign investor can gain control in such sectors. In other words, on the investment space, the lack of full openness by China and its rapid tech upgrade are additional factors pushing bifurcation.

An area where the push for decoupling looks much less obvious is portfolio investment, unless from the United States towards China as reflected in the growing presences of United States' and, more generally, foreign financial institutions in China, but also the rapid increase in portfolio flows into China. In fact, U.S. investors have flocked into China's equity and bond markets in the last few years, following a general trend by foreign investors. One key factor behind this trend has been the massive quantitative easing by the Federal Reserve and the very cheap cost of funding in the developed world. In turn, China's interest rates have remained stubbornly high, and equity performance has been very positive in the light of China's stellar recovery

93 Miguel Helft, "YouTube Blocked in China, Google Says," *The New York Times*, March 24, 2009, <https://www.nytimes.com/2009/03/25/technology/internet/25youtube.html>.

from exit compared to the rest of the world. These factors have lost steam recently, given the regulatory crackdown affecting the equity market and the increasingly lax monetary policy pushing interest rates down.

### *China's Response: Self-Reliance Under the Logo of "Dual Circulation"*

The West's and especially the U.S. move from engagement to containment have come in tandem with a much more assertive China. In fact, China has announced retaliatory measures for close to every announcement made by the United States. However, the measures are bound to be less effective, as the trade and technology relation between the United States and China remains unbalanced in favor of the United States. At the same time, China has taken measures to accelerate its quest for self-reliance, which already existed, as the China Manufacturing 2025 plan clearly exemplifies. This quest, clearly enshrined in 14th Five Year Plan<sup>94</sup> through the dual circulation strategy<sup>95</sup> can have much longer lasting consequences both for China and the rest of the world.

The dual circulation strategy basically stands for China's quest to insulate the domestic market from the rest of the world by eliminating any bottleneck, whether natural resources or technology, for China to vertically integrate its production and achieve self-reliance served by China's huge domestic market. A relevant consequence for the world is that China will no longer need to import high-end inputs, with obvious negative consequences for major exporters of technology like Germany, Japan, South Korea, or the United States. As if this were not enough, the second aspect of dual circulation, boosting external demand, in a context of Western containment, will increase the importance of the Belt and Road Initiative (BRI) to ensure open markets in the emerging world. In essence, the dual circulation is part of China's master plan to become self-reliant in resources, technology, and also demand, through its huge market as well as that in third markets through BRI. In other words, as China become more vertically

94 *The Fourteenth Five-Year Plan for the National Economic and Social Development of the People's Republic of China and the Outline of the Long-term Goals for 2035 (Beijing: National Development and Reform Commission, 2021)*, <https://www.ndrc.gov.cn/xxgk/zcfb/ghwb/202103/P02021032353879779059.pdf> (in Chinese).

95 *Plan of Promoting Deep Integration and Innovative Development of Logistics and Manufacturing Industry (Beijing: National Development and Reform Commission, 2021)*, <https://www.ndrc.gov.cn/xxgk/zcfb/tz/202009/P020200909333031287206.pdf> (in Chinese).

integrated, major exports of manufactured inputs will suffer. The semiconductor sector remains a bottleneck for China, however, which explains Chinese companies' buying spree during the last few years. Interestingly, in geopolitical terms, Taiwan could hold the key for China to achieve self-reliance in semiconductors, given its companies' strength (especially TSMC) in the most difficult steps of the semiconductor supply chain, namely, foundry and lithography.

Against this backdrop, it is important to note that China's growth will not only decelerate further in the future but it will also be increasingly less shared with the rest of the world, due to the dual circulation strategy. Those governments or companies expecting the manna from China in terms of exports, as happened when China announced its rebalancing towards domestic demand in 2008, may be proven wrong. In other words, whereas the old rebalancing was designed to move China away from excessive external imbalances, the dual circulation strategy aims at self-sufficiency, but with a continued push on exports as long as it is feasible. In fact, the new dual circulation is nothing more than an important substitution strategy while trying to keep foreign markets for Chinese goods.<sup>96</sup> This change in strategy is not a capricious move by the Chinese leadership but a hedging response to the changing nature of Beijing's relations with the United States as the leading global power.

