China Extends a Hand to the West

by Antonia Colibasanu - June 21, 2023

China's leadership is meeting this week with leaders or senior officials from the most important Western powers. On a visit announced just days in advance, U.S. Secretary of State Antony Blinken traveled to China over the weekend – the first high-level U.S. visit to Beijing in almost five years, since a previously planned trip in February was canceled due to the spy balloon incident. The Chinese government described Blinken's meeting with his counterpart, Qin Gang, as "candid, in-depth and constructive." Chinese President Xi Jinping also unexpectedly met with Blinken. Meanwhile, Chinese Premier Li Qiang will this week be in Germany and France.

These diplomatic engagements come at a key moment in relations between China and the major Western powers. The pandemic raised concerns among business and government about economic interdependence, and Beijing's ambiguous stance on the Ukraine war spurred the West to seriously consider ways and means to reduce their economies' dependence on China. At the same time, debt and youth unemployment are growing problems in China, and the country's anticipated strong rebound from pandemic restrictions is disappointing. For these reasons, China urgently needs to engage with the West to exploit divisions between the U.S. and Europe, or at least slow the pace of "de-risking."

Europe's Perspective

The major European powers are reluctant to go as far as the Americans in erecting barriers to the Chinese economy. The buzzwords – like de-risking versus decoupling – have become almost meaningless, but they reflect disagreements about the desirability and risks of reducing economic interdependence with China. Europe prefers de-risking, which accepts the necessity of economic engagement but seeks to reduce the risks by diversifying supply chains, strengthening domestic industries and crafting political tools to deter or counter Chinese economic coercion. Decoupling better describes Washington's approach, though U.S. policymakers have co-opted "de-risking" to appeal to the Europeans. Decoupling seeks to reduce or even eliminate economic interdependence with China using tariffs and sanctions, investment restrictions and export controls. Due to its alliance with the U.S. and in light of the Ukraine war, Europe could eventually consider tougher measures against China more in line with decoupling.

 | Copyright © Geopolitical Futures. All rights reserved.

With that in mind, Premier Li Qiang's visit to Berlin on June 20, which included a meeting with Chancellor Olaf Scholz, was carefully prepared in advance. China's senior-most diplomat, Wang Yi, traveled to Berlin in early June to ensure that the Li-Scholz meeting would "keep China-Germany cooperation in the forefront of the world." After Germany, Li will visit France, where he hopes to improve bilateral cooperation and, more important, boost Chinese exports to the European market.

However, just days ahead of the consultations, Germany published its first national security strategy. The document describes China as a "partner, competitor and systemic rival" but notes that "the elements of rivalry and competition have increased in recent years." In addition, Berlin reportedly urged Beijing to downsize the number of ministers participating in the summit so as not to give its allies – especially in Washington – the impression that it was too welcoming of China. After all, Scholz's visit to Beijing in November 2022 was criticized as being too friendly toward China – which, among other states, is suspected of helping Russia avoid Western sanctions.

The German strategy document comes amid reports that France is pressuring the European Commission to take action against what it sees as China's unfair trade advantages, particularly in electric vehicles. Moreover, the commission on June 15 announced measures to rid its internal telecommunications networks of China's Huawei and ZTE, and urged member states to use the authorities in the bloc's 5G security toolbox to restrict or ban the Chinese suppliers from their national networks. Taken together, the signals ahead of Li's visit were pointing toward a potential hardening of Europe's stance toward China.

China still needs U.S. and European investment to drive its economic growth, and it cannot afford to lose access to both markets. Last year, the U.S. was the second-largest importer of Chinese goods, accounting for more than 15 percent of China's exports. It was the third-largest source of foreign direct investment, making up 10 percent of all FDI in China. The European Union was China's largest export market (more than 20 percent of Chinese exports) and second-largest source of FDI (15 percent).

Exports keep the Chinese economy humming, while foreign investment brings in capital and technology to help Chinese businesses grow and become more competitive. Roughly a third of the Chinese workforce is employed in manufacturing, which accounted for 20.5 percent of China's total exports in 2021. Though the sector has declined in importance over the past two decades as China's economy became more services-oriented – in 1995, manufacturing accounted for 42 percent of China's employment – it remains a major employer and contributor to China's exports. With exports making up about a quarter of China's gross domestic product, high exports mean a stable economy.

 | Copyright © Geopolitical Futures. All rights reserved.

