

THE PARTY KNOWS BEST

Aligning economic actors with
China's strategic goals

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It is important to clarify that any errors present in the text are solely the responsibility of the authors.

Executive Summary

THE PARTY STATE AIMS TO RETURN CHINA TO THE CENTER OF THE GLOBAL ECONOMY

After a decade in power Xi Jinping has fundamentally reshaped China's political economy and the nation's reform path. The shifts currently unfolding in China's economy are showcasing the systemic features of what China's leaders today call "Chinese-style modernization" (中国式现代化) and how it will materialize at home and abroad. The impacts are visible in the domestic economy as the party expands its control over businesses in an attempt to align them, by hook or by crook, with national strategic priorities. Internationally, China's relationship with liberal market economies is moving from integration to intense competition – and potential conflict.

Simultaneously reconfiguring the domestic economy and China's international economic relations is generating frictions. Economic growth may be in a slump, but China is not in a crisis. A key factor is the downsizing of the real estate sector, which is part of a painful but necessary transition – and that means nobody should expect meaningful course correction. For better or worse, this is the development path put forward by Xi Jinping as the Chinese Communist Party (CCP) aspires to achieve "The Great Rejuvenation of the Chinese Nation" (中华民族伟大复兴) – the return of a strong and prosperous China to the heart of the global economy by 2049.

Policymakers and corporate leaders across the world are faced with a new environment in which China-induced risks and challenges abound. These encompass economic and tech competition, but also competition over markets and influence in the "global south".

By analyzing the structural shifts in China's economic governance, this report aims to provide a better understanding of China's future path under Xi Jinping's strategic vision for the nation. It is likely that already significant differences between China's economic model and those in Europe and other liberal market economies will continue to grow and create more friction. Observers should shed any wishful thinking of a return to pragmatism and focus less on hoping that Beijing will course correct itself. Instead, it is necessary to consider their own strategy to deal with a changing China.

THE PARTY HAS ALTERED THE POLITICAL ECONOMY IN PURSUIT OF ITS STRATEGIC GOALS FOR THE NATION

During his first decade as China's paramount leader, Xi Jinping steadily broke away from the political economy norms of his predecessors – Deng Xiaoping, Jiang Zemin, and Hu Jintao. Where the previous era was governed under a development-oriented political economy, Xi's new era has been put under a geopolitically oriented political economy. Growth and socio-economic progress still matter in Xi's China, just as catching up with the developed world technologically always mattered in the past.

However, Xi's recalibration of the political economy first and foremost aims not at boosting China's overall development, but rather at securitization – the pursuit of resilience in a geopolitically challenging environment - as the precursor to national "rejuvenation". To realize such a vision, the party-state is increasing its control and guidance over economic actors to

steer them towards three chief priorities throughout the intermittent period between now and 2049:

- **Priority #1 - Attaining technological and supply chain self-reliance** – Where possible, the CCP will endeavor to localize supply chains and close technology gaps to secure value chains within China’s own borders. The goal is to make it impossible for any other nation to hold China down through access to resources, technology, capital, or markets.
- **Priority #2 – Reshaping and diversifying China’s international economic ties** – Where China cannot localize supplies, such as for oil, gas, soybeans, iron ore, and critical raw minerals, the CCP aims to diversify suppliers to build resilience. The party state also seeks to diversify and develop export markets, and to take a central role in the global economy, especially as the self-proclaimed leader of the developing world.
- **Priority #3 – Maintaining and strengthening China’s socio-economic base** – While no longer the top priority for Beijing, development still matters. However, in recent years there has been a clear priority in managing risks in the domestic market like in real estate and deleveraging rather than prioritizing growth. Meanwhile, consumption growth has lagged despite Xi’s own calls for higher spending by households.

THE PARTY STATE STRIVES FOR NATIONAL REJUVENATION WITH A NEW TOOLKIT TO STEER ECONOMIC ACTORS ALONG

Xi’s economic policies encompass Marxist-Leninist elements with a much stronger role for the CCP. The new political economy promotes an “all of nation model” that engages in a 21st century type of economic and technological mass mobilization. Party-state controls and guidance over economic actors were extended drastically, ensuring alignment with contributing to reaching national strategic goals. The measures include a mix of discipline system and incentives. Xi Jinping’s policies focus less on profitability of companies or enriching the middle class. Instead, economic resources should be geared toward strategic sectors in the real economy – mainly high-tech manufacturing and emerging technologies such as AI. Sectors such as the real estate sector or consumer internet are seen as non-strategic and/or destabilizing, resulting in massive crackdowns over the past two years.

More party guidance has significant implications on the business environment of China’s private sector and entrepreneurs who occupy key roles in reaching high-tech supremacy. Ownership and governance models that help Beijing influence the steering wheel of companies have materialized, with golden shares securing veto-rights in some firms while party influence and window guidance pull on strings behind closed doors.

Meanwhile, sticks have been brought to bear against firms unaligned with Beijing’s goals, with crackdowns and rectification campaigns, blocked IPOs, and seemingly capricious (but actually orchestrated) regulatory enforcement beating prominent firms into line while sending a message to everyone else. At the same time, for the firms already in line with Beijing’s vision, carrots are ripe for the picking, like advantageous stock listings, protection from foreign competition, and access to everything from subsidies and cheap financing to the Little Giants Initiative – a government incentive to foster world leading high tech small and medium sized companies.

THE PRIVATE SECTOR MUST FOLLOW THE PARTY'S LEAD

By prioritizing ideology over pragmatism, some have suggested that the CCP is now opposed to the private sector. To the contrary, Xi is not trying to undermine the private sector, he is aligning those that he needs to fall in line while rewarding those already on board. After all, tech rectification didn't aim to kill the tech giants, but to align them with strategic goals and bring them into compliance with the evolving national security ecosystem – especially on cyber and data security matters.

The efficacy of this model has shown some success, as seen in some of China's most technologically advanced and globally competitive firms, each of which are examined in case studies throughout this report:

- **Alibaba**, which, after taking a beating from a variety of Beijing's sticks, has so aligned with the party-state agenda that it has broken itself into six different entities so that different lines of business can align with respective strategic goals, with a priority on tech self-reliance.
- **Tencent**, which has experienced blows from many sticks, and is not so subtly being told by regulators that are tightening down on the gaming sector including with a lengthy freeze on new approvals that it should focus less on the domestic gaming market and more on local tech gaps.
- **Huawei**, which needed no discipline from Beijing to get in line with national objectives, largely because it already was aligned with them. Instead of sticks, Huawei has enjoyed a bounty of carrots in the form of support and protection to close the tech gaps identified by Beijing.
- **BYD**, which was already fully in line with Beijing's aspirations for the electric vehicle market and enjoyed extensive procurement favoritism, local subsidies, and a wide range of other carrots as it has skyrocketed in the home market even while it secures a global export and investment footprint.
- **COSCO**, which is already under the direct control of Beijing as one of the centrally owned SOEs, is not only already aligned with national strategies, but also enjoys tremendous support and protection at home. As it projects its home market advantages overseas, COSCO is playing a central role in China's international shift, especially through the Belt and Road Initiative.
- **GAC-Toyota**, which as a sino-foreign JV must manage a delicate balance in terms of party-state control, largely benefits from benign neglect. In Beijing's eyes, the company fulfills a role as an economic baseline holder that provides jobs, tax revenue, job training, etc. as it flies under the radar.
- **Leaderdrive**, one of China's "Little Giants" that enjoys massive support through policy measures and through favorable state promotion, including in special financial markets. In many ways, smaller high-tech firms embedded in strategic technologies are co-opted and nurtured by the party state that seeks to accelerate their upward trajectory.

STRONGER GUIDANCE IS HERE TO STAY DESPITE POLICY ADJUSTMENTS FOLLOWING WEAK GROWTH

The current technology-centered agenda has set China on a clear trajectory, though its success is far from guaranteed. The sustainability of Xi's path will be put to the test when ideology-driven ambitions clash with economic reality. The policy direction is effectively being

implemented but the choices made come with trade-offs and economic costs. GDP growth is waning, and China is running a serious risk of failing to unleash its potential thriving middle-class consumer market. The two big areas where resource allocation remains strong are in tech self-reliance and military modernization. But at the same time, productivity gains are stalling, despite aggressive industrial upgrading. That is not to say that the self-reliance campaign is not yielding results, but the productivity gains are secondary, and they add limited real productivity gains when all they have done is replace something they used to just import.

As Beijing approaches the 2023 Third Plenum – an event which could further indicate the direction of China’s overall political economy – it is critical to understand the context under which it is taking place. The leadership acknowledges the current economic challenges and the increasing pressure to shore up confidence. Recent minor policy shifts have given the impression of a return to pragmatic economic policymaking, but those few data points should not be interpreted as a break from a trendline that has taken shape over years.

Xi has given no indication that he intends to walk back the substantial strides the party has taken in the past decade to enhance its control over the economy. Although plenty in China and overseas may express frustration, Xi's economic vision remains steadfast. Policymakers and business leaders should plan accordingly.

1. A new era: Xi steers China's economy on a different path

1. A new era: Xi steers China's economy on a different path

KEY FINDINGS

- China is contending for the central position in the global economic order and to establish itself as an innovation power.
- Xi's new policies are responding to slower growth and perceived Western containment, but they also aim to establish foundations for a new development path for its economy.
- Beijing's answer is a tech-centered agenda - to deal with a shrinking workforce, enhance productivity, and decrease reliance on the US and its allies.
- China's future development path is shaped by growing distrust between China and liberal market economies. In contrast to previous decades of economic integration and accepted interdependencies, in the new era risk mitigation is at the top of everyone's agendas.

After four decades of market reform and global integration, China's economy is at a critical juncture. It now faces the most challenging phase of economic development as a new growth model is needed to break through the middle-income trap and become more innovative and productive. The Third Plenum of the 20th Central Committee in fall 2023 will shape China's economic trajectory for years to come. At the Third Plenum in 2013, Xi Jinping introduced his priorities for political and economic reform: a careful balance between the role of the state and the market. Many abroad were hopeful he might be the reformer China needed, even as his reforms represented a compromise between the more liberal and more conservative forces in the party. Xi's adjustments to China's economic policies aim to deal with the negative side effects of what he terms "unbalanced and inadequate growth", a legacy of the previous growth model. This includes, for example, a highly leveraged financial system and a real estate sector accounting for nearly 30 percent of GDP". Simultaneously, they are also a response to perceived Western containment and its efforts to limit China's access to technology.

Xi Jinping wants new kind of modernity for China by 2049, achieving key milestones and development targets by 2035. The path forward under Xi will lay the foundation for the Chinese Communist Party's (CCP's) aim of "national rejuvenation" – returning a strong and prosperous modern China to the center of the global economy and innovation by 2049. Achieving this with China's special economic model – Socialism with Chinese Characteristics – would establish a system that can outcompete the liberal market economic system and prove that Chinese-style modernization can be dynamic and innovative. If successful, the CCP could establish China as the superior economic system. But there is also a real risk that the economy will hit a period of stagnation during Xi's third term, as the country confronts a complex set of domestic and international challenges.

China's economy is at a critical juncture

1.1 POLICY PRIORITIES ARE UNLIKELY TO MEANINGFUL CHANGE EVEN AS ECONOMY IS FACING HEADWINDS

At the start of his third term, Xi clarified his vision of how the CCP should reach its targets for the country. Over his first two terms, economic policy shifted towards political, ideological and security objectives. But 2022 marked a sea change for Xi's policy priorities and their attendant trade-offs. Xi's ideological views permeated economic policy – to the detriment of economic growth. To reverse the downturn after the prolonged lockdown of its “zero-Covid” policy, China has downplayed ideology in 2023, and “pragmatism” has returned to economic policymaking.

Economic relations with China are likely to be profoundly different in the future

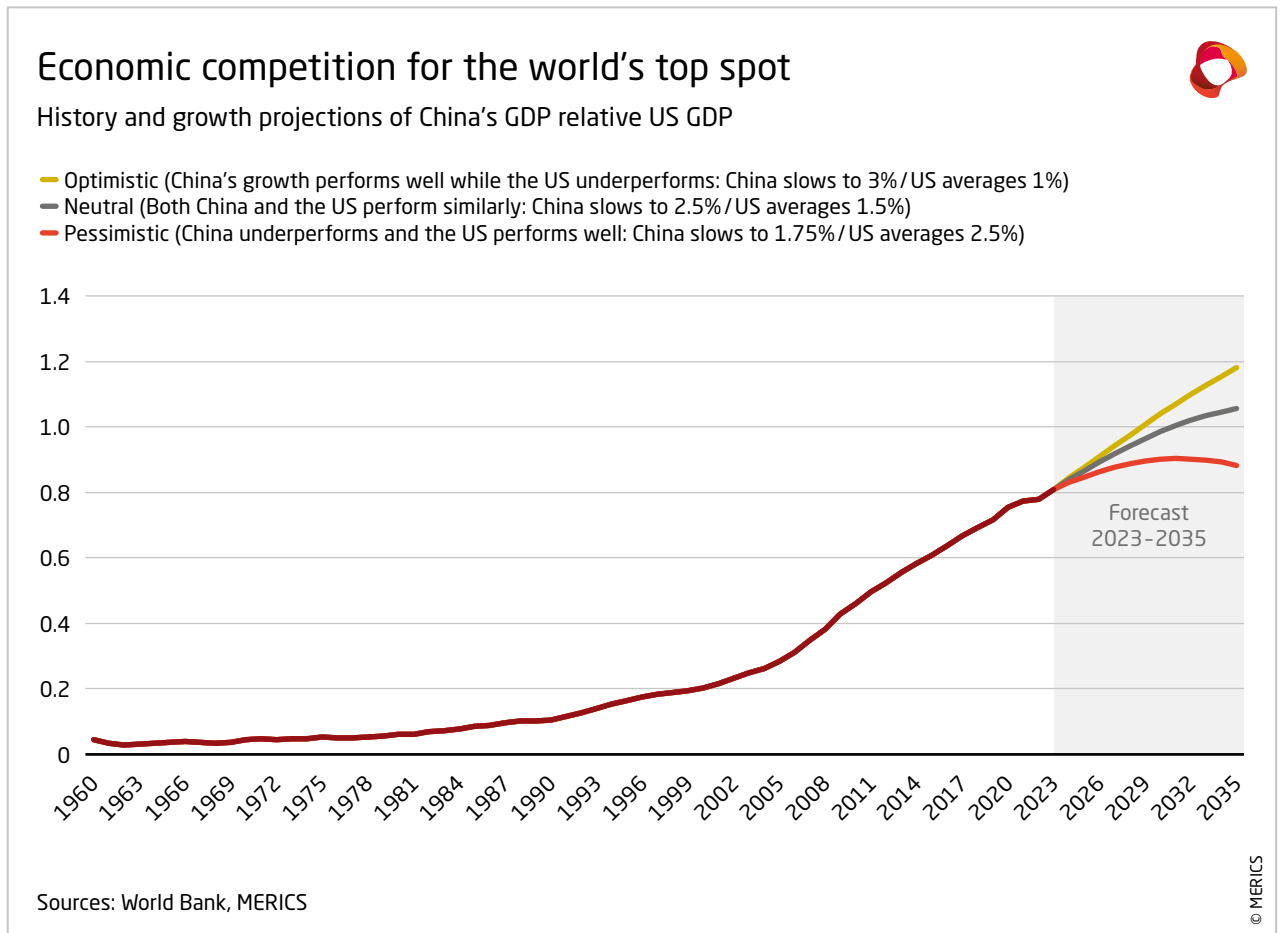
This is not a course reversal, but rather a matter of tone and timing. Despite softer language and a less ideological tone, the flurry of rules and regulations imposed in 2020-2022 to strengthen the party's grip over the economy have not been abolished. They are simply taking a back seat to boosting investor and consumer confidence amid a disappointing post-Covid recovery. China's leadership has gone into overdrive to woo foreign investors who have become wary of China, not only due to growth prospects but also to political dynamics – both in China and at home.

China is now an economic giant, accounting for around 20 percent of global gross domestic product (GDP) and 30 percent of global manufacturing. Xi Jinping no longer feels bound to the foundations that guided his predecessors. In the past, leaders tolerated considerable risk in their domestic reforms in order to maximize economic development opportunities. These included the massive displacement of capital and labor with Zhu Rongji's state-owned enterprise (SOE) reforms, or Deng Xiaoping's agenda of opening up and pushing integration with the global economy.

This “gamble” has paid off, and Xi is setting his sights on taking China to a higher level of development and global influence. In pursuit of the second centennial goal (100th anniversary of the PRC / 中华人民共和国成立100周年), Xi has shifted the party baseline (党的基本路线) from focusing on economic development to coordinating development and security (统筹发展和安全). This marks a new direction that emphasizes party control over the free hand of the market and puts a greater priority on minimizing risks and achieving political and geopolitical goals than on economic development.

China's economic policymaking in the last decade was characterized by an urgency to build an economy that could withstand external shocks. Increasingly, its policy priorities are geared toward a geopolitically oriented economy that is obsessed with US-China competition and deprioritizes the emphasis on social development. A key metric in measuring success is whether or not China can eclipse the US economy. This depends on many factors, including GDP growth in China and the US, inflation and exchange rates. This offers a range of possible outcomes (see Exhibit 1). Following years of strong growth, China's next phase of “catching up” will be accompanied by slower growth. But success is also measured in relative terms: China sees the US and the West as in decline. Regardless of its relative size to the US economy, China is back on the world stage and will remain an economic heavyweight.