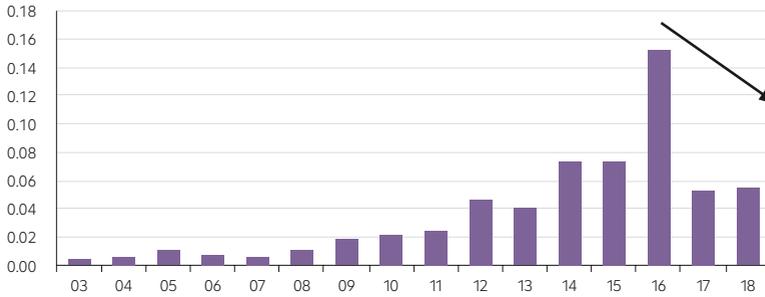
### *Another Important Threat Is Financial Decoupling*

Beyond trade and technology, U.S. containment has also moved into finance. To start, U.S. financial sanctions on China are now in place, as the Biden administration finally passed the Trump-era list of military-related Chinese companies banned from receiving U.S.-based investment. China's response with the Anti Foreign Sanction Law (AFSL) and forcing Chinese companies to delist from the United States on the grounds of unwarranted data sharing is further pushing towards financial decoupling.

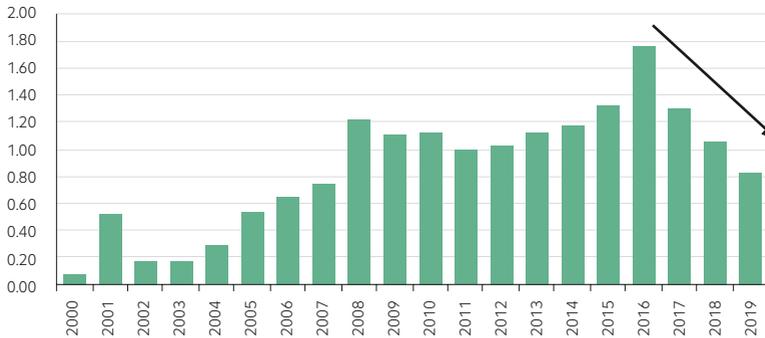
The reality is that financial linkages have been waning for years, at least as FDI flows are concerned. U.S. FDI flows into China peaked after China's entry into the WTO but have been decreasing since (Figure 13). Chinese FDI in the

<sup>96</sup> Alicia Garcia-Herrero, "Why China's 'Dual Circulation' Plan is Bad News for Everyone Else," *Nikkei Asia*, September 17, 2020, <https://asia.nikkei.com/Opinion/Why-China-s-dual-circulation-plan-is-bad-news-for-everyone-else>.

United States grew until 2016 (Figure 14) and has remained low since former President Trump came to power.



**Figure 13:** U.S. FDI in China (% of GDP)  
Sources: Natixis, UNCTAD, WIND



**Figure 14:** Chinese FDI in the U.S. (% of GDP)  
Sources: Natixis, UNCATD, WIND

Portfolio flows are a different story. Whereas China's holdings of U.S. treasuries are clearly on a downward trend, U.S. holdings of Chinese assets have increased very rapidly, notwithstanding the U.S. sanctions on some specific names (Figure 15 and Figure 16). The web of sanctions is becoming increasingly complex.<sup>97</sup> Some are Xinjiang or Hong Kong-related, but the most important

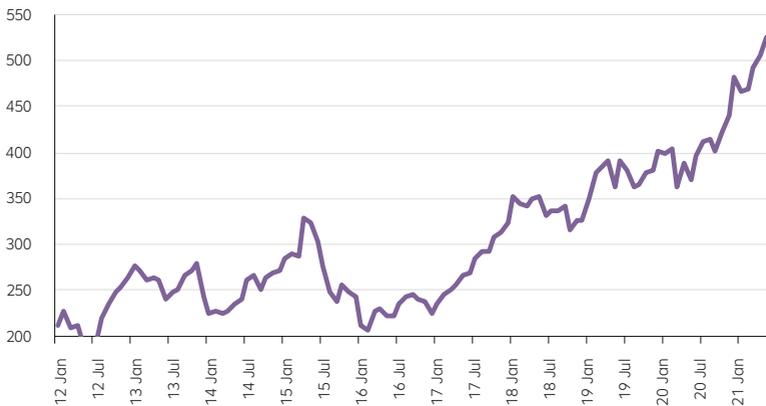
97 "Executive Order on Addressing the Threat from Securities Investments that Finance Certain Companies of the People's Republic of China," The White House, June 3, 2021, <https://www.whitehouse.gov/briefing-room/presidential-actions/2021/06/03/executive-order-on-addressing-the-threat-from-securities-investments-that-finance-certain-companies-of-the-peoples-republic-of-china/>.

ones are the Pentagon list of Chinese military companies via the Office of Foreign Assets Control (OFAC), for which an investment ban for U.S. investors is in place. These are by now about 60 companies, some of which are of very relevant size, such as ChemChina or Xiaomi. China's retaliation, namely, the anti-foreign sanctions law passed in June 2021, could increase the costs for foreign firms operating in China and thus further deter investment flows.