Economic Slowdown

Therefore, China's anxieties about European protectionism reflect deeper fears about China's social and political stability, particularly in light of recent underwhelming economic data. In response to the economy's sluggish recovery from the pandemic, on June 13, the People's Bank of China reduced the seven-day reverse repo rate to 1.9 percent from 2 percent. Later that day, the central bank cut rates on its standing lending facility, lowering the overnight rate by 10 basis points to 2.75 percent. It also lowered the rate on one-year medium-term lending facility loans to some financial institutions by 10 basis points to 2.65 percent. On June 20, the PBOC reduced the loan prime rate by 10 basis points, a move that is supposed to make it cheaper for banks to lend.

PBOC Governor Yi Gang pledged earlier this month that the central bank will continue to implement prudent monetary policies while supporting the real economy, promoting employment and maintaining currency and financial stability. This indirectly says that China is facing three main challenges: slowing economic growth, a property market slowdown and high debt. Declining growth is likely Beijing's biggest concern. From double-digit growth in the early 2000s, the Chinese economy in recent years has grown by single digits. However, considering the international climate and the country's aging population, there is no easy fix for falling growth rates. For its part, the property market has been a major driver of China's growth in recent years, but it, too, has been slowing. Concerns about the **fragility of the property market** still haunt the country.

The debt problem stems from a number of factors, including the government's stimulus spending after the 2008 global financial crisis and dubious lending practices by state-owned banks. The government is trying to tackle the debt burden, but it is a slow process, and the effort constrains Beijing's ability to stimulate the economy in the short term. This means the government has limited room to spend on addressing its most important structural problem at the moment: youth unemployment.

China's official figures indicated that unemployment among youth (16-24-year-olds) hit a record high of 20.4 percent in April. This month, an additional 11.6 million Chinese students will complete their studies at colleges and vocational schools and begin looking for work. Earlier this year, Beijing announced several programs to reduce youth unemployment, including a 15-point plan to expand job training and apprenticeships, provide financial support to start-ups and encourage businesses to hire more young people. All this is however a long-term process. At the same time, FDI into China declined further in 2022. According to the fDi Markets global investment monitor, China saw decreases in the number of announced FDI projects (by 24 percent), capital expenditure (by 44

 | Copyright © Geopolitical Futures. All rights reserved.

percent) and job creation (by 59 percent). Compared with 2019, the number of projects last year was down 60 percent and capital investment was down 68 percent.

Local reports back up this data. On May 26, Wuhan city's financial regulator published in a local newspaper a list of 259 public and private debtors who it said owed 300 million yuan (roughly $42 million) and urged them to pay up. The amount is not huge, but the gesture is unprecedented for a town hall. On April 12, Guizhou province announced that it would be unable to pay back a debt of 1.2 trillion yuan. Both reports made their way to foreign media before Chinese officials scrubbed them from the websites of local outlets. Despite Beijing's efforts, the dire situation surrounding local government debt is no secret; it climbed to more than 30 trillion yuan in 2022 from 10.7 trillion yuan in 2011.

It's no wonder, then, that some Chinese municipal governments this year have loosened regulations to allow street vendors to operate in cities. Previously looked down on as detracting from a city's image, as laid out in China's 2003 National Civilized City plan, street vending has become more accepted since 2010. Laws are adjusted depending on the employment situation in a given city. In 2017, China's State Council authorized the unlicensed sale of agricultural goods and items of daily use at specific locations and hours. In the current climate, street vending may help metropolitan areas recover from pandemic-related disruption and reduce unemployment.

These local stories underline the challenges facing China. Beijing's zero-COVID policy imposed restrictions much harsher and more economically damaging than other countries' measures, and they were generally in effect more than a year after others had reopened. It is understandable, therefore, that China's economic recovery is lagging behind that of other countries. However, this is only the beginning of China's problems.

Exhausted Growth Model

For decades, China's economic growth has been driven by manufacturing exports or investment in industrial plants to serve external markets. Foreign businesses boosted profits by outsourcing to China, and in the process new supply chains were created and interdependence grew. Commercial banks and investors helped emerging enterprises raise enough capital to acquire and restructure their inefficient rivals, making the Chinese business sector among the most competitive in the world.