Globalization and economic relations with China are likely to be profoundly different in the future. This year's Third Plenum will have historic significance comparable to the opening up and reform process that began in 1978 or the country's WTO accession in 2001. But while China's rise was largely seen as an opportunity in Europe and elsewhere, fundamental changes are at play that could – once again – shake up the world economy. The Third



Plenum is taking place at an inflection point for China's economy, with several key factors shaping its future development:

- **A period of slower and more volatile GDP growth:** China's economy is undergoing an inevitable structural slowdown after a period of rapid growth. This requires adjustments to its growth model. Engineering a stable economic slowdown has become more difficult amid China's disruptive policy shifts in response to external and internal challenges such as Covid-19, high debt levels and the prioritization of national strategic goals in face of rising geopolitical risk.
- **Quickly rising innovation capacities that have yet to yield productivity dividends:** China has made remarkable strides in boosting its innovation capacity, becoming a cutting-edge nation in a number of technologies ranging from traditional sectors such as high-speed rail to emerging technologies such as artificial intelligence. At the same time China's total productivity growth has decelerated.
- **China's gravitational pull on the global economy:** Despite slower growth, China is an economic heavyweight aiming to challenge the global economic order, establish itself as an innovation power and an expand its global economic footprint.
- **The politicization of globalization:** Geopolitical risks and efforts to strengthen economic security in China and worldwide are shaping international global supply chains and innovation.

- **Non-convergence with liberal market economies:** China is seeking its own development path that serves the goal of “perfecting” the Chinese socialist system. Under the leadership of the CCP, new theoretical foundations of economic development are being created with an emphasis on tech-centered economic nationalism.

1.2 IDEOLOGY MEETS ECONOMIC REALITIES: TRADE-OFFS IN XI'S TECH-CENTERED ECONOMIC NATIONALISM

Looking forward, a key challenge will be reconciling Xi's national strategic priorities with economic prospects, including jobs and income. China is neither ending its era of reform and opening up nor returning to the closed Mao years that preceded it. Instead, its internal reform and external opening agendas are taking place under fundamentally different conditions with new political parameters, incentives, and drivers. In the past, internal reform was heavily driven by maximizing development opportunities, while external opening was about accepting interdependencies to accelerate growth and expand export opportunities with liberal market economies.

Under Xi, economic reforms are about fine-tuning control

Under Xi, internal reform is about fine-tuning control of the economy to steer it through domestic hard times with an aging population and sluggish productivity growth. External opening aims to reduce interdependencies with liberal market economies that recently began to restrict China's access to their key technologies. Xi's answer to these problems is technology – to deal with a shrinking workforce, enhance productivity, and decrease reliance on the US and other countries Beijing believes to be Washington's pawns.

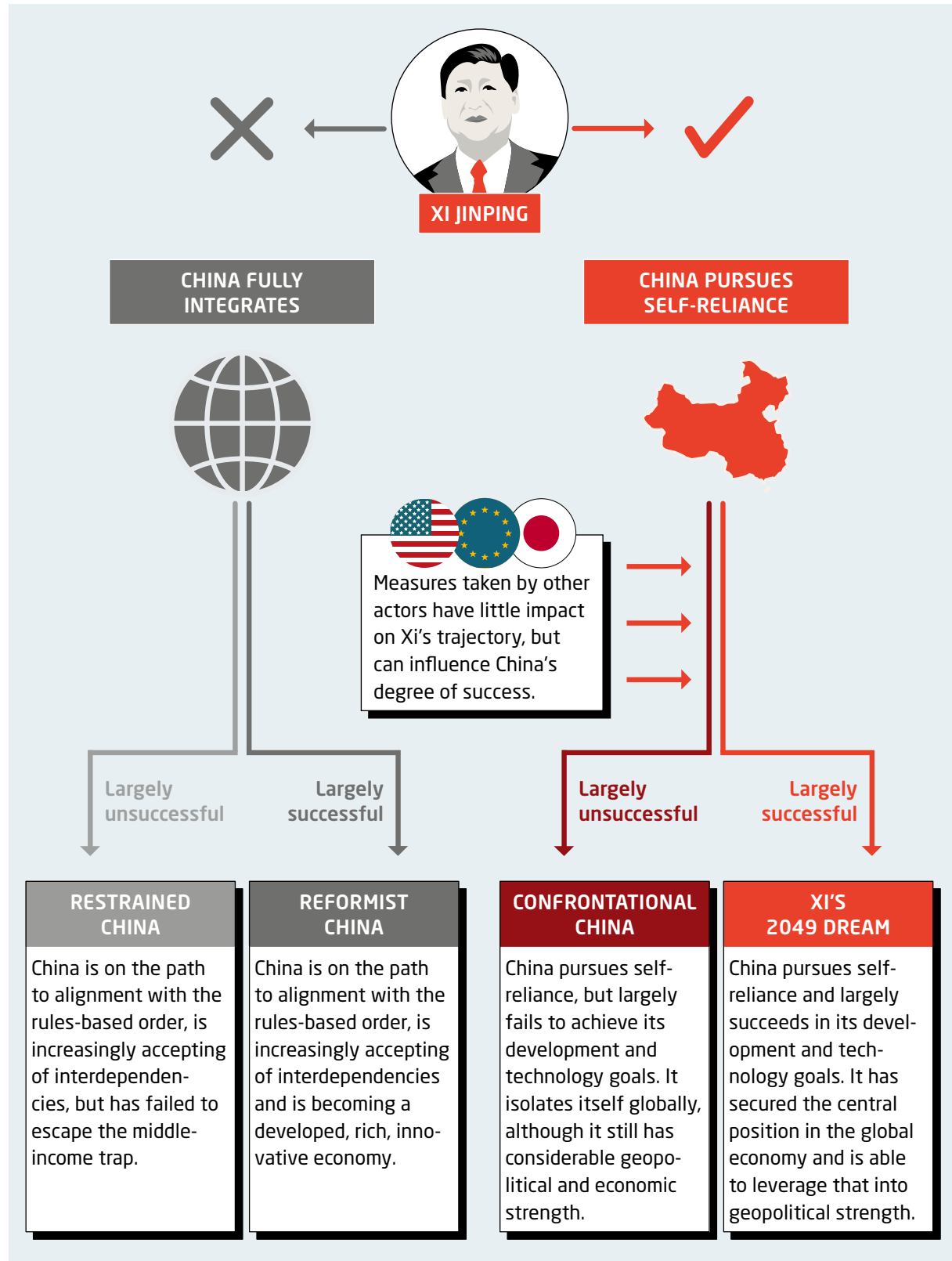
The current technology-centered agenda has set the country on a clear trajectory, though its success is far from guaranteed. The sustainability of Xi's path will be put to the test when ideology-driven ambitions clash with economic reality. For example, despite China establishing itself as a global innovation power, total factor productivity growth has slowed from 22 percent between 2003 and 2011 to only 5 percent between 2011 and 2019.¹ Aligning national strategic goals with the national wellbeing is causing tensions. Another example is the popular backlash in November 2022 over economically stifling zero-Covid policies triggered a rapid course correction, with further corrections taking place amid a sluggish economic recovery in 2023. But this is no paradigm change or return to economic pragmatism. There may be bigger tests ahead if Xi continues down his chosen path and the strategy fails (see Exhibit 2).

1.3 XI HAS CHOSEN CHINA'S TRAJECTORY, BUT OTHER ACTORS ARE CHOOSING HOW TO RESPOND

While countries may only exert limited pressure on China to deviate from Xi's charted course, there are plenty of other ways to affect its chances for success. Somewhat oversimplified, countries with liberal market economies may continue to give China access to their markets and technologies, or they may further restrict it. China, on the other hand, may accept economic and technological interdependencies with liberal market economies, or further pursue self-reliance. The issue is that every step China takes toward self-reliance pushes liberal market economies to restrict China's access to their markets and technology. In turn, this drives China further down the road of self-reliance.

Xi has chosen China's path

Breaking from previous leaders, Xi has aggressively pursued an agenda of self-reliance



Source: MERICS

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In that sense, China and liberal market economies are on a path toward long-term, profound disruption to economic and technological globalization, despite likely worse outcomes for all actors. The net positive result for all would be to restore globalization with all sides willing to accept common rules and norms as well as interdependencies. This goes as much for the US, EU and Japan depending on China as it does China depending on them.

But the disincentive for China to reverse course and abandon its self-reliance campaign is that liberal market economy countries might cut it off anyway, leaving it too far behind to catch up. The disincentive for liberal market economies to allow China access to their markets is that Beijing might maintain its path to self-reliance and succeed, unleashing China's geopolitical power and "replacing" them in the global economy.

The problem of renewed globalization is that, for each side, the net gain from the best-case scenario is less beneficial than the net damage is from the worst-case scenario – meaning countries have more incentive to take damage-limiting action than to pursue risky opportunities. Furthermore, the growing distrust between China and liberal market economies and previous actions by both China and the US have put everyone in a poor position.

1.4 HIGH STAKES: CHINA'S ECONOMIC DEVELOPMENT IS SHAPING THE GLOBAL ORDER

China's development also depends on access to technology

The evolution of China's political economy, market reforms and integration in the global economy under Xi will shape its economic path forward. Its development also very much depends on how advanced economies control access to technology. Success or failure not only depend on China's own performance but how liberal market democracies respond to the current structural shifts shaking up the global order.

Dealing with an economically large, technological capable, and systemically non-convergent China requires a deep understanding of the structural shifts in China's next stage of development:

- What are the key building blocks of China's political economy under Xi's ideology?
- Which party and state measures are used to steer economic actors?
- How will the CCP attempt to secure the socio-economic base?
- How will innovation look under an increasingly authoritarian regime?
- How will China pursue global integration?

Our baseline scenario is that China will continue down Xi's chosen path, at least as long as he is in power, with continued uncertainty over the success or failure of his strategy. Keen to ensure success, Xi recently codified his own economic thought in a new development model worthy of his "New Era." This vision aims to contend with, as he puts it, "changes unseen in a century," and is matched with a growing set of measures to shape the economy. These party and state measures aim to operationalize his ideology and galvanize all economic actors to strive for strategic goals – all to enable the success of the 2049 dream.

2. Xi's policies serve strategic national goals beyond growth

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KEY FINDINGS

- Xi Jinping economic thought is expanding the roles of the party and state to guide economic actors towards Beijing's strategic goals.
- Economic liberalization as a goal in and of itself is dead in Beijing. Xi uses market forces as a tool when convenient, but only as a part of a broader party-state toolkit.
- The leadership has no intention of isolating China. dual circulation strategy aims to alter China's position in the global economy - remaining open to the global economy while boosting domestic consumption and climbing global value chains.
- Beijing has begun to heavily emphasize the "New type of all-of-nation system" to close key technology gaps, and economic actors are increasingly playing along.
- In Xi's view, the private sector had become detached from national interests and drove up systemic risks in the financial sector, an issue that could only be addressed with more control.

After the Mao years, China experienced four stages of economic development, each characterized by a distinct approach to political economy in respective generations of leadership: Deradicalization (reform and opening up), liberalization, stabilization, and now, under Xi, securitization, which means assessing all political economy issues as though they were security issues for China. During his first two terms, Xi harnessed the CCP's greatly diminished confidence in market forces as the central driver in resource distribution after the global financial crisis to advance his economic ideology.

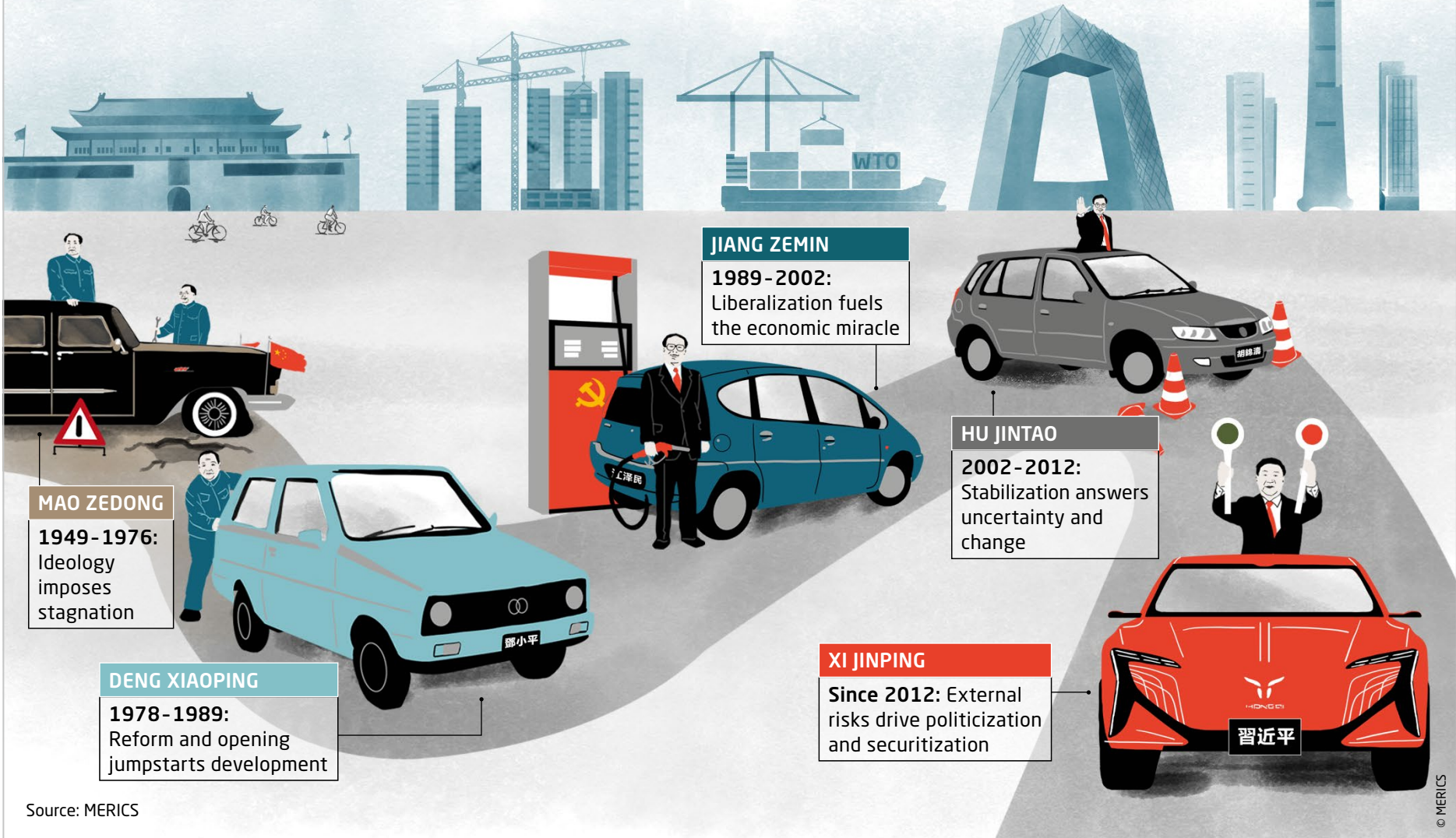
As Deng Xiaoping *deradicalized* the economy in the 1980s, state-owned enterprises (SOEs) remained the undisputed champions, with privately owned enterprises (POEs) only allowed at the cottage industry level, as pragmatism and experimentation took hold.² As POEs emerged, the Jiang Zemin era of the 1990s saw the reforms of his premier, Zhu Rongji, who *liberalized* the economy with a focus on SOE reform under the mantra of "grasp the large and let go the small" (抓大放小). The state held onto hundreds of the country's most important firms, Lenin's "commanding heights" of the economy, while the rest were privatized or allowed to collapse.

From then on, the national SOEs were largely used to advance the strategic goals of the CCP. Under Hu Jintao in the 2000s, liberalization slowed and SOEs retrenched to *stabilize* the economy in light of the global financial crisis. SOEs developed infrastructure, supported employment, provided social security, and maintained China's industrial foundation, independent of market forces. Meanwhile, POEs pursued profits, job creation, development, and innovation. Trust in market forces stagnated under Hu, after growing under Deng and Jiang, and then deteriorated under Xi (see Exhibit 3).

Trust in market forces stagnated under Hu and deteriorated under Xi

Xi is deviating from the reform era with a focus on building a geopolitically securitized economy

With sights on 2049, the third-term paramount leader is firmly in control of the steering wheel



Source: MERICS

2.1 XI BREAKS FROM THE REFORM ERA AND ENVISIONS STRATEGIC ROLES FOR ALL COMPANIES

Xi initially wanted to continue Hu's approach to the SOE–POE divide, as expressed in the 2013 Third Plenum Decision document naming both state ownership and market forces as central pillars to development. But faced with emerging and clear risks in 2015-18, Xi shifted course and pushed back against more reform-minded factions in the party. Key triggers were:

- A. Financial instability:** Highly leveraged companies, fears of a housing bubble, financial market turbulence in 2015-16. This triggered a deleveraging campaign in 2016 and set the seeds for crackdowns on real estate (and tech) to control speculative investments and markets not aligned with national strategic goals.
- B. Foreign dependencies:** Already suspicious of the US, trust in China's dependency on foreign tech evaporated with the US trade and tech wars starting in 2018 and US President Donald Trump's threats to block telecommunications firm ZTE from American technology.

The steady shifts in Xi's management of the economy are underscored by an attempt to construct or at least project a coherent economic governance model. As a somewhat clearer picture of his vision for the economy emerges (internally promoted as "Xi Jinping economic thought for a New Era"), Deng's era of opening up and reform looks like a transitional period, now possibly succeeded by an era of security and control.