**Figure 15:** China's Holding of U.S. Treasuries (US\$trn)

Source: TIC

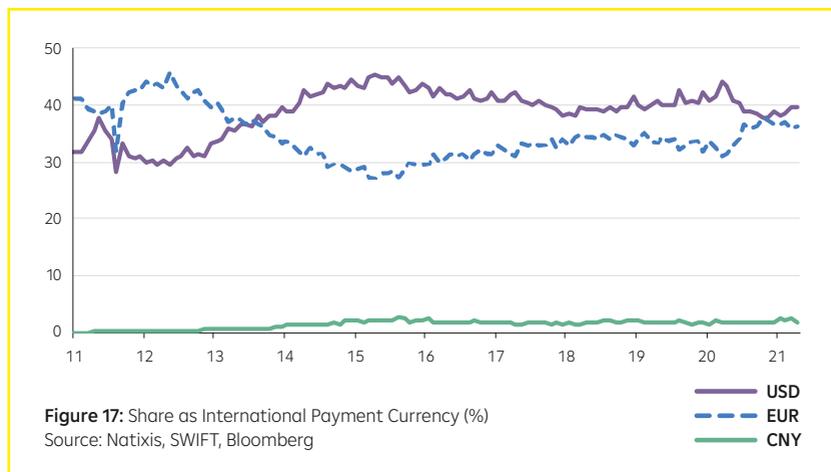


**Figure 16:** U.S. Holding of Chinese Long-Term Securities (US\$bn)

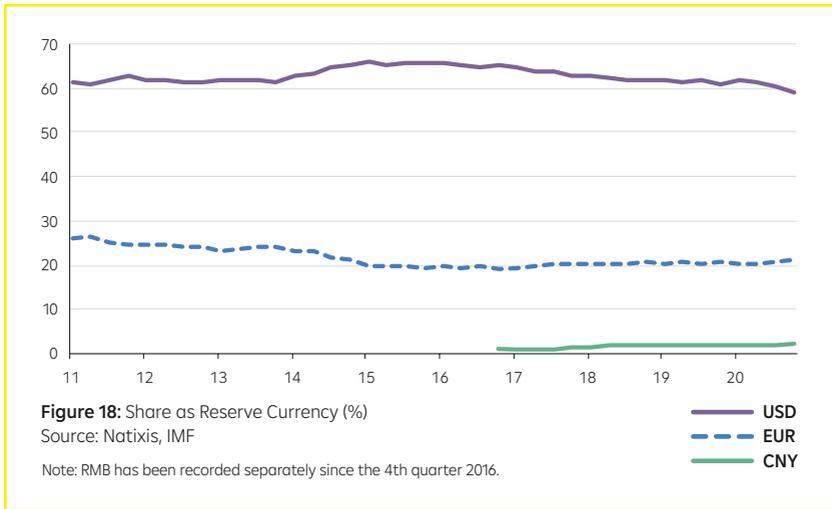
Source: TIC

Such costs may stem from additional compliance-related costs but also reputational costs if the perception exists that companies are too dependent on China.

In line with the reduction in cross-border lending, cross-border financing has become more difficult. For example, Chinese technology firms listed in the United States have opted for secondary listings to avoid the risk of delisting from the U.S. stock market. This is the case for Alibaba Group, JD.com, and NetEase Inc. At the same time, the Chinese government has meanwhile adopted policies to encourage the domestic funding of technology companies, including the launch in 2019 of the Science and Technology Innovation Board (SSE STAR Market). Based in Shanghai, the STAR Market has the objective of supporting promising technology start-ups in their equity financing, helping avoid U.S. equity markets. As if this were not enough, the Chinese government is also resorting to penalizing Chinese listings in the U.S. market, as the case of Didi shows.



Beyond the specific retaliation measures, China's grand strategy to respond to financial bifurcation is for the RMB to eventually become an international currency. This used to be a long-term objective, but it has become more urgent as a consequence of the United States' extraterritorial use of the U.S. dollar to target China. The fact that RMB only captures a tiny share in either global payments or reserve currency, roughly 2%, adds to the urgency (Figure 17 and Figure 18).



The first attempt by China to internationalize the RMB was centered on facilitating Hong Kong as the global hub for offshore RMB business; efforts then extended to other offshore centers, which did not work out well after the 2015 Chinese equity and currency shocks. Now China is trying again by fostering cross-border acceptance of its digital currency, profiting from a first-mover advantage.<sup>98</sup> This is important not only in the long run but also immediately, as it can help China bypass the use of the dollar when and if needed.