However, since 2008, stricter financial regulation and a prolonged period of low interest rates have made major financial institutions more cautious. Globally, foreign direct investment has dropped, and less money is available for risky projects. Given the global trend toward greater protectionism and the

 | Copyright © Geopolitical Futures. All rights reserved.

uncertain future of China's bilateral relations with both the U.S. and Europe, business projects in China look increasingly risky. This is in addition to the Ukraine war and the disintegration and restructuring of some global supply chains during the pandemic. Not only have reshoring and friendshoring superseded outsourcing to China, but amid the geopolitical tumult countries are racing to unlock new markets and develop cutting-edge industries.

China's Belt and Road Initiative is in many ways an answer to these threats, but it has not been able to free China of its dependence on Western markets and investment. More important, to fully realize its BRI plans, China needs more cash. But its attempts to recoup BRI-related debt in Asia have so far been unsuccessful. And with international banking being unreceptive to Chinese investors, the next-best place to look for funding is financial markets.

At the moment, those seeking higher yields are going to less regulated private markets. According to McKinsey's Global Private Markets Review, private market assets under management globally reached $11.7 trillion in June 2022, having expanded at 20 percent annually since 2017. The growth was fueled by increasing acceptance of limited partnership private-equity funds, which generally invest in companies that are not publicly listed, and venture capital funds, which invest in risky startups or young enterprises with long-term promise.

Considering the size of the Chinese economy – its GDP accounts for 18 percent of the global economy – there is certainly room for expansion for Chinese businesses in the private market, which would help Beijing's reform push. However, two factors need to be considered. First, foreign funds play an important role in private equity markets by providing expertise and market reach – though at the moment, international investment in this space is down significantly.

Second, a significant share of business investment in China currently comes from various levels of government. By the end of 2022, Chinese government agencies formed 1,531 investment funds worth approximately $380 million. The central government accounted for just 7.5 percent of the value of these funds, but provincial and municipal governments represented a much larger share: 38.4 percent and 42.7 percent, respectively. District and county governments, which accounted for 11.4 percent, assist businesses that can stimulate local economies. Until recently, this meant investing in infrastructure, particularly real estate, but job creation and reorganizing local companies are now a bigger focus.

In theory, this would be an advantage for China, if the local workforce is willing to support restructuring in the long term. Considering that youth unemployment is concentrated in urban areas, having young people move out of the cities could help rebalance the economy. But that's easier said

 | Copyright © Geopolitical Futures. All rights reserved.

than done. Moving from urban areas to the countryside is not easy no matter where you live, but it is especially difficult in China. Smaller cities and rural areas have significantly lower-quality amenities compared to big cities – which is true in most middle-income nations. While some of China's first-tier cities appear to be more prosperous than New York or Tokyo, many third-tier cities struggle to provide stable energy and basic sanitation services. As a result, most college graduates avoid moving to more "affordable" rural areas and rely on parental support to stay in the big cities until they can find work.

Thus, the Chinese economy is less developed than the official numbers would indicate, meaning its ability to grow into a consumption-based economy is limited. The full impact of the pandemic on Chinese society is still unclear; even the death toll is unknown. But given that Beijing is still quashing reports – even those released by municipal governments – it finds unfavorable, it is safe to assume that the government is worried. China needs not only more jobs but more high-paying jobs to address its economic insufficiencies. Youth unemployment is particularly concerning because it tends to lead to other problems, such as increased crime and social instability.

All of this will make the Chinese leadership even more willing to work with the Europeans to expand trade. But to do that, Beijing needs to stand against Russia on Ukraine and accommodate the United States. Washington, meanwhile, needs to make sure it mitigates the risks that come from a declining Chinese economy. Blinken's visit is therefore not only an attempt to mend ties with China but also a step toward gauging China's intentions. Through the visit, the U.S. has made it clear that it can negotiate. The potential for internal unrest resulting from poor economic conditions likely compelled Xi to meet with Blinken and release a positive statement on the talks afterward. The momentum, therefore, seems to be in the West's favor.

Author: Antonia Colibasanu
Read more from this author on geopoliticalfutures.com

 | Copyright © Geopolitical Futures. All rights reserved.