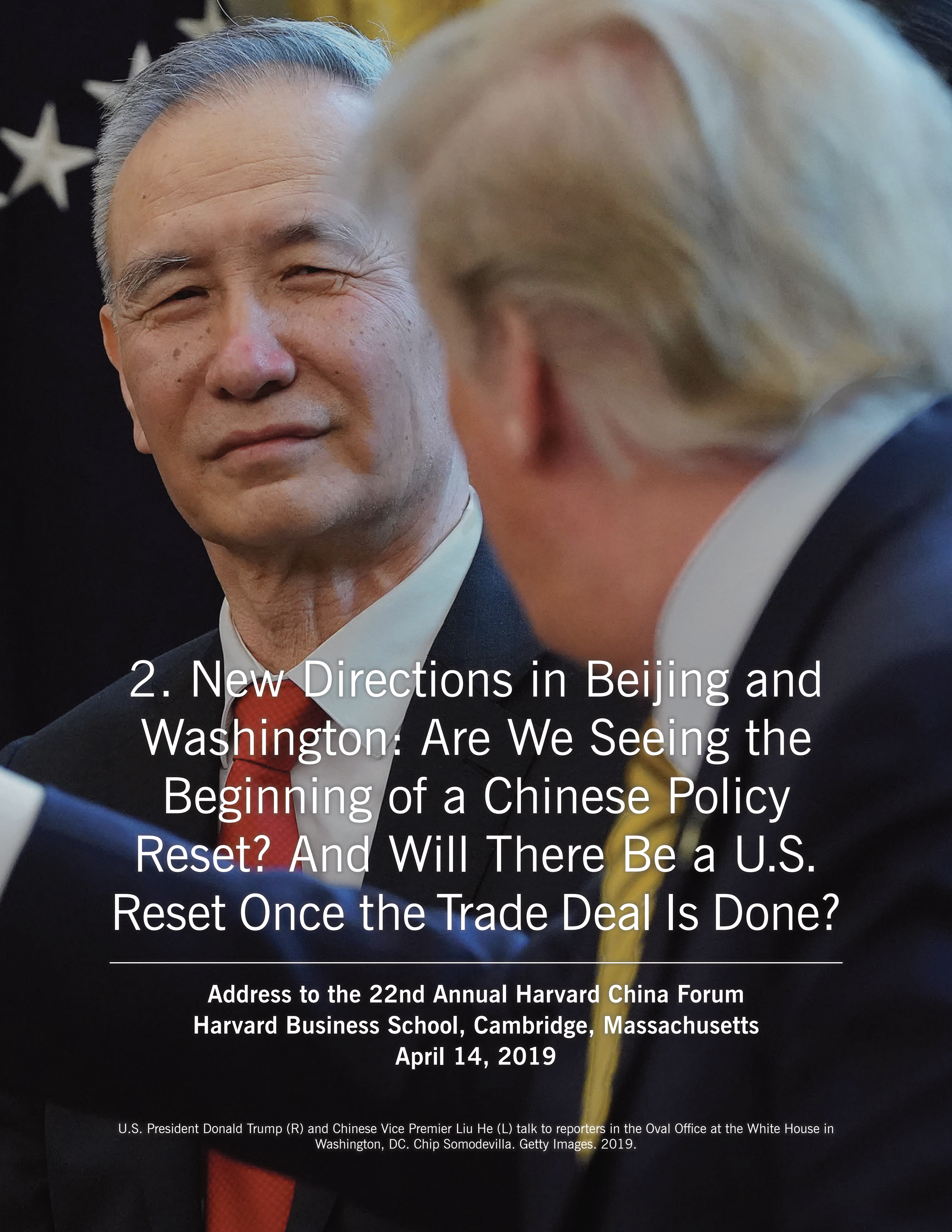

2. New Directions in Beijing and Washington: Are We Seeing the Beginning of a Chinese Policy Reset? And Will There Be a U.S. Reset Once the Trade Deal Is Done?