According to China's leaders, the country is on a path to completing a "historic transformation from standing up and becoming prosperous, to growing strong."³ (从站起来、富起来到强起来⁴) China's reform process and global integration have substantially advanced living standards and science and technology capabilities. But to "reach the new development stage of socialist modernization" (社会主义现代化) by 2035, the CCP under Xi Jinping is resorting to policies that held back China's development for decades: ideology, centralization, securitization, and reversing the separation of party and state.

After the 19th Party Congress in 2017 and the subsequent Central Economic Work Conference, Xi Jinping economic thought became the CCP's central ideology shaping China's economic development. Loyalty to Xi and his agenda have always mattered most, as manifested in Xi's omnipresent anti-corruption campaign launched in 2012. But beyond loyalty and ideological adherence, Xi Jinping Thought also demands competence – Xi still believes that technocrats are best placed to advance the country and has promoted STEM graduates to leadership positions during his tenure at a higher pace than under Hu Jintao.⁵

Xi still believes that technocrats are best placed to advance the country

Those cascading requirements – loyalty, ideological alignment, and competence – were on full display in the selection of cadres elevated to top leadership at the 20th Party Congress. Competing factions, such as the Communist Youth League, were sidelined while close contacts of Xi rose to the surface.⁶ Anyone with a voice that could have pushed back on Xi's strategies was suppressed, be it Li Keqiang or Hu Jintao's protégé, Hu Chunhua. Meanwhile, promotions were in line for Xi loyalists like Li Qiang, who stuck to the zero-Covid ideological position that locked down Shanghai for weeks in 2022.

Xi's Economic Thought is laying the key building blocks for China's economic system. It is defining the role of the state for guiding economic actors and expectations for companies and society, as well as how China engages with the rest of the world. Even more ideological are the goals laid out by the CCP and the means by which Xi intends to reach them. Econom-

Liberalization as a goal in and of itself is dead in Beijing

ic liberalization as a goal in and of itself is dead in Beijing. It is not seen as compatible with the political system. Xi Jinping's ideological choice has been to extract the tool of market forces from the scrap heap of economic liberalization and to use it only for specific goals – while building out new economic measures in which the party-state plays a central role.

The CCP dominates the economic system in a similar way it does the political system through strategic guidance and controlling market mechanisms and by demanding strict obedience from those companies and individuals that can contribute to national strategic goals.

2.2 XI'S ECONOMIC THOUGHT IS A CONTINUATION IN SOME AREAS AND A CLEAN BREAK IN OTHERS

Some of the clearest origins of what would later become Xi Jinping economic thought were revealed in August 2020 when Qiushi, the CCP's chief theory journal, published a speech he had delivered on November 23, 2015, one of his earliest speeches as paramount leader overviews his ideological perspective on China's political economy. The speech, made during a study session of the Politburo, outlines key priorities in Xi's political economic strategy in a post-Third Plenum and pre-19th Party Congress interregnum. Titled "Unceasingly open up the borders of contemporary Chinese Marxist political economy" (不断开拓当代中国马克思主义政治经济学新境界), it focuses on six key goals:⁷

- **First**, adhere to the people-centered development philosophy.
(第一, 坚持以人民为中心的发展思想)
- **Second**, adhere to the new development concept.
(第二, 坚持新的发展理念)
- **Third**, uphold and improve the basic socialist economic system.
(第三, 坚持和完善社会主义基本经济制度)
- **Fourth**, uphold and improve the basic socialist distribution system.
(第四, 坚持和完善社会主义基本分配制度)
- **Fifth**, adhere to the direction of socialist market economic reform.
(第五, 坚持社会主义市场经济改革方向)
- **Sixth**, adhere to the basic national policy of opening up.
(第六, 坚持对外开放基本国策)

Over the rest of his first and second terms in office, these core tenets of what would become Xi Jinping economic thought were matched with Xi-specific slogans and campaigns.

The core goal: Adhere to a people-centered development philosophy.

This is Xi's primary aim for his New Era. At the 19th Party Congress, Xi changed the "principal contradiction" at the core of CCP thinking from was "between the ever-growing material and cultural needs of the people and backward social production" to "between unbalanced and inadequate development and the people's ever-growing needs for a better life." Instead of the previous approach of development at all costs, Xi has now put "quality over quantity" into the development mix.

Subsidiary goals: Adhere to the new development concept of quality over quantity.

Xi frequently emphasizes the need to focus on quality development rather than merely driving up the numbers – meaning people-centered development. However, Xi also often elaborates that the "New Development Concept" must balance innovation, coordination, greening, openness, and "sharing."

The economic model: Uphold and improve the basic socialist economic system and adhere to socialist market economic reform.

This has been interpreted in the West as raising the role of market forces in allocating resources. Xi has repeated many times that there are two pillars to China's economic model, one public and one non-public. In other words, socialism with Chinese characteristics only works with both strong SOE and strong POE sides to the economy, referred to as "the two unwaverings" – meaning unwavering support for both.

Economic distribution: Uphold and improve the basic socialist distribution system.

In China, the basic socialist distribution system is based on "distribution according to work," although multiple parallel systems for distribution exist (...我们确立了按劳分配为主体、多种分配方式并存的分配制度). Xi would later spotlight distribution in prioritizing "common prosperity." The term dates back to Mao but is known from Deng Xiaoping's famous quote, "Let some get rich first... then lead the rest into common prosperity." Xi quickly clarified that China will not revert to broad redistribution. Common prosperity is a goal, but not via means like "welfare universalism."

Over the rest of his first and second terms in office, these core tenets of what would become Xi Jinping economic thought were matched with Xi-specific slogans and campaigns.

China's global economic position: Adhere to the basic national policy of opening up.

Xi has no intention of isolating China and is instead eager to grow China's role in the global economy. His signature foreign economic policy has been the Belt and Road Initiative (BRI), China's major infrastructure project to connect Asia, Africa and Europe via land and sea. This would grow into Beijing's dual circulation strategy which aims to alter China's position in the global economy – remaining open to the global economy while boosting domestic demand. Unlike Deng's idea to drive growth by luring technology, investment, and raw materials to produce low – to mid-value goods for export, Xi aims to import raw materials and lower-value goods and export higher-value goods, tech, and outbound investment.

Xi is eager to grow China's role in the global economy

Some core priorities of Xi's economic thought weren't part of his 2015 speech. Innovation and technology have begun to play a much more central role in Xi's economic policymaking. The US trade war gave this momentum, especially actions against Chinese tech companies and recent export controls. Xi has begun to heavily emphasize the "all of nation effort" to close key technology gaps. Consumption-driven growth is also a major focus. This has always been a goal, and is the second half of the dual circulation strategy – external circulation being China's position in the global economy and internal circulation being domestic consumption as the key driver of growth (rather than exports) (see Exhibit 4).

2.3 THE TRADE WAR AND THE PANDEMIC CATALYZED DEEPLY ROOTED SELF-RELIANCE IN XI'S ECONOMIC THOUGHT

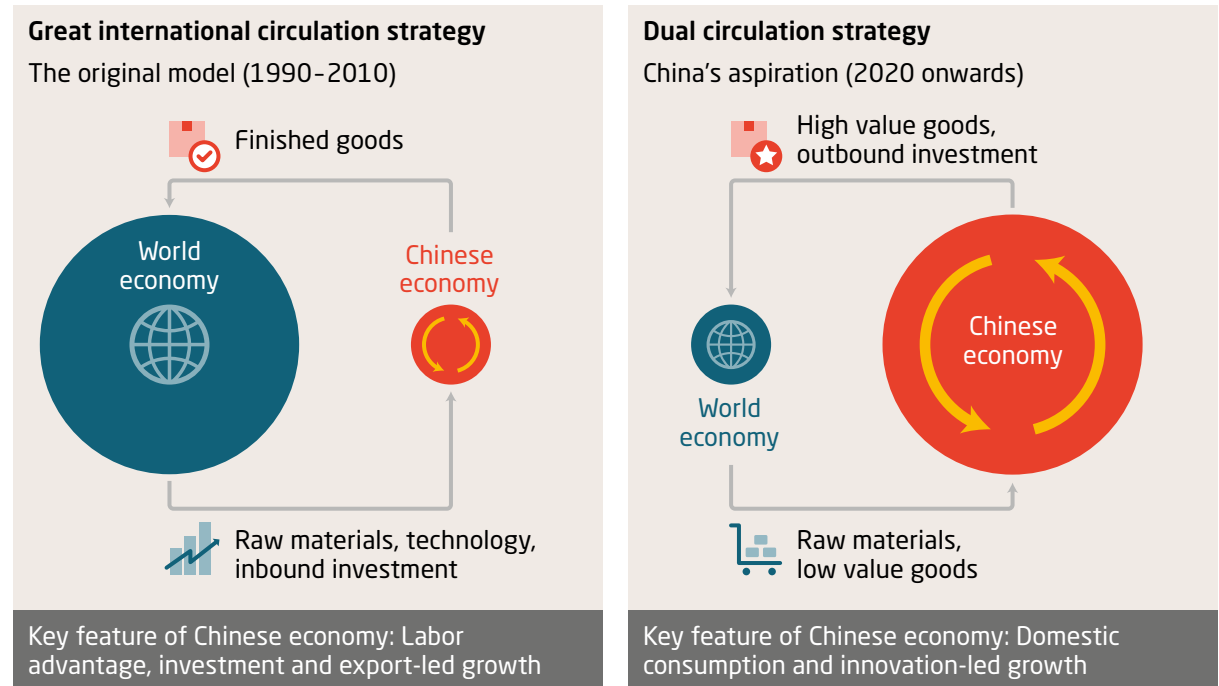
Xi consolidated his power base over his first two terms, but there were limitations as to how aggressively he could push his then still-evolving economic ideology. First, it was difficult to get buy-in for his radical approach to self-reliance from most economic actors at a time when China had virtually complete access to foreign markets and technologies. Second, The CCP's very legitimacy had, since the crackdown on the Tiananmen Square protests, been dependent on securing economic development gains in return for political silence from the masses – meaning that Xi needed to keep growth strong, irrespective of his ideology. Two things happened to change this: The US-China trade and tech war and the pandemic.

Exhibit 4

Beijing aims to decrease dependencies for growth and advanced technology

Comparing the great international circulation strategy and the dual circulation strategy

→ External circulation → Internal circulation ●● Relative importance to China's economic development

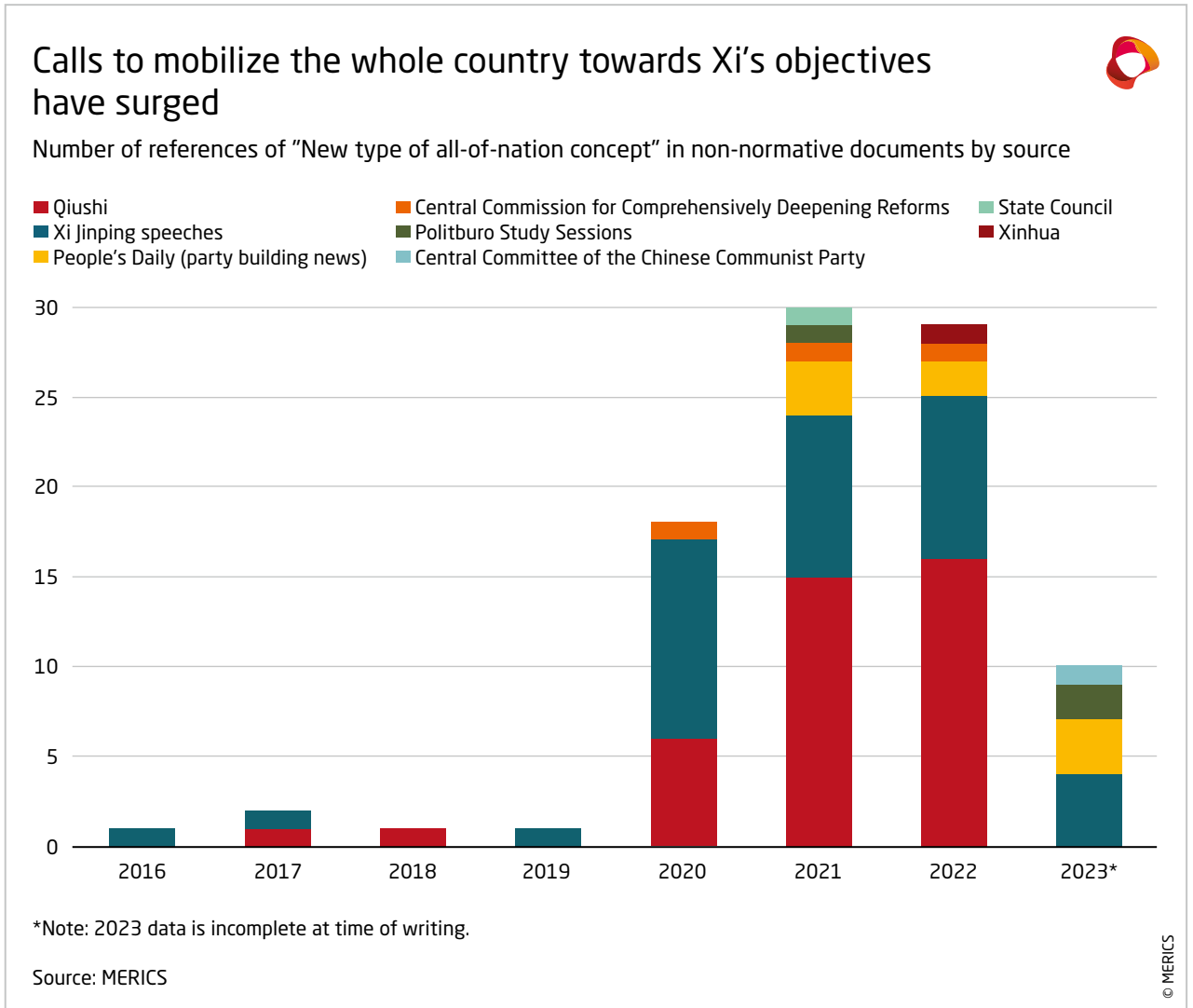


Source: MERICS

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Self-reliance is a long-standing principle in CCP ideology – indeed, of any communist or more generally authoritarian ideology. However, aside from more ideologically conservative types in the CCP and China's major SOEs, much of China's private sector, scientific community, and broader society were not behind the idea. The US-China trade war, and the more significant tech war that began with restrictions on Huawei and ZTE, changed that around 2018. Private companies faced being technologically strangled by the US. For the first time in decades, there was truth behind the idea of an all-of-nation effort to close the tech gap and achieve self-reliance. This opened up considerable political space for Xi to push his economic ideology (see Exhibit 5).

The pandemic did something similar. China's initial failure to contain the virus was later met with an effective zero-Covid policy that, despite its often draconian nature, worked for the first two years. Compared to the rest of the world, China seemed stable and back to "normal life" – something state media was happy to demonstrate with coverage of global chaos next to rosy reports about Beijing's leadership. This gave Xi political space to deprioritize economic growth as a measure of success in pursuit of other political goals. This is not to say that multiple crackdowns on the tech sector, private tutoring or the real estate sector would not have happened in absence of the pandemic, but the unquestionable legitimacy of Covid measures offered a window of opportunity to advance these goals.



2.4 THE TRANSFORMATION FROM CHINA, INC. TO CCP, INC.

Xi Jinping economic thought did not emerge by design but evolved in response to weak spots in the domestic economy and shifts in the external environment, marked by confrontation with the US – all of which empowered Xi Jinping’s vision for the economy. The CCP seeks to increasingly dominate the economic system just like the political system. It uses strategic guidance to contain “misguided” market decisions that increase financial risks and fail to advance strategic objectives or “de-risk” from the West. Economic policy is becoming more problem-oriented, preparing the nation for difficulties ahead. One priority is to reestablish the party’s leadership in China’s modernization efforts and foster the securitization of everything.

This has allowed the CCP to reach into the private sector, which in Xi’s view has become detached from national interests and has contributed to systemic risks in the financial sector. As a result, some of China’s most successful and celebrated private companies found themselves up against a wall.

First, a deleveraging campaign launched in 2016 targeted highly indebted companies, especially in the real estate and property sectors, which had contributed to excessive debt and

risks to the financial system. While SOEs were also targeted in an effort to improve their performance, regulators started to focus on private companies including the rapidly expanding industrial conglomerate HNA Group and Anbang Insurance Group in 2017. The companies have since ended in bankruptcy or become defunct with their founders imprisoned.⁸

Some of the most successful companies and entrepreneurs were increasingly seen as rivals to the CCP's grip on power. Most prominent was the halting of the world's largest IPO in 2020 – Ant Financial, after founder Jack Ma made comments challenging the state-dominated banking system.⁹ His subsequent de facto silencing sent a signal to other entrepreneurs about who was in charge, which was combined with a broader crackdown on tech firms accused of “disorderly expansion of capital.” This meant they had done so well that too much capital was flowing their way at the expense of investment in areas designated by Beijing.

Xi's elevation of the party is a remarkable shift in China's political economy

This can be seen as a follow up to Xi's first anti-corruption campaign targeting officials. But this time, the CCP targeted the private sector and entrepreneurs to force their alignment with the ideological and political goals of the party-state. While not a return to a command economy through state takeovers of private firms, it is a new model that raises party interests above both the state and the private sector, thus advancing the transformation from “China, Inc.” to “CCP, Inc.”¹⁰

2.5 ALL ECONOMIC ACTORS MUST ADVANCE STRATEGIC GOALS

Xi Jinping's economic vision has expanded over the years. His elevation of the party is a remarkable shift in China's political economy. Hu Jintao once tried to rein in state-owned enterprises that had wandered from their core industries but failed due to vested interests. Even the People's Liberation Army (PLA) was notorious prior to Xi for its wide array of investments in the private sector. Leveraging ideology, Xi managed not only to rein in SOEs and get the PLA to divest, but expanded the CCP's control over private companies.

