Stability for Xi, Not for China

by Victoria Herczegh - October 27, 2022

Ahead of the 20th National Congress of the Chinese Communist Party, which ended last Sunday, it seemed as though President Xi Jinping had lost some control of the country. China was riven with anti-government protests and weakened censorship, and there had emerged a real opposition faction, the key figures of which were expected to keep their seats in the Politburo. But not only did Xi manage to retain his position as general secretary of the CCP, but he also excluded those affiliated with the opposition from the Politburo and replaced them with loyalists.

The direction of the country's management, then, seems unlikely to dramatically change; Beijing will continue to follow the consumption-and-production-based model espoused by Xi and his camp, despite the economic predicament it has put the government in. Over the past year, China's real estate bubble has come close to bursting, with once highly successful large companies like Evergrande defaulting on their debt. The banking sector is also in trouble. Recently, Chinese banks, anticipating significant losses, have taken dramatic steps to enhance their loan loss reserves, tapping China's bond markets for about 30 percent more funds than they did last year. Moreover, China has an ever-growing unemployment problem, food insecurity and general dissatisfaction and uncertainty about the future that is enhanced by the almost daily mass testing and lockdowns of entire districts and cities. As a result, gross domestic product growth is well below government targets. The faction opposed to Xi prior to the congress wanted to solve these problems with an export-oriented approach, putting emphasis on trade conducted from wealthy coastal cities. With their expulsion, this now seems unlikely.

One of the ways out of the economic mire – indeed, a method embraced by both Xi and his opponents – is to boost high-tech innovation and development, getting into the global market. And there was reason for them to think of it as a viable solution. Over the past few years, China has managed to advance its semiconductor industry and establish a sizable domestic market. In the first quarter of 2022, China's share of global chip sales managed to surpass Taiwan's and was closing in on Europe's and Japan's. Still, in terms of technology and quality, China's semiconductor industry is far behind that of its peers, and the only way to bridge the gap is to acquire advanced parts and equipment from abroad. However, last week the United States introduced wide-ranging export controls aimed at cutting China completely off from acquiring or manufacturing key chips and components for supercomputers, making it illegal for any American company to trade advanced semiconductor chips with Chinese companies.

Thus is China's dilemma. It needs economic growth and stable finances in order to be able to support the recovery of its struggling real estate and banking sectors. It cannot give up high-tech innovation and development because it is the field that has advanced the most in the past few years, and it is also the sector China wants for leading its economic growth. As important, it needs access to dollar-denominated trade and investment. (There has been speculation about trade opportunities in places like Central Asia, and China is indeed interested in trading with them, but their markets simply cannot provide what the American market can.)

For these reasons, Beijing would ostensibly want to avoid confrontation with the U.S., but its rhetoric of late has been anything but conciliatory. During his speeches at the congress, Xi never mentioned the U.S. directly, but he spoke about intensifying the competition against the "anti-China" coalition, called on the party to work against "hegemonism and bullying," and encouraged authorities to prioritize security over economic interests. As soon as the U.S. announced its trade restrictions, Beijing responded by saying the U.S. was abusing export control measures and bullying Chinese industry. And to be sure, the industry will suffer. The China Semiconductor Industry Association believes that if they remain in place, they could set the sector back by as long as a decade, thus depriving the country of one of its most viable paths to economic recovery. Hence the heightened rhetoric: Beijing seems to understand that this could mean a massive escalation of the trade conflict between the U.S. and China.

This means China needs to find other solutions to save its tech sector, but no solution is without its limitations. It has shown a willingness to pursue tech-based cooperation with the EU and South Korea, but both are U.S. allies and as such have refused to cooperate. Beijing may consider expediting its efforts to bolster its domestic markets, but technological production and innovation have been upended by the pandemic – and by China's disruptive zero-COVID measures that have left entire cities on lockdown. (At the congress, the party explicitly said these measures will remain in place.) Beijing may also try to persuade Washington to revoke the ban or at least ease the regulations. That, of course, would require concessions on China's part – for example, by distancing itself from Russia, or by making the purchases from the U.S. it had failed to make under "phase one" of the U.S.-China trade deal. As recent U.N. votes showed, the former may be more viable than the latter, which is constrained by finances Beijing would otherwise rather spend on its lagging real estate and banking sectors.

Xi may have achieved what he wanted to at the congress by sidelining his opponents, but it's not clear what his accomplishments have wrought. The anger that led to anti-government protests has not abated, and if the economy doesn't improve – which is hard to do without mending ties with the U.S. or ending lockdown measures – things may only get worse. Stability for Xi isn't the same thing as stability for China.

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