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

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

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

Meanwhile, the Donald Trump administration has announced, and partly executed, a new policy of "strategic competition" with China. The U.S.-China trade war has been its most concrete manifestation to date. But Vice President Mike Pence's speech to the Hudson Institute in October 2018 foreshadowed a much broader "doubling down" against China across foreign policy, security policy, and human rights—as well as the eternally vexing question of Taiwan. Six months after the vice president's speech, however, the precise operationalization of this new U.S. declaratory policy remains unclear—although the U.S. campaign to deny Huawei further access to global 5G markets is a harbinger of what may soon be on the way.

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There are, nonetheless, two big new questions arising for policymakers, which so far have not featured prominently in the public debate but may significantly shape the evolution of the U.S.-China relationship during the course of this year. The first is, are we witnessing the emergence of a significant change in economic policy direction in Beijing in response to the slowing of Chinese growth during 2018 that was brought about by a combination of domestic policy and trade war-related factors? If so, how do we best characterize this change in terms of further market liberalization—or, for that matter, the reverse? Is this change tactical or strategic? And will it be accompanied by any wider reset in Chinese foreign policy?

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

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

A Chinese Policy Reset?

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

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

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

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

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

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

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

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

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

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

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

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

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

To stimulate the Chinese economy, the authorities drew on the traditional instruments of monetary and fiscal policy to repair the emerging growth gap. On the monetary policy front, China reduced the capital reserve requirements for banks to lend to small and medium-sized private sector firms. It also issued an edict for large state-owned banks to increase lending to small businesses by 30 percent. The result has been that interbank and commercial lending rates have declined, and there has been general improvement in liquidity.

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

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

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

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

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

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

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

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

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

There is, however, from the Party's point of view, a political risk attached to all the above: namely, that just as foreign capital, through these new market openings, is now welcome to come into China in far greater quantities than in the past, the same foreign capital can quickly exit the country as well. In other words, if markets were to form a view in the future that China's overall economic policy direction was heading "left" (that is more favorable treatment of state-owned enterprises as part of a continuing political strategy of increasing Party control of the economy), then this would likely have a profoundly negative effect on underlying financial market sentiment. Of course, China could simply prevent foreign capital from leaving the country abruptly. But that would create a fundamental crisis of confidence with even deeper economic consequences for China's future. On balance, therefore, Chinese economic policymakers appear to be taking a calculated risk that making the country's capital markets more open to foreigners is worthwhile—both in terms of the immediate task of dealing with the practical problem of balancing the current account, as well as pinning the country's longer-term policy commitment to market reform.

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

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

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

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

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

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

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

Nonetheless, it is important for us all to be alert to whether China uses the resolution of the U.S.-China trade war as a political window of opportunity to undertake a much broader policy reset—toward the United States, its BRI partners, and the broader international community. China has heard much international criticism of its "overreach" in recent years. This, in turn, has led to some considerable reflection by the center. However, these are very early days, and we have yet to identify the extent to which any such policy reset would be tactical or strategic in nature. This remains very much an open question.

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

We should also reserve judgment on whether China will return to open and free markets, both at home and abroad, to sustain its growth performance over the long term. Xi Jinping's conclusion during his first term in office was that the ideological, political, and policy balance across the country and the economy was not right in the past. Xi has sought to rectify that balance in a direction more conforming to Xi's fundamental Marxist-Leninist worldview. He has also sought to reassert Party control. But at the same time, Xi Jinping has around him senior colleagues and economic advisors who understand deeply the impact that declining market freedom will have on economic growth, employment, living standards, competitiveness, and productivity. Xi Jinping recognizes, however reluctantly, the fact that a buoyant private sector is fundamental to his "China Dream" of a "strong and powerful Chinese nation," combined with a "great renaissance of the Chinese people." Therefore, we are likely to see further acts in this long-running play between the competing "dramatis personae" in Chinese politics contending for China's economic future—continued Party authority in one corner, always roiling against fundamental market freedoms in the other.

A U.S. Policy Reset?

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

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

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

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

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

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

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

Conclusion

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

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

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

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