Xi's tenure in office began with a clear continuation of Hu Jintao's dual-pillar economic model – POEs were responsible for growth and innovation, SOEs were responsible for stability and intervention. The extent of party involvement depends largely on two factors:

First, the strategic relevance of a given firm. This spans from the most strategically important firms on one end – the “tech gap closers” that help overcome China's technological deficit in relation to liberal market economies – to the strategically important, though less critical “high-value development drivers” that are the new areas of growth that help China climb global value chains, and also to the least strategically relevant, though still important, “economic baseline holders” that fulfil the roles of maintaining employment, managing logistics and traditional infrastructure, and even to those sectors viewed with hostility from Beijing.

Second, the degree of party-state control/guidance, which operates on a scale from high to low. This is reflected in the areas in which the CCP needs to advance control to drive innovation or consolidate and advance monopolistic national champions at home and abroad, as well as the areas in which the CCP wants to have greater control, such as over digital champions that process vast quantities of consumer data or in the sectors Beijing wants to suppress for political reasons, such as the gaming industry and private tutoring (see Exhibit 6).



Xi's vision: A role for every company, and every company in its role

Companies are allocated roles based on their capabilities, and the party state will apply control, sticks, and carrots to get them in line

		STRATEGIC RELEVANCE		
		ECONOMIC BASELINE HOLDERS	HIGH-VALUE DEVELOPMENT DRIVERS	TECH-GAP CLOSERS
DEGREE OF PARTY-STATE DIRECTION/CONTROL	HIGH	The untrusted Can't quite be done away with but social risks demand extensive control <i>Examples:</i> Consumer internet, Tencent Games, tutoring/training schools	The new commanding heights Key SOEs that lead and facilitate China Inc going global <i>Examples:</i> High speed rail, nuclear, aerospace, space, shipping, shipbuilding	The must-haves Technologies that Beijing demands self-reliance, and expends whole-of-nation efforts on <i>Examples:</i> SMIC semiconductors, OS like Kailin, industrial and consumer software, Alibaba Chip development, Hisense AI
	MODERATE	The old commanding heights Provide important economic stability and ballast, but too important to trust to the market fully <i>Examples:</i> Real estate, transportation, freight rail	Consumption multipliers Facilitates higher domestic consumption and helps connect urban consumers to rural producers <i>Examples:</i> Digital Digital platforms and services, e-commerce, such as Alibaba Cloud, AliExpress, Rural Taobao	Known domestic gems Leading global competitors that need protection and support <i>Examples:</i> AI [Alibaba City Brain, AliOS; Ant Group (AI)] Huawei Harmony OS, Tencent
	LOW	The dead-end employers Provide jobs, but little value elsewhere <i>Examples:</i> Low-value consumer goods, retail, consumer services, local SOEs	Value-chain climbers Non-sensitive goods/tech that contribute to higher value consumption and exports <i>Examples:</i> Higher value consumer goods, growing consumer brands like Xiaomi, ANTA, Geely	Known foreign gems and unknown domestic gems Key tech providers that could leave China (foreign) or that fly under the CCP's radar <i>Examples:</i> Exxon Mobil, BASF, Tesla

Source: MERICS

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Exhibit 6

Xi's policies serve strategic national goals beyond growth

This shift from a division of labor in which SOEs had certain roles and POEs had others to one based not on ownership type but on the strategic relevance and degree of control over individual actors creates many niche roles that companies can occupy in Xi's new economic model.

A series of case studies demonstrating this shift in detail are referred to throughout the text, and the full version of those case studies can be found in the annex of this report. However, perhaps the clearest example of the varied strategic roles companies are meant to play is the planned break-up of Alibaba into six different lines of business, as outlined in the case study below.

Case Study: Alibaba falls in line on national strategic goals, breaks itself up

Jacob Gunter

China's retail and e-commerce giant Alibaba was long a key private company driving extensive growth and innovation, but Beijing has taken a critical view of the company and its founder Jack Ma in recent years. Certain lines of business, such as digital financing, were viewed as risky to socio-economic stability under the party-state campaign against the "disorderly expansion of capital," while other socio-economic goals under the "common prosperity" banner and "anti-trust" rules have also been impressed on Alibaba.

Meanwhile, the tech giant has been pushed to play more of a role in China's tech self-reliance campaign, with the expectation clearly to use its innovative potential not only on lines of business that consumers demand, but also those that are strategic bottlenecks for Beijing. In that sense, Alibaba's decision to split itself into six entities with different lines of business is a prime example of a private company being cowed into aligning with Beijing's strategic goals.

DIRECT CONTROL AND MANY STRIKES AT ALIBABA WITH REGULATORY AND POLITICAL STICKS

Blocked IPO – In November 2020, Beijing suddenly blocked the IPO of Alibaba's Ant Financial (set to be the largest in history).¹¹

Regulatory crackdown – Days after this, the State Administration for Market Regulation (SAMR) released anti-trust regulations for comment that were finalized in February 2021. The measures specifically target the internet platform industry. Alibaba's stock price has yet to recover, with its high of EUR 261/share on October 30, 2020, greatly eclipsing its value of EUR 198 at the end of 2021 and EUR 99 at the end of 2022.¹²

Golden shares – The party-state has used state-owned investment vehicles to take one percent stakes with special voting rights in two of Alibaba's units. Zhejiang Media Group seized one percent of Alibaba's Youku Film and TV unit, while an entity under the Cyberspace Administration of China took a one percent share in Alibaba's Guangzhou Lujiao.¹³

Common prosperity – Alibaba created a Common Prosperity fund in September 2021 that will reach a planned USD 15.5 billion by 2025. The funds are planned to support SMEs, enhance insurance for workers in the gig-economy, and promote rural development.¹⁴

Tech self-reliance – Alibaba traditionally focused its R&D and R&D collaboration specifically in the design part of the semiconductor value chain but has recently expanded its investments in closing the technology gap in other segments of the value chain.

ALIBABA IS RESHAPING ITSELF ALONG BEIJING'S OBJECTIVES

Not only has Alibaba fully aligned with the regulatory crackdown, both data and anti-trust related, but also with Beijing's self-reliance goals – in terms of the tech it was already developing, like cloud solutions and AI development, and in other technologies Beijing needs, like the broader semiconductor value chain.

In fact, Alibaba has fallen in line so obediently with party-state goals that founder Jack Ma largely has stepped back from the company and public life and the company has split itself into six different entities: China-based e-commerce, global e-commerce, logistics, cloud computing, digital mapping and food delivery, and media and entertainment. The stated goal is to allow these subsidiaries, all run independently by different CEOs, the flexibility to operate in a changing environment, and especially to make it easier for each entity to pursue an IPO when the time is right.

Beyond that goal, splitting up the company will allow for more differentiated political alignment. For example, the media and entertainment entity will need to move slowly and in line with what is politically correct at any given moment without poisoning other lines of the business; dividing up China and global e-commerce will make compliance with different data regimes easier; and separating cloud computing, and with it much of the semiconductor value chain and innovation on AI and quantum computing, allows the company to contribute to Beijing's tech and innovation goals without getting bogged down in the sensitivity of other lines of business.

3. The party state's emerging toolkit gets companies in line

3. The party state's emerging toolkit gets companies in line

KEY FINDINGS

- Xi isn't unwinding earlier reforms, but is giving the party-state a stronger role in shaping the ecosystem that economic actors must navigate.
- Breaking from the old model where SOEs advance national goals while POEs drive growth, Xi seems ambivalent about ownership and instead has varied goals for firms based on their relevance to his strategic goals.
- Beijing is using a toolkit of policies, regulations and informal instruments to reshape economic actors that do not align with strategic goals, or to direct support to firms that are on board. Ownership/governance, carrots, and sticks are the key tools.
- The government understands that private firms often have the dynamism and creativity SOEs lack to innovate and commercialize emerging technologies - key ingredients for China's new development agenda - but that they sometimes need steering to develop the 'right' technology.

On the surface, it might seem the market reform process is advancing, if not even accelerating. Xi Jinping rhetorically supports the “decisive role of the market” and he and his cadres often repeat the line that private firms provide “50 percent of tax revenue, 60 percent of GDP, 70 percent of innovation, and 80 percent of urban employment.”¹⁵ The share of private companies in key sectors and their presence in the top 100 companies has steadily increased.¹⁶

China's financial markets have also become more sophisticated. Private companies are omnipresent and financial markets have adjusted to serve the needs of these innovation drivers. Over the past 15 years, stock exchanges like ChiNext (2009), STAR Market (2019) and the Beijing Stock Market (2021) were launched to provide funding for the country's fast-growing companies that were not adequately served by the state-owned banking system. Venture capital also grew alongside new investment channels for foreigners, such as the stock connect mechanism, which allows participation in Chinese capital markets like Hong Kong, Shanghai, and Shenzhen.¹⁷

Today, such market reforms are not being rolled back but the function and scope of prices determining economic activities has become far more restrictive. Prices as a coordinating mechanism fluctuate within a lower and upper band in which the government is comfortable, similar to the managed exchange rate of the renminbi (RMB). Sudden and rapid changes increasingly trigger a policy response to “correct” the market. Faced with increasing capital outflow pressure from a depreciating exchange rate, the People's Bank of China (PBOC) introduced an opaque “counter cyclical factor” – an adjustment to daily yuan quotes by the central bank – to “help” guide the market.¹⁸ Another prominent example was the heavy-handed government intervention during the stock market crash in 2015 or interventions to manage commodity prices in 2021.¹⁹ With increasing levels of intervention,

On the surface, it might seem the market reform process is advancing

prices are losing their significance as a regulator in the economy. Increasingly, the CCP is the deciding factor determining levels of supply, production, and investment.

3.1 XI ISN'T UNWINDING EARLIER REFORMS, BUT IS GIVING THE CCP A STRONGER ROLE

As private companies have gained a foothold in strategically relevant sectors, the CCP has had to develop a new disciplinary system and incentive structure to compel rent-seeking entrepreneurs to serve the party's interests. This was done in part by regulatory intervention in previously largely unregulated sectors. To increase political and operational control over private companies, regulatory measures have been complemented by stronger party affiliation of the management and traditional economic guidance tools via the state-controlled financial system. As the structure of the economy has changed, the party-state has supplemented its toolkit, turning increasingly to the private sector to achieve ambitious national priorities.

Beijing reshapes economic actors that do not align with strategic goals

As demonstrated with Alibaba, Beijing is using this growing set of policies, regulations, and informal instruments to reshape economic actors that do not align with strategic goals, or to direct support and guidance to firms that are generally on board. These new tools fall broadly into three categories: Ownership/governance, sticks, and carrots. These are discussed briefly here but are illustrated in detailed case studies at the end of this report.

Ownership/governance

- Direct ownership
- Mixed-ownership/reverse-mixed-ownership
- Golden shares
- Party roles in decision making
- Market access restrictions
- Vertically integrated value chains
- Facilitated investment/divestment

Ownership/governance tools give Beijing direct influence in the decision-making processes of economic actors. Some of this happens through traditional means like direct ownership of SOEs at the central or even local level of the government, or through market access restrictions that have historically forced foreign private companies into joint ventures (JVs) with (often state-owned) local partners, thus creating channels for the party-state to guide decisions.

Others are the result of more recent efforts like mixed ownership reform efforts that in many ways tied SOEs and private companies together, or the application of golden shares in certain companies to ensure the party-state has certain veto powers. Finally, the party-state has other unique means to intervene, such as through party roles of board members, the ability to facilitate investment or divestment (to offload toxic assets from firms like the troubled real estate behemoth Evergrande or to raise funds through rapid sales like tech giant Huawei did with its Honor smartphone brand), or the ability of the State-owned Assets Supervision and Administration Commission (SASAC) to use its ownership of multiple SOEs in a given value chain to coordinate action.

Sticks

- Regulatory direction
- “Crackdowns” and “rectifications”
- IPO blocks
- Common Prosperity demands
- Assignment to “national teams”

Sticks in Beijing’s arsenal give it the means to drive unruly actors away from the things Beijing doesn’t include in its objectives. This can happen through traditional regulatory direction, both to drive legitimate compliance (like with the new cyber and data legal regime) or as means of political signaling through “crackdowns” and “rectification campaigns” (like choosing the internet platform sector for its first round of cyber and data rules enforcement to send a message to other industries). This can also include steps like scuttling planned IPOs at the political direction of Xi himself. Some sticks don’t look so offensive or damaging, but instead are means of atonement, like embracing Common Prosperity by putting billions into common prosperity funds or joining “national teams” to help close strategic technology gaps.

Economic policies increasingly focus on high-tech SMEs

Carrots

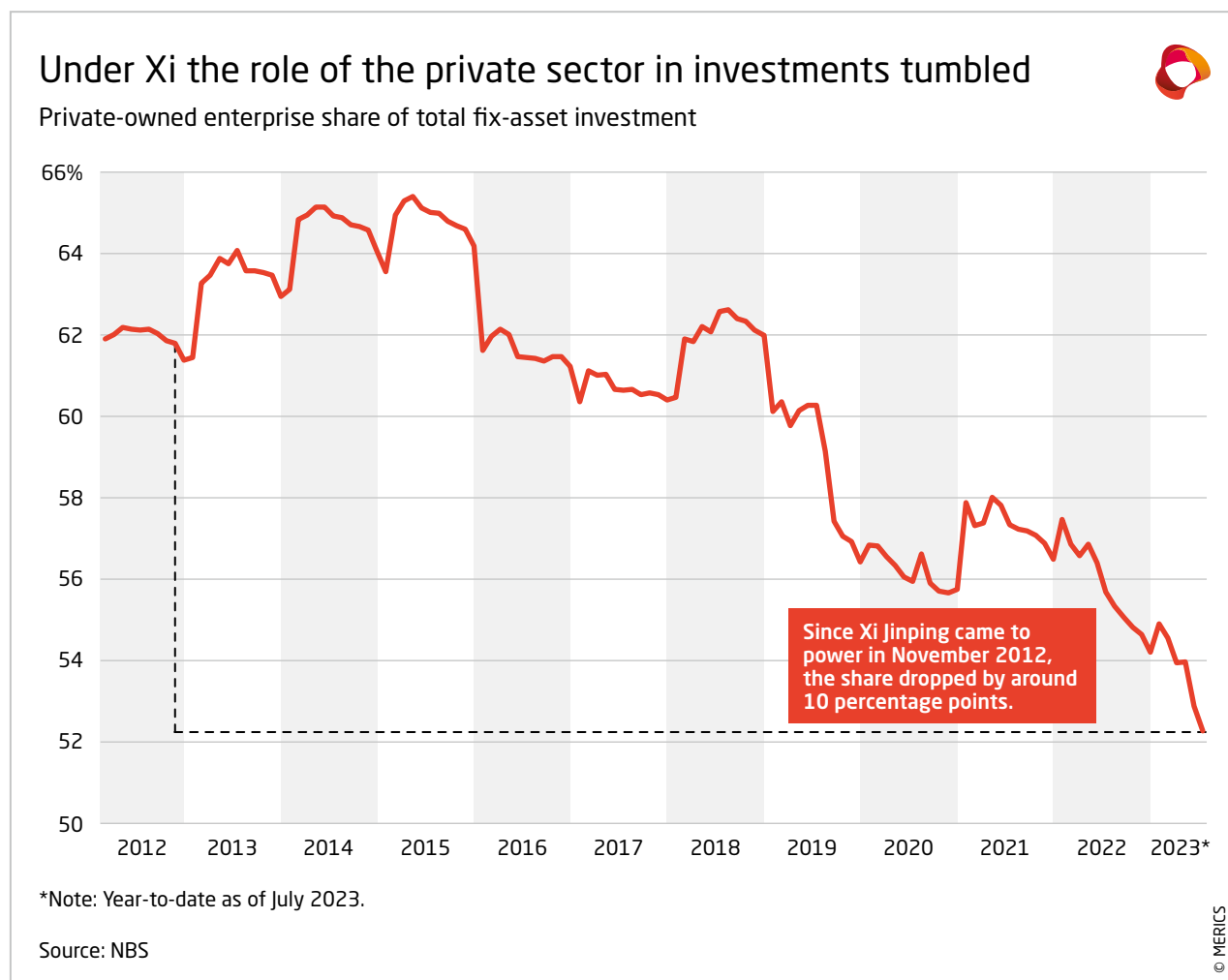
- Direct subsidies/tax relief
- Policy banks
- Cheap loans
- Advantageous stock listings
- Implicit guarantees
- State guidance funds
- Little Giants status
- HNTE status
- Ensured customer base
- R&D support
- Protected home market

Carrots are a way for Beijing to direct support to economic actors already aligned with national goals to help facilitate their success. They include many traditional means of state aid like subsidies, tax relief, cheap loans from state-run commercial and policy banks, implicit guarantees for SOEs, and protection from foreign competition. However, new support mechanisms have emerged in recent years to help achieve strategic goals, especially those related to closing the tech gap: advantageous stock listings in tech- and SME-specific markets, state guidance funds, status as a Little Giant (small firms in important areas of development) or as a High and New Technology Enterprise, ensured customer bases through public procurement or support from SOE customers, and extensive support in R&D through China’s innovation chain strategy.

3.2 THE GROWING CAST OF ROLES FOR POES

Economic policies increasingly focus on private enterprises, particularly high-tech small and mid-size enterprises (SMEs), as key actors to solve core issues like technological bottlenecks and economic self-reliance (see Exhibit 7).