But the internationalization of a currency needs more than just technical preparations. It also requires certain conditions to be fulfilled for its global acceptance, namely, preserving its value through price stability, offering a large pool of highly liquid assets, and allowing full capital account convertibility for money to instantly flow in and out of RMB. This means that the Chinese government will need to take additional steps toward the liberalization of the capital account so as to enhance the full convertibility of the RMB.

As such, a key question is whether the digital renminbi, the E-CNY, may help Chinese authorities to square the circle, namely, to allow for more capital account openness while still being able to trace capital flows and act accordingly. This explains why E-CNY's traceability under the design of "controlled

<sup>98</sup> Alicia Garcia-Herero, "Could the RMB Dislodge the Dollar As a Reserve Currency?," *BRINK News*, July 8, 2021, <https://www.brinknews.com/could-the-rmb-dislodge-the-dollar-as-a-reserve-currency/>.

anonymity" is key, as it allows China to control seemingly free financial flows. In other words, the digital currency could offer a way to promote RMB as an international currency, while still keeping control of cross-border flows. Another important objective is for China to further project soft power by using its own currency for trade and investment exchanges particularly in the areas under China's influence, which tend to coincide with the BRI geographies.

Although clearly a master plan at a time when big uncertainties exist about the U.S. ballooning debt, there are relevant technical barriers to a cross-ledger solution, and the institutional differences make it easier said than done. Data sharing of financial transactions is also an important stumbling block. Another important factor that needs to be improved is the liquidity of RMB financial assets. Although the size of the bond market has grown rapidly since the global financial crisis, it is dominated by corporates and financial institutions. More liquidity on central government paper is needed, with a longer yield curve and clearer benchmarks. But whether the E-CNY can help on this front remains an open question.

## Conclusions

The meteoric rise of the Chinese economy, not just in sheer GDP size but also income per capita, has a lot to do with China's reform and opening-up, but both, especially the reform path, have slowed down. In that regard, although the Chinese economy is poised to become the largest in the world around 2028, its convergence in income per capita with the United States is set to slow down quite substantially in the next few years, led by aging but more importantly by the rapid deceleration in productivity. The latter trend does not seem to be changing course, notwithstanding Chinese massive investment in human capital and especially R&D. This is all the more the case if the current, much more hostile, external environment continues, which seems very likely.

The Biden administration has not shown any sign of wanting to change Trump's containment towards China or of going back to the good old times of engagement. In fact, the scars of the trade war remain in place, although the Phase 1 deal and the COVID-19 pandemic have further pushed up trade exchanges. Still, the Biden administration is more focused on supply chain reshuffling than import tariffs, as well as on containing China in its tech upgrade. This, added to the outright ban on key components in China's key

companies as well as Chinese software in the United States are clear signs of bifurcation. All of these things are pushing China towards self-reliance as suggested by the introduction of the dual circulation strategy, which is clearly very bad news for global exporters, as China will engage in substituting imports with domestic production while competing in third markets. Through dual circulation China might be able to achieve further vertical integration, but there is also a risk that existing bottlenecks, such as in the semiconductor industry, will further reduce China's growth potential. Regarding finance, the push for decoupling is coming from both sides. The United States is imposing sanctions on key Chinese corporates, and China is forcing its companies to delist from the United States. Furthermore, the push by the United States to profit from the extraterritorial reach of the U.S. dollar as reserve currency is putting pressure on China to internationalize the RMB faster. The silver bullet is the RMB digital currency, the E-CNY. This is obviously an experiment, and as such a risk, so the impact on China's potential growth remains uncertain.

All in all, there seems to be a big geoeconomic puzzle overshadowing China's future economic policy that relates to the CCP's current clamp-down on China's Big Tech companies and, more generally, China's – relatively more productive, and thus profitable – private sector. The impact of this crack-down is bound to reduce China's potential growth further. This will make the redistribution of income, promised under the new "common prosperity"<sup>99</sup> mantra, much more difficult.

99 „China Economists Say ‚Common Prosperity‘ Won't Rob the Rich,“ *Bloomberg*, August 25, 2021, <https://www.bloomberg.com/news/articles/2021-08-25/china-economists-say-common-prosperity-not-about-robbing-rich>; „Common Prosperity' Push to Share China Wealth More Fairly,“ *South China Morning Post*, August 20, 2021, <https://www.scmp.com/comment/opinion/article/3145702/common-prosperity-push-share-china-wealth-more-fairly>.

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