Exhibit 7



The tech sector has benefited from “walled gardens” protecting them against foreign competition. Now that they have blossomed into strategically relevant companies, the CCP is beginning to tighten its grip. Private firms’ increasing prominence in policies also entails greater party-state guidance to focus on core objectives (see Exhibit 8). Prominent cadres call on private enterprises to “continuously increase S&T innovation efforts [...] and to strive to become the force to solve the bottleneck technology problem.”²⁰ The government understands that private firms often have the dynamism and creativity that SOEs lack to innovate and commercialize emerging technologies, which are key ingredients for China’s new development agenda.

The greater guidance of private enterprises is accompanied by new carrots and sticks. If private companies follow party-state guidance, they stand to benefit from direct and indirect policy support and improved financing options. A top-level policy published in 2019 by the CCPC and the State Council is directed at improving the business environment and financing options for private firms to harness their innovation for national goals.²¹ Furthermore, the party has greater expectations of the private sector to fulfill national priorities and “unswervingly listen to and follow the party at all times.”²²

This does not mean that all companies are tightly controlled by the party-state – far from it. The bulk of private firms fall outside of the areas deemed strategically relevant by Beijing. Even in some important industries like the new energy vehicle (NEV) sector, which is

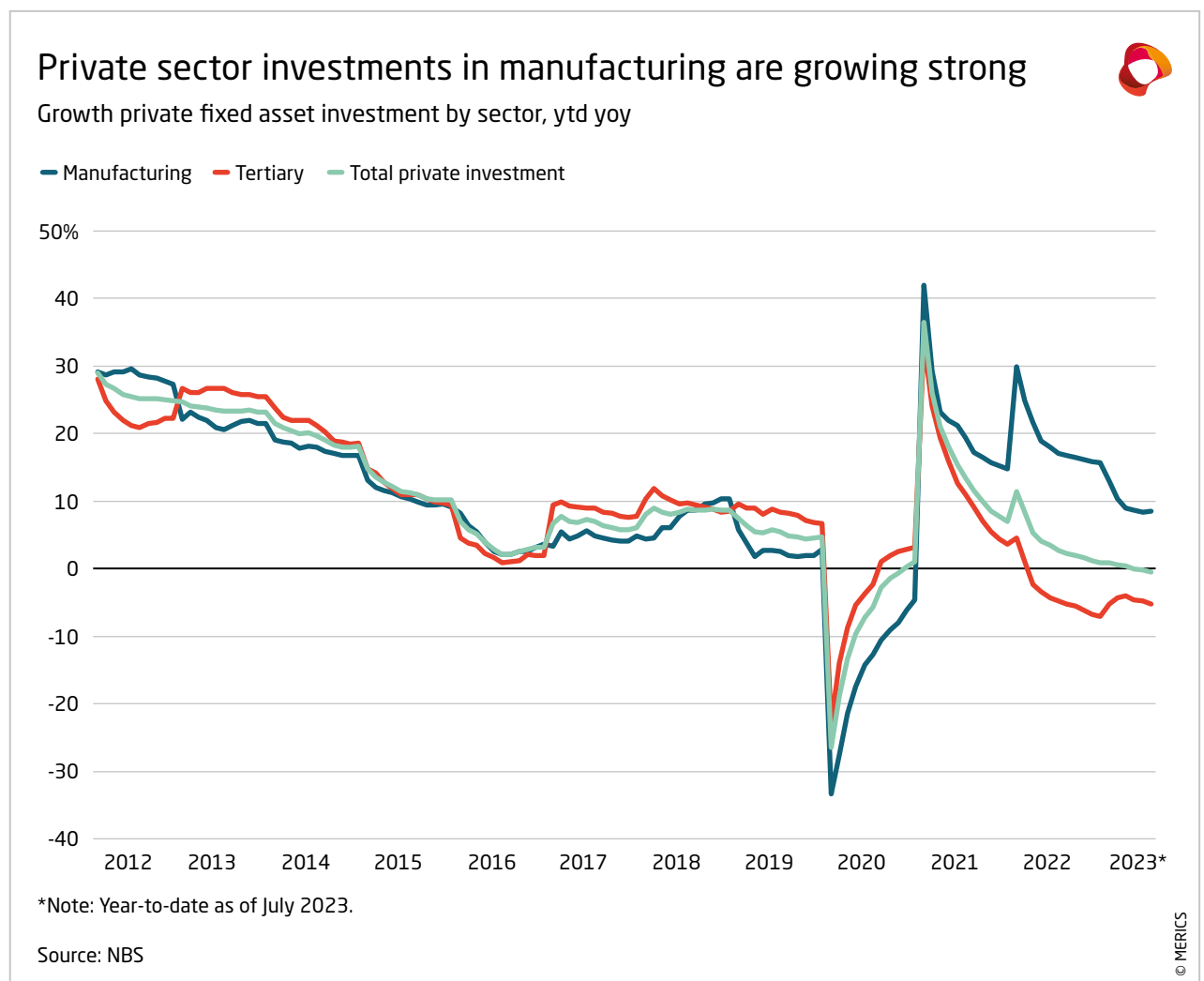
critical for China's green transition and is also an important growth sector where Chinese firms are on the cutting edge, the party-state has given considerable space to private actors.

It has adopted a surprisingly lax approach to directing NEV makers while also throwing mountains of state aid into the sector to drive up demand – effectively dedicating a large field where contenders could take root with ample fertilizer for all. Only after some NEV makers emerged as commercially viable did Beijing begin to tighten standards and cut off state-aid – eventually leading the weakest players to exit the field and leave the remaining space to China's most promising NEV brands.

Since at least the 2013 Third Plenum, the leadership has been optimizing economic policies in order to establish a more efficient economic system (driven in part by market forces) that also responds to the guidance of the party. Xi recognizes the superiority of a competitive environment in allocating economic resources in terms of *market efficiency* for the purposes of growth and general development. However, in areas where investment would not be efficient from a market perspective, but where the leadership urgently needs China to be technologically competitive on a global scale, party-state intervention is essential. From the perspective of the CCP, this is not seen as a contradiction.

In Xi Jinping's era the share of POE in China's fixed asset investment has deteriorated by nearly 10 percentage points. Despite these notable shifts, China is not a command economy

Exhibit 8



in which all companies follow the party overlord by investing in the “real economy.” The deterioration of POE investment is mainly due to a slowdown in services and real estate, while investment in manufacturing has been growing in the double digits.

But the private sector remains fairly reluctant to follow the CCP's growing influence, requiring the CCP to develop new tools for control and guidance. Private companies continue to have similar opportunities as in far more capitalistic systems. But market mechanisms, including how private companies and financial markets operate, are increasingly guided, if not dominated, by the CCP. All in all, the CCP is trying to come up with a system of economic rules that forcefully merges party control with market mechanisms.

4. Beijing advances technological self-reliance by all means

4. Beijing advances technological self-reliance by all means

KEY FINDINGS

- Tech self-reliance in a geopolitically focused economy is the central goal that Xi has in his economic agenda.
- A whole-of-nation approach aims to close tech gaps and make China less dependent on foreign actors Xi believes aim to hold China back.
- Taking hold of the innovation chain, the party-state guides and supports each actor to gain tech effectiveness and market efficiency, while centralizing and streamlining everything from basic research to commercialization.
- Beijing will promote indigenous solutions where it can, even at the expense of efficiency, but will also welcome foreign investors in areas where China's tech gap is largest - better to have secure, onshored foreign technology providers than rely on easily targeted imports.
- China is using its dominance in raw materials and is also seeking disruptive technologies where it can lead, to be used as trump cards in international technology rivalries.

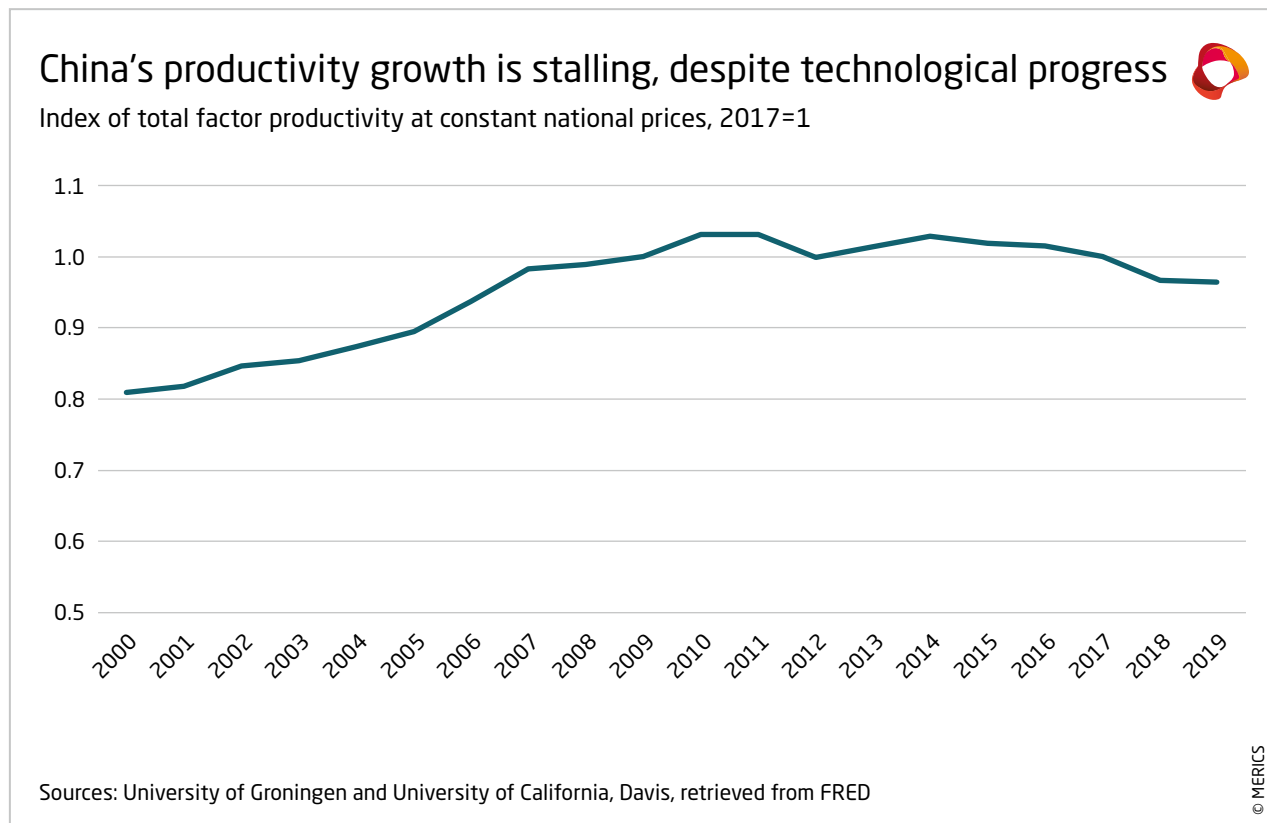
Xi's geopolitically focused political economy is on full display in the way innovation is being pursued in China, as well as how the country's innovation dividend is materializing. Considering the remarkable progress that China has made in advancing itself as a technological great power, there would normally be an expectation that total factor productivity would have climbed as the returns on innovation gains kick in. Instead, total factor productivity has trended downward, begging the question of where the dividend has gone.²³ Rather than going towards productivity, much of it has gone towards Xi's tech self-reliance goals. This is because in most technologies, China is playing catch up in terms of tech effectiveness, but it has enjoyed extensive access to foreign technology – in previous years, Chinese firms could simply acquire the foreign technology to maximize their return, which could bring productivity growth. Instead, Xi has set the country on a path where, in many key areas, it is more important that companies expensively develop that tech themselves. Had China instead focused on its own comparative advantages and accepted interdependencies on others in areas where it lagged, the innovation dividend would likely have moved the needle up on productivity, but instead, it has only gone to closing tech gaps (see Exhibit 9).

The tech self-reliance priority has now been cemented in place. Now facing a showdown with the US and its allies, Xi has called for a “New type of whole-of-nation approach” (新型举国体制) in the 2020 Central Economic Work Conference to close technology gaps and rid China of its dependency on the foreign actors he believes intend to contain his country.²⁴

Several clear patterns in these efforts have emerged in the national strategy: First, closing gaps across as many strategic technologies as possible. Second, in strategic technologies where China has achieved effective competitiveness, protecting market share from foreign competition so indigenous firms can achieve *market efficiency*. Third, in strategic technologies where China remains far behind, attracting foreign investment where possible and continuing to import from abroad *where necessary*.

The tech self-reliance priority has been cemented in place

Exhibit 9



4.1 INNOVATE EVERYTHING, EVERYWHERE, ALL AT ONCE

In an attempt to better align innovation and industry, the CCP is setting up new hierarchies within the economy. By mixing tested methods with a stronger embrace of “technocratic laboratory capitalism” – a form of capitalism that operates in a highly controlled environment – the CCP aims to increase centralization and coordination of economic actors. While higher levels of political control may hinder innovation of privately owned companies, the CCP is also attempting to integrate them into China’s evolving innovation ecosystem, including networking them with national research institutions, universities and other companies.

The government has also recognized the private sectors strength in emerging technology and incentivizes technology development and competition by reducing their financial risk. The new type of centralized administration of innovation aims to accelerate innovation in strategic areas by aligning the private and state sectors in pursuing national strategic targets.

Ministries and relevant departments play a crucial role in developing the required plans, including roadmaps, timetables and responsibilities. The plans set the framework for direct and indirect financial incentives that help steer market actors toward the most efficient way to reach targets. In sectors where POEs dominates, they compete for full government support, currently especially seen in semiconductors, but previously for electric vehicles (EVs).

Likewise, in sectors where SOEs dominate, they are expected to help reach goals by transforming themselves into profitable drivers of innovation. This is consistent with the emphasis on POEs and SOEs as pillars of the Chinese economy outlined in the 2013 Third Plenum. Increasingly, both are operating in a similar environment with the CCP exerting control over their operational direction regardless of their ownership.

Yet, it is not simply down to POEs and SOEs to contribute to the leadership's call for innovation. In line with the whole-of-nation approach, Beijing has been refining its approach to bringing the party-state and the scientific community in at early stages and then fostering commercialization at the corporate end of China's innovation chain. The intention of the innovation chain is to centralize and streamline everything from the earliest basic research to eventual commercialization, first in terms of tech effectiveness and then market efficiency, all with the party-state guiding and supporting each actor along the way.

Encapsulating the whole-of-nation approach is the role that larger POEs and SOEs are also meant to play in the innovation chain. This includes expectations that they support the scientific community in the research phase, and often also invest – either in their own subsidiaries (which then benefit from tech transfer) or in startups (providing much needed capital and business support). For China's startups seen as having the potential to close the technology gap in key areas, that support can also come through China's "Little Giants Initiative." Little Giants provides extensive support to qualifying SMEs through the innovation chain model and by connecting them with financial markets like the Beijing Stock Market (see the case study on the Little Giant company Leaderdrive at the end of this chapter). In 2022, 40 percent of listings on the Shanghai, Shenzhen and Beijing stock exchanges were made by Little Giant companies.²⁵

The party-state is guiding all actors along the innovation chain

4.2 TAKING INDIGENOUS CHAMPIONS FROM TECH EFFECTIVENESS TO MARKET EFFICIENCY

As innovation is often a contest of incremental improvements, technology that is one or two steps behind the cutting edge can still achieve much of what its most advanced version can. An EV with a range of 200 km can fulfil most of the same needs of commuter drivers as an EV with a range of 300 km. And a chip made with the 22 nm process can achieve in a smart phone much, but certainly not all, of the same functionality as a 14 nm version.

Even if the more advanced tech can do some things its lesser version cannot, there is still enough overlap to satisfy many customers. Obviously, Beijing would like to be on the cutting edge in many technologies, but it will often settle first for getting close enough to produce most of the desired applications of a given tech.

This tried and true formula has been demonstrated most clearly in the area of high-speed rail (HSR) technology. China's ambition to create an HSR network was hampered by a lack of expertise and technology to build domestic models. Foreign HSR companies were invited into the market and required to enter JVs and transfer technology to local players such as northern and southern rolling stock companies CNR and CSR. Brands like Kawasaki, Alstom, Siemens and Bombardier all jumped into the market hoping to become the dominant players.

Over time, CNR and CSR merged into a single monopolistic giant CRRC which then had access to all of the transferred foreign tech and eventually caught up and managed to produce technologically effective alternatives to the foreign brands. It didn't take long for the procurement system in charge of purchasing engines and rolling stock to favor CRRC over its foreign competitors, effectively pushing them out of the market aside from some niche tech related to HSR. Since then, China's HSR network has dwarfed all others. Anyone who has ridden the CRRC Fuxing "(national) Rejuvenation" line, which is the exclusive intellectual property of CRRC, can tell you how its speed and smooth ride make European high-speed rail feel outdated.

A similar story is currently playing out with Huawei, which has overtaken its rivals in 5G technology and now enjoys a protected home market to build out almost entirely without foreign competition. Beyond that, Huawei is central to Beijing's strategic ambition to close other technology gaps, and the company is covered in a case study at the end of this chapter.

Some of the same rules that are benefiting Huawei as sources of protection in its home market are also applicable to other sectors. Xi's ambition to securitize China in every possible way have created regulatory and other means to drive out undesirable foreign competition in certain industries, but also to compel the rest of the foreign business community and local firms to integrate with indigenous tech in affected areas.

This is happening most sharply in the Critical Information Infrastructure (CII) (关键信息基础设施) space, where suppliers of relevant information communications technology (ICT) and digital solutions must be whitelisted by a multitude of government bodies for customers designated as CII operators. The rules have a massive negative impact on foreign suppliers and operators. The former report to the European Chamber of Commerce that they face far higher levels of scrutiny than their local competitors, while the latter say they often need to gut their hardware and software used globally and furnish their China operations with indigenous solutions.

A less deep-cutting, but more widespread, source of protectionism is the autonomous and controllable (A&C) (自主可控) campaign, which aims to ensure value chains that can go it alone if needed. Importantly, as more and more industries undergo digitalization and rely more on networking and automation, there is a higher likelihood they will fall under greater scrutiny as operators. It is hard to imagine that Beijing will allow highly automated chemical plants (in a country with a history of exploding chemical plants) or autonomous vehicles to operate without much more oversight and intervention from authorities.

4.3 DRAWING IN FOREIGN TECH WHERE POSSIBLE, IMPORTING IT WHERE NECESSARY

It is impossible to talk about China's own tech self-reliance ambitions without also covering the very dependencies on foreign technologies it seeks to remedy.

China also approaches self-reliance through opening up

Where China remains too far behind foreign technology providers, it approaches self-reliance through opening up. The onshoring of foreign technology brings that tech within China's borders and under Beijing's jurisdiction – a much preferred choice to importing it and being subject to potential restrictions from the US or elsewhere. This can mean removing restrictions, but also rolling out the red carpet with additional support measures to incentivize onshoring. While a variety of external restrictions make it impossible, Beijing would eagerly provide abundant support to companies on the cutting edge in the semiconductor value chain – firms like TSMC, ASML, Nikon, and Intel could effectively name their price if they onshored their most advanced production.

A similar situation emerged for foreign chemical makers BASF and Exxon Mobil when they each announced plans in 2018 to build plants valued at USD 10 billion in Guangdong. These chemical plants will produce highly advanced chemicals for customers in China that previously would have been imported – which would potentially have subjected them to disruption. To facilitate this investment, Beijing approved 100 percent foreign ownership for each investment, something that had never before happened in China.

Finally, China will reluctantly continue to import foreign technology where it has no other choice – though it will simultaneously focus efforts on closing the tech gap in these areas. This is most widely the case in the semiconductor space, where China must import the most cutting-edge chips that empower its own innovation system and its exports, albeit with much greater difficulty since the October 2022 restrictions on US chip tech and the early 2023 joint agreement of the US, Japan, and the Netherlands to restrict exports of the most advanced lithography machines. However, this applies to far more technologies than Beijing would like. Just to name a few:

- Due to their status as military contractors in the US and Europe, many of Airbus and Boeing’s suppliers are only allowed to export certain components to Chinese passenger airliner aspirant COMAC
- A multitude of European and Japanese industrial machinery makers will only export their most cutting-edge products to China
- Legions of hidden champions/so-called Mittelstand firms that fill niche roles as the primary (or even sole) providers of certain components have the luxury of a seller’s market and are under no pressure to onshore.

4.4 SEEKING TECH SUPREMACY, CHINA HAS USED DOMINANCE IN MANUFACTURING AND RAW MATERIALS AS LEVERAGE

In one of his signature speeches, *Some Major Problems Facing Medium to Long Term National Economic and Social Development* (国家中长期经济社会发展战略若干重大问题) published in Qishi (the CCP’s theory journal) in late 2020, but originally delivered in April 2020, Xi expounded on his vision for China that was very technology-centric.²⁶ Coming out of the intense initial lockdowns at the start of the pandemic, the speech called first for a resilient domestic market to decrease reliance on foreign demand and second for localized value chains and secure technology access. One plank for achieving secure technology access is by catching up and overtaking the technological high grounds so that Beijing will have deterrence through a sort of technological mutually assured destruction position. Specifically, Xi envisions “assassin’s mace” technologies – the Chinese equivalent of a trump card, something which can be unexpectedly thrown into a contest or a fight that changes the dynamic.

The ambition is to establish China as the dominant tech supplier for an emerging technology that will be in high demand globally. From that position, Beijing would control its own tech bottleneck which it could credibly use against other markets, much in the way Washington uses the semiconductor bottleneck to gain a hold on China. The effect would be deterrence – so the US would think twice about cutting China off from its chip technology lest China cut the US off from its bottleneck technology. This could be in AI, quantum computing, life sciences, or new materials – anything China is currently on the edge of and which could become critical in empowering not just one or two end products, but multiple value chains, and a country’s innovative capacity itself.

For now, that also means other technologies that can drive deterrence. Beijing’s early 2023 crafting of restrictions on outbound intellectual property related to photovoltaic (solar panels) tech opens the door to a kind of export control over a key technology for the green transition – and one where China holds around 80 percent of the global market share in the full

The aim is to become the dominant supplier for an emerging technology

value chain for solar panels.^{27 28} Meanwhile, on July 3, 2023, China's Ministry of Commerce announced export controls on gallium and germanium-related materials on the grounds that they have dual-use applications.²⁹ China produces around two-thirds of the world's germanium, and 97 percent of its gallium, with each mineral being the base for a variety of applications in semiconductor, optics, and electronics more generally.³⁰ This came after the Netherlands announced details of its own restrictions on exports of cutting edge lithography machines aligned with the US and Japan. Beijing clearly had prepared its own response and kept it ready to play at the right moment as a possible deterrent – gallium, for example, is essential for cutting-edge chip wafers made by Japanese firms, used by Korean and Taiwanese chipmakers, all made with Japanese and Dutch lithography machines.

Case Study: Leaderdrive, one of Beijing's "Little Giants"

Alexander Brown

Leaderdrive (Leader Harmonious Drive Systems (绿的谐波)) is a private SME and producer of harmonic reducers, a type of core component for robots. Beijing has long sought to build up domestic capabilities in robotics core technologies, where foreign firms dominate.³¹

Robots and CNC (computer numerical control) machines are among the ten key industries included in the Made in China 2025 strategy. Beijing set targets for indigenous Chinese firms to occupy 50 and 70 percent of the domestic market for industrial robots by 2020 and 2025, respectively. It is also aiming to increase localized production of core robotics components to 50 and 80 percent by 2020 and 2025, respectively.³²

But the industry has so far failed to meet the government's expectations. In 2020, the domestic market share of indigenous brands in industrial robot production was about one quarter.³³ With regard to core components in 2020, the localization rate of reducers, servo systems and controllers had reached about 36 percent, 25 percent and 31 percent, respectively.³⁴

Hence, the robotics sector is one where China's dreams of technological self-reliance remain unfulfilled. This is particularly the case in upstream components, where Leaderdrive has the potential to fill a gap in China's domestic supply chain.

ABUNDANT GUIDANCE THROUGHOUT THE INNOVATION CHAIN

Little Giant program: Leaderdrive was included in the first batch of Little Giant (小巨人) firms, announced in 2019.³⁵ Little Giant companies are high-tech SME firms with strong innovation capabilities operating in niche markets. The designation grants companies special access to government support and encourages both public and private sector actors to facilitate the companies' growth, which includes not only extensive support mechanisms, but also guidance mechanisms that the firms can tap into.

Government subsidies: Since gaining the Little Giant title, Leaderdrive received CNY 78 million in subsidies between 2019 and 2022, accounting for 6 percent of its revenue over this period. Subsidies amounted to just 3 percent of revenue during the period 2017-2018.³⁶

Equity financing: The company received a large windfall following its listing on the STAR market in August 2020, where it raised CNY 1.06 billion in capital. It has received direct equity investments from private and public investors, including government guidance funds. For instance, the Advanced Manufacturing Investment Fund is the third largest shareholder in the company, holding 5 percent.³⁷

R&D support: Leaderdrive has developed long-term collaborative partnerships with several universities, including Harbin Institute of Technology, Shanghai Jiao Tong University and Southeast University. It led a National Key R&D program project into robotic reducer manufacturing launched in 2017, with CNY 13.4 million in funding support from the central government.³⁸

Customer base: Beijing encourages large firms to build stronger links to high-tech SMEs and support their growth. Leaderdrive counts some of the largest indigenous producers of industrial robots such as Siasun, Estun, STEP Electric and Huashu Robot among its key customers.

Manufacturing Champion program: In 2021, Leaderdrive was further recognized as a Manufacturing Champion (制造业单项冠军), essentially one step above a Little Giant company. This marks it as a leading manufacturing company in a specific subsector and further underlines its importance to the government.³⁹

LEADERDRIVE AS A SUCCESS STORY FOR CCP GUIDANCE TO FURTHER NATIONAL GOALS

Leaderdrive's growth trajectory has accelerated since its selection as a Little Giant. The company's revenue more than doubled and its assets more than tripled between 2019 and 2022. In 2021, Leaderdrive accounted for 25 percent of the domestic harmonic reducer market, ranking second.⁴⁰ Among the three main core components of industrial robots (reducers, controllers and servo systems), reducers are the only ones where a Chinese firm has a significant market share (above five percent).⁴¹

The firm has been lauded by the Chinese Institute of Electronics for its success in achieving breakthroughs in "bottleneck" technologies and developing robotics core components.⁴² According to Zhang Yuwen, deputy general manager of Leaderdrive, the company is fulfilling the mission Beijing has ascribed to it. Through its high-quality, reliable and relatively cheap products, it has successfully reduced the dependence of Chinese robot makers on high-end harmonic reducers imported from Japan.⁴³

Case Study:

Huawei's base station tech overtakes foreign competitors

Alexander Brown

Huawei Technologies (华为技术) is the flag bearer of China's progress in high-tech manufacturing. It is one of the first private Chinese firms to become a global leader in high-tech goods. In 2012, it became the largest telecommunications equipment producer in the world.⁴⁴ Its products underpin the telecommunications infrastructure in China, deemed to be of critical importance for national security. The company's leadership in 5G technology, supported by heavy investment in R&D and innovation, has enabled China to roll out the latest network technology far more quickly than other advanced economies. This will support digitalization and greater productivity across all sectors, from manufacturing, to transport and health. Since 2018, when Huawei was directly targeted by technology restrictions imposed by the US, Huawei has led the charge in efforts to build up self-reliance. It has moved swiftly to replace hardware and software previously sourced directly or indirectly from the US, either through developing its own technology or by supporting other domestic firms.

FRONTLINE LEVELS OF SUPPORT FROM THE PARTY-STATE

Technology transfer: In exchange for market access, foreign telecommunications firms were required to share intellectual property with domestic firms such as Huawei, facilitating its early development.⁴⁵

Protected market: Priority access to contracts for the rollout of telecommunications equipment in China has provided a huge market for Huawei and helped it to scale up. As of 2022, China accounted for over 60 percent of the world's 5G base stations.⁴⁶

Policy banks: Tens of billions of US dollars have been granted to Huawei and its international customers to support projects overseas.⁴⁷

Grants and tax incentives: A review conducted by the Wall Street Journal suggests the company has received USD 46 billion from loans, credit lines and other support from state lenders. Tax incentives saved Huawei as much as USD 25 billion between 2008 and 2018.⁴⁸ Subsidies granted to Huawei more than doubled in 2022 to reach over RMB 6.5 billion (approximately USD 950 million).⁴⁹

Facilitated divestment: Beijing acted as an "investor of first resort" to transfer Huawei's HONOR brand assets to a non-Huawei entity, to bring them outside the scope of US sanctions.⁵⁰

Economic coercion: Chinese officials have on multiple occasions threatened to retaliate should Huawei be excluded from supplying equipment to markets overseas countries.⁵¹

PRIME EXAMPLE OF BEIJING'S INNOVATION HOPES AND CONTAINMENT FEARS

Government backing smoothed the way for Huawei's transformation into a technology powerhouse. The company is among China's most innovative firms and most prolific generators of invention patents.⁵² It has successfully entered markets all over the world, and to a large degree European countries still use Huawei technology in their 5G networks, although this may not last.⁵³ Ultimately Huawei's ties to the government and its home market advantages have caused pushback overseas and are beginning to restrict its access to some markets in advanced economies. The company has been drawn into the center of China's stormy relationship with the US.

Huawei's fight for survival amid the US technology embargo embodies the Chinese government's fears for the country as a whole. Over the past few years, it has made significant progress in fully localizing its supply chains. Ren Zhengfei, the company's founder, says domestic alternatives have been found for more than 13,000 components and over 4,000 circuit boards redesigned.⁵⁴ In the realm of industrial software, Huawei has switched to its own MetaERP (enterprise resource planning system), thus replacing US vendors.⁵⁵ The company is also active in the semiconductor space. It has become a leading supplier of AI chips for the domestic market and is leading local advances in electronic design automation tools for chips.⁵⁶ What's more, in 2019 Huawei launched a semiconductor investment fund which has backed over 80 local firms.⁵⁷

Most importantly for Beijing's goals, Huawei and SMIC had jointly worked on near-7 nanometer chip technology, which seems to have yielded effective, though likely not efficient, results. In early September, 2023, Huawei unveiled its new Mate 60 Pro smartphone, which uses Kirin 9000-S chips made by SMIC. While a tear-down of the technologies in the phone are ongoing at time of writing, it suggests that major progress has been made through indigenous innovation.

5. Xi's emerging social contract puts strategic objectives first

5. Xi's emerging social contract puts strategic objectives first

KEY FINDINGS

- The transition towards a consumption led growth model is taking the back seat. Achieving industrial policy objectives takes precedence over advancing socio-economic targets, so long as the economic baseline is held.
- Despite Xi's ambitious social reforms, advancing structural socio-economic change and redistribution have never been the priority for CCP since it embarked on economic reforms.
- Under Common prosperity there is discontent with those displaying excessive wealth and an expectation for companies to take on more social responsibility.
- Aligning strategic priorities with jobs and income is becoming more difficult as China deals with a more demanding middle class and its needs and wants.
- Ideology and geopolitical rivalry are nurturing a more repressive political economy that may well run counter to the expectations of a large middle class.

China's economic transition has been a remarkable success. In the process, over 800 million people have escaped poverty.⁵⁸ Just in time for the CCP's centennial in 2021, Xi declared the end of extreme poverty. The annual income of at least 100 million people had exceeded RMB 4,000 – China's definition as the rural poverty line. In 2022, GDP per capita reached USD 12,720, putting it close to the World Bank's definition of a high-income country of USD 13,845.⁵⁹ But this still leaves China below Bulgaria (USD 13,772) and Romania (USD 15,892), the countries with the lowest GDP per capita in the EU.

Solely focusing on national GDP per capita levels in China might be misleading as it is already an innovation power to reckon with. In a large economy like China, various development stages take place simultaneously. Already 42 percent of its population lives in regions that would be categorized as high income by the World Bank. Jiangsu, Fujian, Zhejiang and Guangdong all have a GDP per capita greater than USD 15,000 in 2022. Together, their population is over 330 million, giving China a very sizable middle class.

Despite this remarkable success in improving the well-being of society, China's economic policies have remained geared toward supporting industry in pursuit of greater technological sophistication. Reaching national strategic goals requires large capital investments in infrastructure, production capacity and science and innovation. Empowering the autonomy of private households' consumption patterns is not compatible in a system that seeks greater centralization and control – after all, consumers might not buy what the party wants them to. This sets limits to the decade-old demands for rebalancing the economy to rely less on investment. In Xi's economic logic, it is a strong capacity to provide effective

In China, various development stages take place simultaneously

supply that creates jobs and income – and from that follows demand.

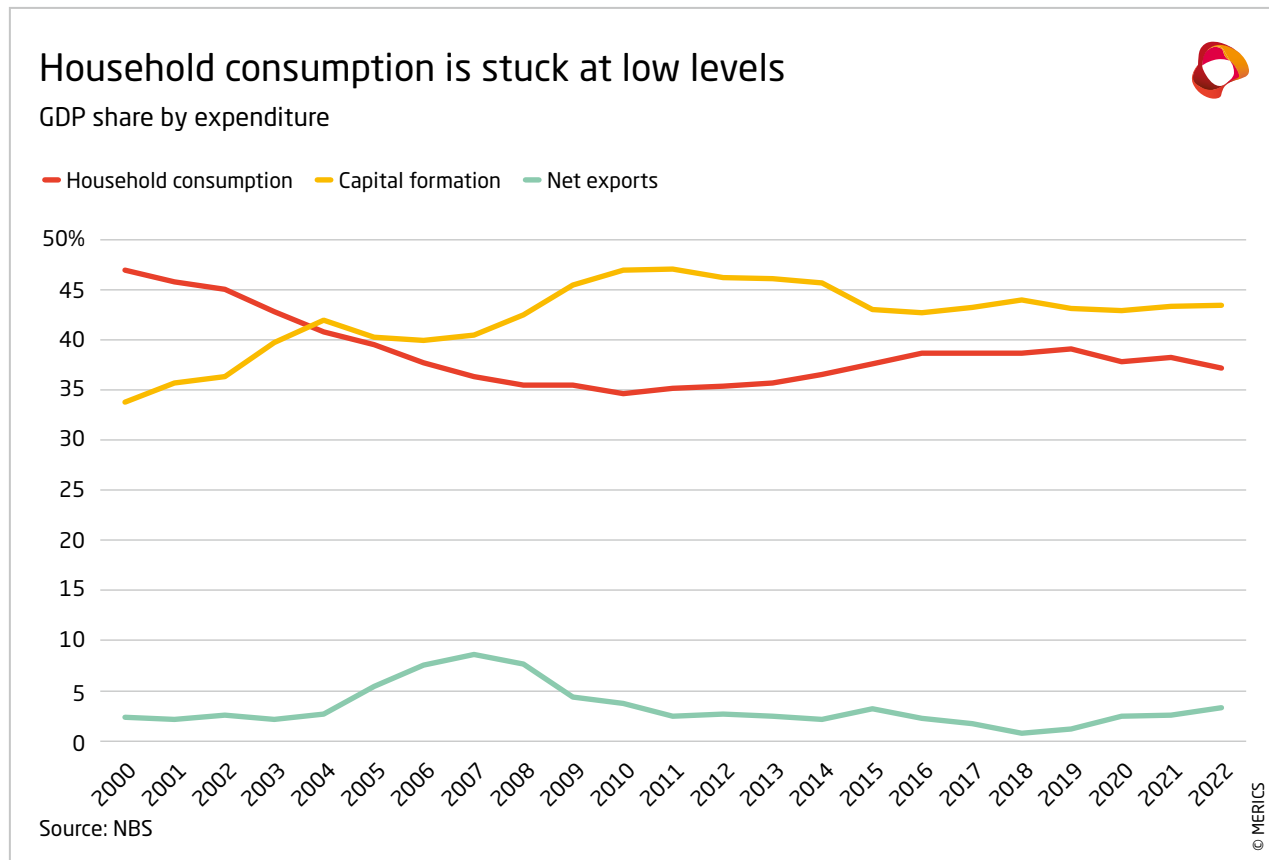
The type of socialism that Xi Jinping envisions for China emphasizes ideology and nationalism. A fundamental part of this are collectivist principles as an important feature of China's economic system. This means that the nation's interest supersedes that of the individual. While individuals are not yet only seen as a means to an end by the CCP, more repressive structures in the political economy are limiting their corridors of economic activity.

Advancing authoritarian elements as a key principle of governance under the leadership of Xi Jinping is leaving its marks on the socio-economic structure of the country. As in other parts of China's economy, the CCP is advancing its position and guidance over economic actors. This does not bode well for a substantial shift in China's growth model toward more household consumption and has significant implications for China's development path.

5.1 CONSUMPTION-DRIVEN GROWTH FAILS TO LIFT OFF

One of Xi's signature policy agendas, The dual circulation strategy, is centered around just that. The core principle is to shift China from its previous model of export- and investment-driven growth to one that is primarily fueled by domestic consumption, and in which exports play a supplementary role. However, broad acknowledgement that such a shift toward consumption-driven growth is necessary does not inherently facilitate that transition. There are other priorities to consider, and Xi has clearly ranked consumption-driven growth as a second-tier goal.

Exhibit 11



Countries with higher government control over the economy have generally lower degrees of private consumption.⁶⁰ The household consumption share of GDP has barely improved since Xi's first term in 2013 – going from 34.3 percent in 2010 to 38.5 in 2021, basically the same level over the past five years. Despite a long debate on the transition to a more sustainable growth model, investment remains the most important element in the economy. This should not come as a surprise as achieving industrial policy objectives takes precedent over advancing socio-economic targets. A higher share of consumption and the autonomy of households would counter efforts toward greater centralization of China's economic system favoring industrial policy (see Exhibit 11).

The household consumption share of GDP for countries classified as middle income by the World Bank is typically around 50 percent while for high income countries the share is around 60 percent. In isolation, the failure of the dual circulation strategy to drive change might suggest a policy failure, but in the broader context of Xi's economic policy making, it is rather a failure caused by tradeoffs. From the perspective of Xi's economic thought, however, a low household consumption share should be understood as a feature of China's economic system rather than a structural problem.

5.2 THE REBUTTAL OF THE WELFARE STATE: SOCIO-ECONOMIC INDICATORS STAGNATE UNDER XI

Advancing socio-economic policies and redistribution have not been the mainstay of the CCP since it embarked on economic reforms – and are not under Xi Jinping either. Zhu Rongji ended the Mao-era social safety net of the company-level work unit (单位) during the reform of SOEs in the 1990s. Disbanding the “iron rice bowl” was replaced by a laissez faire social system akin to a neoliberal economy.⁶¹ Any substantial rebalancing effort would require a meaningful redistribution and increased social expenditure by the government which would come at the expense of investments in expanding manufacturing capabilities and innovation. This requires change to be institutionalized rather than a campaign-style approach such as battling extreme poverty.

Advancing redistribution has not been the mainstay of the CCP

These priorities are unlikely to change anytime soon under Xi Jinping despite ambitious social reforms announced in 2013. Public spending on health, education, social security, and employment largely remained unchanged in Xi's first two terms, reaching 8.1 percent in 2022. Xi has inherited many of the problems of previous leaders, but despite some lip service to structural reform he continues to kick the can down the road. Addressing these long-lasting structural issues will become even more pressing as GDP growth slows, society ages and the working population shrinks further from its peak in 2015, and highly leveraged local governments struggle to fund social services (see Exhibit 12).⁶²

The lack of a proper social safety net helps explain China's exceptionally high savings rate. Households save money for health care or retirement rather than consume. High saving rates in turn promote an investment-led growth model as it facilitates cheap capital. Savings as share of GDP have held steady at levels close to 45 percent since 2013. China's saving rate is almost in a league of its own and far higher than for middle- or high-income countries as classified by the World Bank. The impression of hyper-consumption in China's modern mega-cities or online retail frenzy do not reflect the macroeconomic reality but rather a snapshot of the society – and entrenched inequality.

Exhibit 12

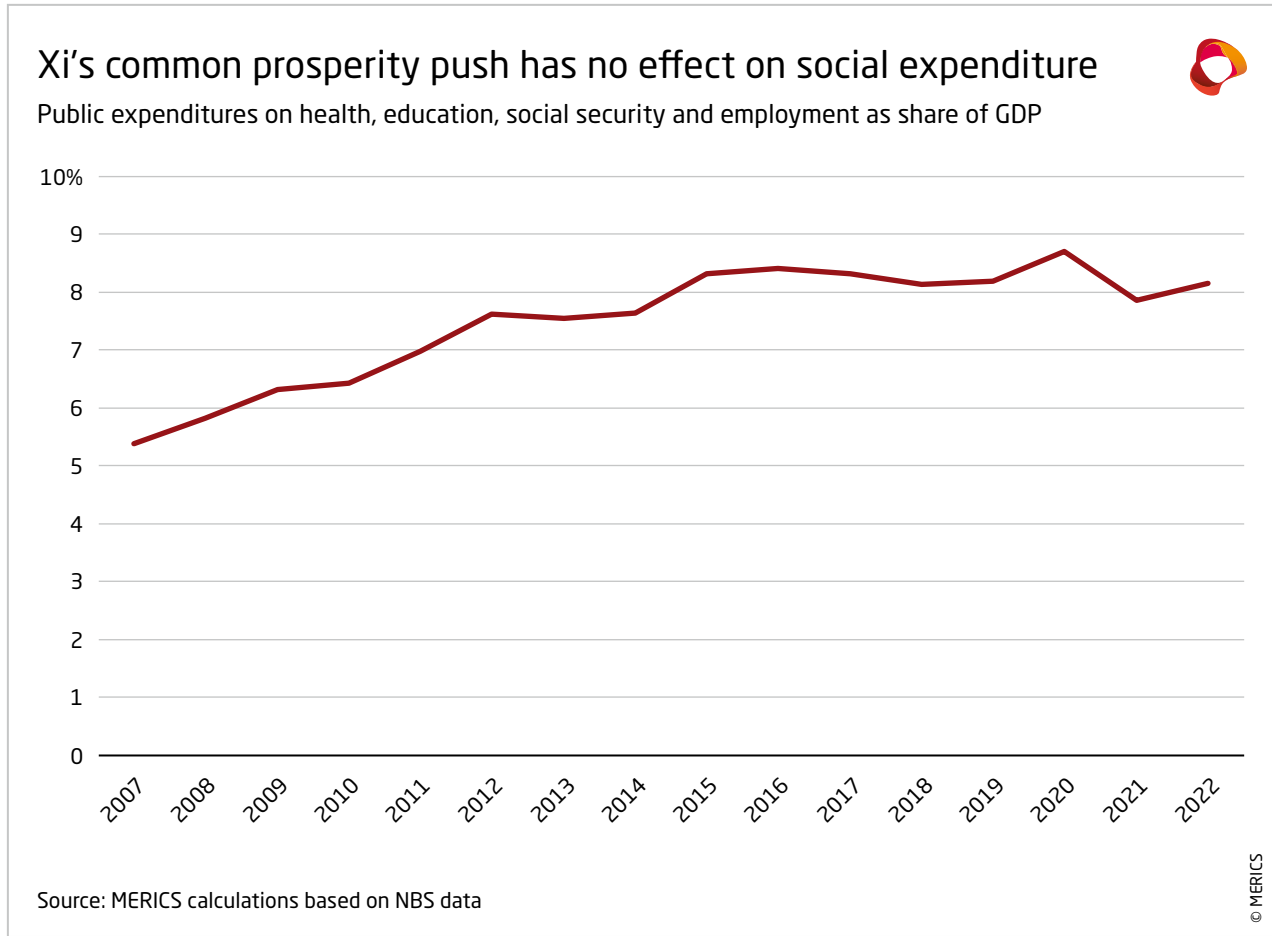
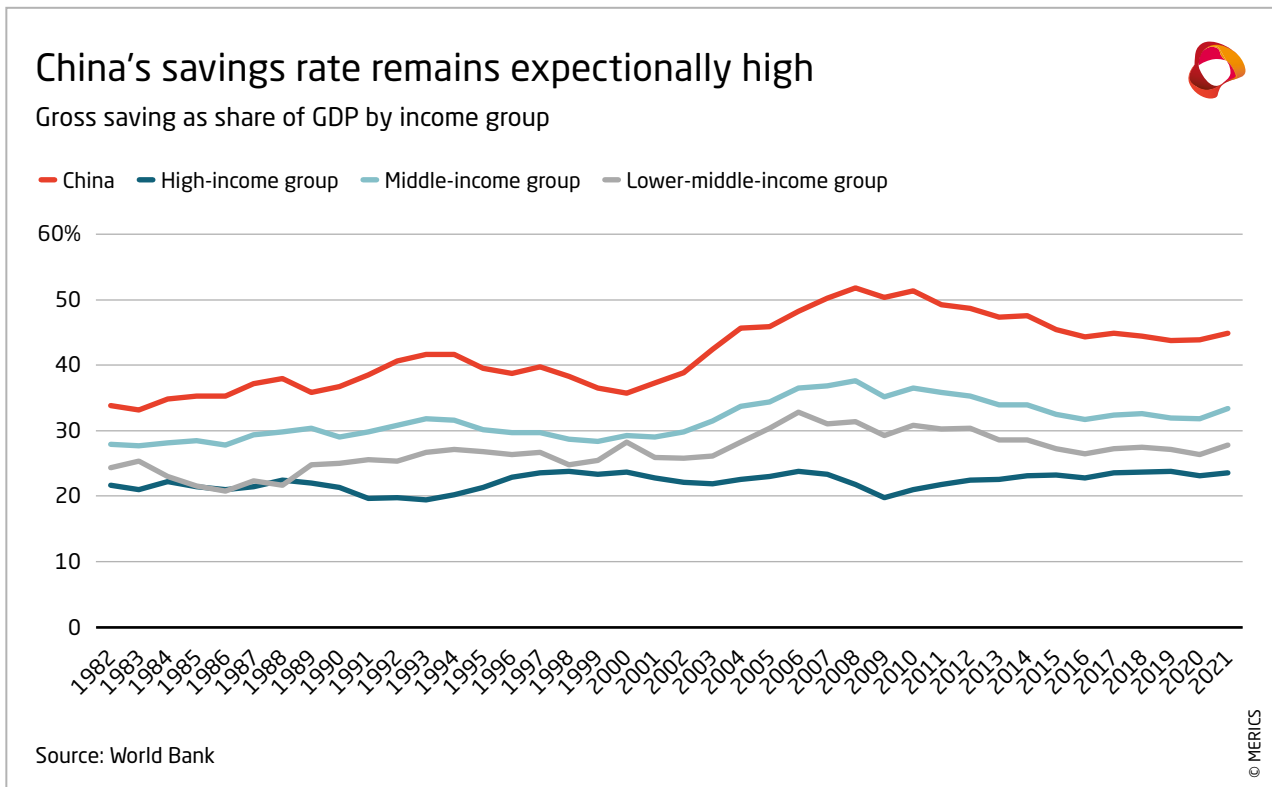


Exhibit 13



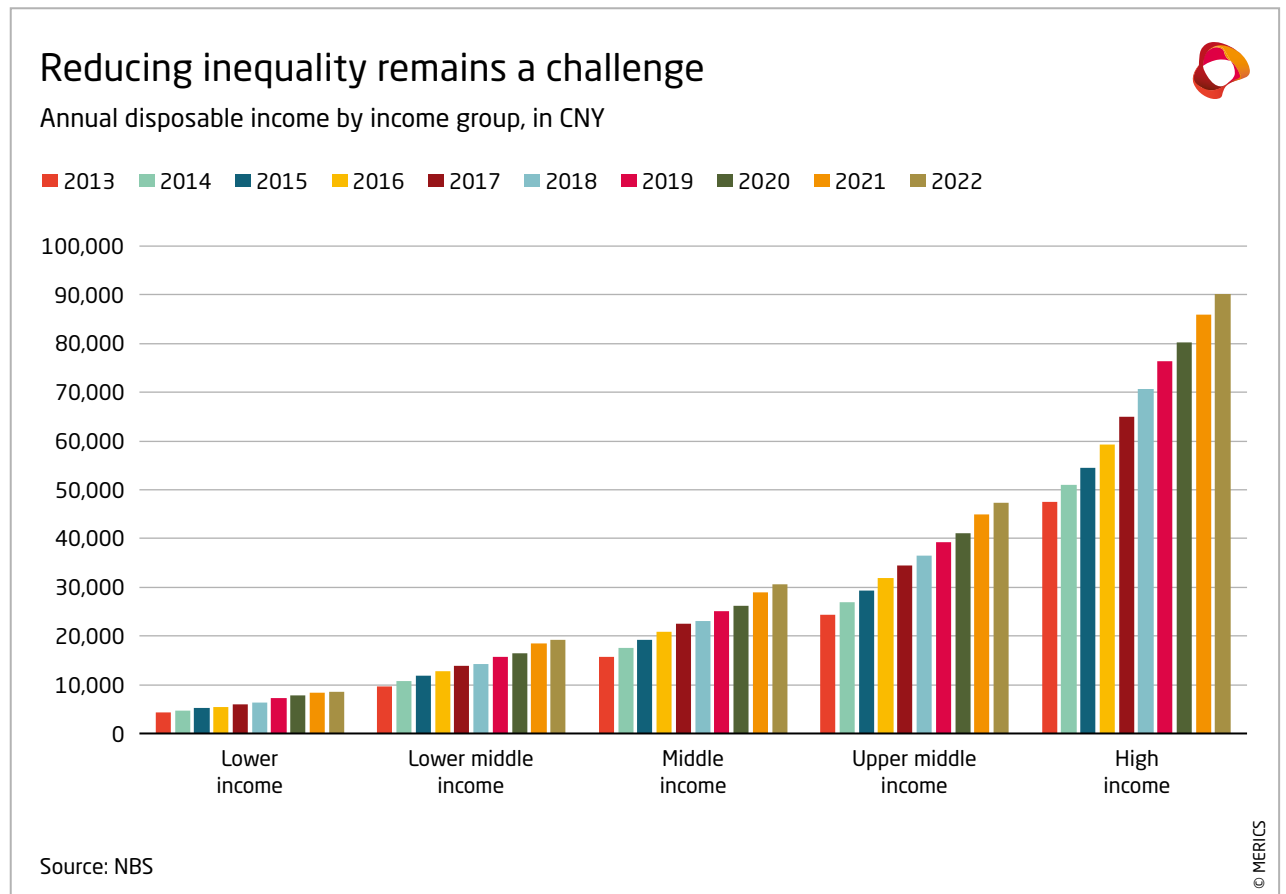
China's inequality has remained persistent but has been less of a policy issue for as long as economic growth remained strong enough to improve the lives of all income groups. This has given the CCP the liberty to set economic policy priorities other than strengthening the social system (see Exhibit 13 and Exhibit 14).

5.3 COMMON PROSPERITY IS MORE SYMBOLISM THAN STRUCTURAL CHANGE

The failure to direct more income to households belies another core tenet of Xi's economic ideology in practice. Common prosperity re-entered the lexicon in 2021 when it was wielded alongside the broader crackdowns on digital tech and real estate. Many initially expected that large-scale redistribution was in store, but this failed to materialize beyond some talk of tertiary distribution – the redistribution from wealth via donation or charities. Companies got the message to take on more social responsibility by expanding philanthropic work, including donating to those in need and setting up funds focusing on rural development and announcing measures to reduce the income gap within companies.⁶³

Under Xi Jinping, the flashy display of wealth by business elites is becoming less fashionable – and potentially risky. China's entrepreneurs could be facing consequences similar to local officials during the anti-corruption campaign in the early days of Xi's rule. In response, officials could no longer hold fancy banquets or be seen with expensive watches. There is an increasing expectation of modesty and the need to demonstrate a role in developing the nation. As a result, China's billionaires donated a record sum of USD 10 billion in 2022 – more than a drop in the bucket.⁶⁴

Exhibit 14



Common prosperity has been used alongside pressure on China's most innovative companies to put their capital and expertise to use in achieving national strategic goals, like closing the technology gap. But Common prosperity is not about deriving prosperity for the working class at the expense of higher taxes on the wealthy or increasing costly social services. Xi's policies, including a crackdown on private companies and elites, in part resemble populist policies introduced by disgraced former senior CCP official Bo Xilai in Chongqing, who was convicted of embezzlement, but they do not concretely address key issues including redistribution and inequality.⁶⁵

So far, his efforts pale in comparison to those under former President Hu Jintao. Hu expanded labor legislation, including contract law and a more serious implementation of minimum wage and improved access to medical insurance for migrant workers, although these efforts lost steam at the end of his term in 2012.⁶⁶ Ironically, Xi's vision of Chinese socialism comes with a rejection of Western-style socialism with its stronger role for the state. Instead of deepening institutional reforms, the responsibility of providing is left in large part to individuals themselves while the state contribution is kept to a minimum. Stronger guidance on companies under Common prosperity is little more than signaling right now, but if accelerated, could shift toward a larger burden falling directly on companies.

This sentiment is also captured in the case study on Tencent at the end of this chapter. The company was front and center during the consumer internet/platform crackdowns of 2020-2021, and it has been pushed by Beijing to align its strengths towards supporting the real economy. Furthermore, Beijing has heavily punished the gaming side of Tencent's operations, with tight regulations not only limiting approvals for new games, but for restricting gaming time for some users. The result is that the company has been cowed domestically and is strategically going overseas to make up for the lost business opportunities within China.

5.4 THE NEW SOCIAL CONTRACT MEANS CONTRIBUTING TO NATIONAL REJUVENATION

Aligning strategic priorities with jobs and income is becoming more difficult

Policies under Xi Jinping increasingly appear motivated by non-economic targets that do not aim to increase profits or the welfare of individuals and private companies, but rather to promote self-reliance and national power, including military power. Allocating national resources to building a welfare state is a luxury the CCP does not want to pursue in a time of growing systemic rivalry with the US. Increasingly, the economic beneficiaries of China's development in past decades, notably entrepreneurs, the wealthy and the middle class, will now be expected to be grateful to the party for allowing them to be far better off than the hard-working generations before them. The new message is: Don't become complacent. Tighten your (economic) belts and roll up your sleeves to do what is in your power to rejuvenate the Chinese nation.

Aligning national strategic priorities with jobs and income is becoming more difficult as China deals with a more demanding middle class and its needs for jobs and income. This comes as social fault lines are becoming more complex. Youth unemployment reached record levels of over 20 percent in Q2 2023, yet companies are struggling to fill vacancies in factories.⁶⁷ One reason for this is a growing mismatch of skills and expectations. Workers with the vocational skills needed in manufacturing are scarce. On the other hand, not every university graduate will become a high-profile scientist helping China close the technology gap. Encouraging youth to work in the countryside seems to be a hard sell for an aspiring future generation.⁶⁸ Most young urbanites most likely do not expect to return to rural life, nor are they keen to work in 3D manufacturing jobs (dirty, demanding, difficult).

Creating a large middle class, one of China's biggest economic reform successes, now looks like a potential vulnerability for the CCP. There is a real risk that parts of society will see a stagnation, or even a possible deterioration, in economic well-being. The CCP will need to respond to these demands of the middle class. It has already shown a return to pragmatism following intense economic pressure built up during the three-year zero-Covid policy. The CCP must control social economic risks, using, for example, extensive party and state intervention in sectors like real-estate, most infamously with the debt-ridden property giant Evergrande, but also to provide an economic baseline that ensures employment and income to satisfy the minimum needs of the majority of society.

Social and regional divisions are likely to become a major issue

Beijing views the role of most companies as holding that economic baseline. This includes companies with a limited role in driving forward high value-added production or helping in the innovation drive to close key tech gaps. One example, GAC-Toyota, a Sino-Japanese JV internal combustion engine automaker, is covered in the case study below.

The greater importance of ideology and geopolitical rivalry are nurturing a more repressive political economy which tends to be less responsive to a moderate society.⁶⁹ Under such a system, social and regional divisions are likely to become a major issue going forward. Though more policy changes attempting to address the resulting problems can be expected in the context of Common prosperity, the overall prioritization of national strategic goals over economic growth seems to be a new hallmark of China's economic system.

Case Study: GAC-Toyota JV shifts from tech provider to economic baseline holder

Gregor Sebastian

GAC-Toyota is a JV between Chinese SOE Guangzhou Auto (GAC) and Japanese car giant Toyota, focused on making passenger vehicles. Both partners have additional, competing automotive JVs and production bases in China. Unlike in the past, Toyota is no longer viewed by Beijing as a technology provider, and such sino-foreign automotive JVs that are not fully committed to EVs will play a limited role in the future – holding up the economic baseline until they are phased out over time.

From Beijing's point of view, the strategic role of such JVs has shifted in recent years. Initially, Beijing saw these primarily as a means to help Chinese carmakers move up the value chain by introducing Japanese car-making technology and knowhow into China. But China's shift to EVs means Toyota is no longer seen as such an important technology partner. Nonetheless, the JV continues to fulfill several important functions such as contributing to economic growth and promoting employment and tax payments. What's more, it continues to serve as an important anchor for Japanese suppliers to localize production in China.

GAC'S STATE OWNERSHIP GIVES BEIJING INFLUENCE THROUGH JV REQUIREMENTS

Market access restrictions: To promote the development of Chinese carmakers, Beijing has restricted the access of foreign carmakers, including Toyota, to China's market. High tariffs have made exporting to China unpalatable but producing locally meant entering into a JV with a local partner and sharing technologies and knowhow.

Promoting electric vehicles: Beijing has reduced its technological reliance on the JV by promoting EV technologies that had not yet been dominated by foreign carmakers such as Toyota. The government incentivized carmakers to develop and produce new energy vehicles (NEVs) using carrots, including subsidies, and sticks, such as a production quota. In an initial pilot phase, hybrid vehicles had been trialed, but fearing future dependency on Japanese carmakers like Toyota, Beijing excluded hybrids from the NEV definition.⁷⁰

The loss of relevance of hybrid technology made Toyota more willing to share its knowhow. In 2019, the Japanese carmaker even offered patented hybrid technologies free of charge to Chinese producers in the hope that hybrid vehicles would be taken up more widely. In 2020, Toyota licensed its hybrid tech to GAC.⁷¹ The JV also announced additional investments for a new NEV plant, further promoting growth in Guangzhou.⁷²

GAC-TOYOTA WILL STILL BE IMPORTANT FOR BEIJING IN PROMOTING GROWTH

The initial goal of promoting technology transfer from Toyota to GAC has partly worked. While GAC is not yet an internationally competitive carmaker and has lagged Toyota in producing internal combustion engine vehicles, it has fared among the best in Chinese state-owned carmakers. Its own brands in the ICE (Trumpchi brand) and EV (Aion brand) have been successful in China. GAC own brands have benefitted from the knowhow and engineering expertise of the Toyota JV. Indeed, with the shift to NEVs, a “reverse technology transfer” has taken place, as jointly produced EVs have used a GAC-developed electric powertrain.

The draw of Toyota has also helped China attract investment from Japanese and other international suppliers. Japanese Nidec formed a JV in 2019 with a GAC subsidiary to produce electric motors for GAC.⁷³

Beijing’s perspective on the JV has shifted from seeing it primarily as a source of technology to considering it more as a means of maintaining an economic baseline. Nevertheless, Guangzhou’s robust local economic prowess and GAC’s capacity to compensate for potential employment losses resulting from the JV have greatly diminished its significance over time, even as an economic baseline.

Case Study: Tencent's best lines of business are under the most political pressure

Aya Adachi

The Shenzhen-based tech conglomerate Tencent has many lines of business, and has experienced some of the most intense application of Beijing's party-state toolkit after initially benefiting from protection from foreign tech giants. The bulk of its products are consumer internet in nature: social media companies like Wechat and Weibo, entertainment, digital payment systems and gaming; and have thus been highly exposed. Despite being one of China's most profitable and innovative companies, the firm has been so besieged to change its behavior at home that it is now seeking foreign markets to balance out the domestic market's now-diminished growth potential.

FROM "VALUE-CHAIN CLIMBER" TO "THE UNTRUSTED," TENCENT HAS SUFFERED MOST IN ITS GAMING SECTOR

Once a boon for consumption growth on paper, Tencent has come under heavy pressure not only for failing to contribute to key national strategic goals, but for allegedly dragging them down. Tencent's data collection across its lines of business likely presented a comprehensive look at many Chinese citizens and their habits, which are seen by authorities as bad enough to become a central focus of the platform crackdown. Tencent has channeled its resources and research capacity to work on, from a stand point of national interests, not-so-important social media, gaming, and entertainment. Worse yet, those very products have proven unwelcome distractions for students whom the party-state expects to focus on their studies, and for young people who, instead of playing video games, should be contributing more to China's rejuvenation.

TENCENT WAS HIT BY THE TECH CRACKDOWN AND A RAFT OF ANTI-TRUST AND GAMING RULES

Frontline levels of support from the party-state

Technology transfer: In exchange for market access, foreign telecommunications firms were required to share intellectual property with domestic firms such as Huawei, facilitating its early development.⁷⁴

Protected market: Priority access to contracts for the rollout of telecommunications equipment in China has provided a huge market for Huawei and helped it to scale up. As of 2022, China accounted for over 60 percent of the world's 5G base stations.⁷⁵

Policy banks: Tens of billions of US dollars have been granted to Huawei and its international customers to support projects overseas.⁷⁶

Grants and tax incentives: A review conducted by the Wall Street Journal suggests the company has received USD 46 billion from loans, credit lines and other support from state lenders. Tax incentives saved Huawei as much as USD 25 billion between 2008 and 2018.⁷⁷ Subsidies granted to Huawei more than doubled in 2022 to reach over RMB 6.5 billion (approximately USD 950 million).⁷⁸

Facilitated divestment: Beijing acted as an “investor of first resort” to transfer Huawei’s HONOR brand assets to a non-Huawei entity, to bring them outside the scope of US sanctions.⁷⁹

Economic coercion: Chinese officials have on multiple occasions threatened to retaliate should Huawei be excluded from supplying equipment to markets overseas countries.⁸⁰

PRIME EXAMPLE OF BEIJING’S INNOVATION HOPES AND CONTAINMENT FEARS

Government backing smoothed the way for Huawei’s transformation into a technology powerhouse. The company is among China’s most innovative firms and most prolific generators of invention patents.⁸¹ It has successfully entered markets all over the world, and to a large degree European countries still use Huawei technology in their 5G networks, although this may not last.⁸² Ultimately Huawei’s ties to the government and its home market advantages have caused pushback overseas and are beginning to restrict its access to some markets in advanced economies. The company has been drawn into the center of China’s stormy relationship with the US.

Huawei’s fight for survival amid the US technology embargo embodies the Chinese government’s fears for the country as a whole. Over the past few years, it has made significant progress in fully localizing its supply chains. Ren Zhengfei, the company’s founder, says domestic alternatives have been found for more than 13,000 components and over 4,000 circuit boards redesigned.⁸³ In the realm of industrial software, Huawei has switched to its own MetaERP (enterprise resource planning system), thus replacing US vendors.⁸⁴ The company is also active in the semiconductor space. It has become a leading supplier of AI chips for the domestic market and is leading local advances in electronic design automation tools for chips.⁸⁵ What’s more, in 2019 Huawei launched a semiconductor investment fund which has backed over 80 local firms.⁸⁶

6. China contends for the central position in the global economy

6. China contends for the central position in the global economy

KEY FINDINGS

- China is reinforcing and strengthening controls over international trade and finance, in- and outbound investment and the flow of data and people that make up “fortress” China.
- Xi sees that China must remain connected to the global economy to advance its development and expand its global power – but is wary of unfettered, Western-style globalization.
- It is not in China’s interest to completely disconnect with liberal market economies, as it still needs their markets for exports and capital and technology to overcome tech dependencies.
- Similarly, Beijing aims to build up ties with global south countries as raw material sources, growing export and investment markets, and destinations for China’s tech and capital.
- Key features of China’s global engagement: challenging the existing economic order, mitigating risks with liberal market economies and engaging with emerging and developing countries.

Throughout the reform process initiated under Deng Xiaoping, China’s foreign economic policies remained highly restrictive and controlled – most notably, its strict capital controls and restrictions on foreign investments. The general mantra of hedged integration with the global economy has not changed under Xi Jinping. But the parameters for China’s future opening are increasingly happening on its own terms. In the process, China is reinforcing and strengthening controls over international trade and finance, in- and outbound investment and the flow of data and people that make up “fortress” China. It is also a reminder that the relative trade openness that has been a key driver for China’s integration over the past decades is more the exception than the norm for China.

Global economic integration should now be on China’s terms to safeguard its national interests and long-term economic development. The objective is to create economic and technological dependencies by developing new markets, controlling value chains and securing access to key resources for China’s industry, energy, and food needs. Instead of pursuing Western-style globalization driven by capitalism, China is seeking its own path consistent with greater party control and guidance. A world in which companies act independently from national strategic goals in pursuit of profitability conflicts with Xi’s economic principles. National interest should take precedence over profit-driven motivations. Beijing recognizes the need for China to remain connected to the global economy to advance its development and expand global power – but is wary of unfettered, Western-style globalization.

However, China is not on a path towards isolation. It is not in China’s interest to completely disconnect with liberal market economies, as it still needs their markets for exports and needs its capital and technology to overcome existing tech dependencies. Providing eco-

Global economic integration should now be on China’s terms

conomic incentives is also an effective tool to keep countries in line with China's interests and positions. To facilitate this, China is highly active in deepening ties with the Global South as it seeks to develop new alternatives.

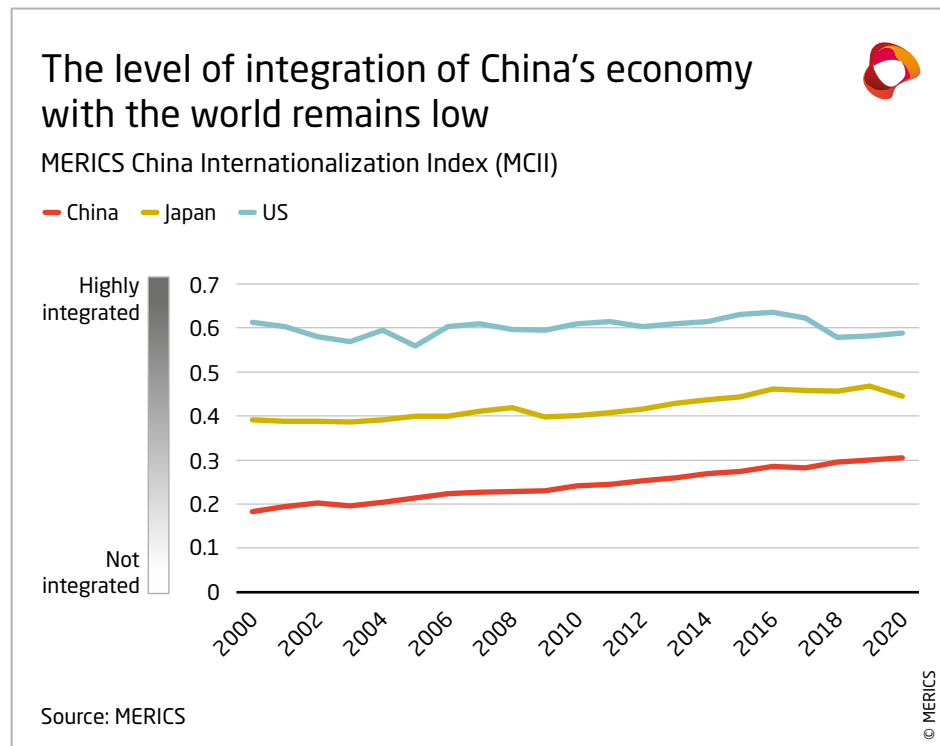
Three key features of China's engagement with the world are: challenging the existing global economic order, mitigating risks with liberal market economies and engaging with emerging and developing countries.

China is deepening ties with the Global South

- **Challenging the global order:** The leadership's efforts to strengthen China's position as a global economic power lacks neither vision nor ambition. China is doubling down in its effort to pull more and more countries and companies into its sphere of economic influence. The BRI has helped China expand its trade faster and served as a new source of external demand. Investment-driven engagement has focused on building hardware, complemented by agreements to provide the software to run it. US economic sanctions and concerns that American global hegemony is waning have provided China additional inroads and growing economic clout. In response to geopolitical shifts, China has accelerated its efforts by rolling out numerous new initiatives. In 2022, it launched the trinity of the Global Development Initiative (GDI), the Global Security Initiative (GSI) and the Global Civilization Initiative (GCI). Older formats such as the Shanghai Cooperation Organization formed in 2001 seem to have gained new momentum.
- **Shifting the economic center of gravity:** Ideally, China should provide an alternative if not replace the dominance of liberal market economies as a global provider of technology and capital. While expanding economic ties with liberal market economies was a catalyst for China's development in the past, China is now seeking greater engagement with the Global South, promoting development in these new markets to cultivate new customers for its exports. It portrays itself as the champion of the Global South, which frustrated with the American-led world order that leverages the gravitational pull of its economy. In a shifting global context, China's multifaceted set of policies are finding welcome takers around the world.
- **Develop China's own de-risking strategy:** Just as voices in advanced economies say there is no second China as a market, the reality is that there is no second set of liberal market economies for China when it comes to technology, capital, and demand for Chinese exports. While it aims for autarky, China is not in a position to cut all foreign dependencies without massive implications for its own development. One way is by absorbing global value chains through greater localization of foreign companies. China has opened up many sectors to foreign investment to onshore key technology providers – ironically, opening up in such areas advances technological self-reliance by bringing foreign technology under Beijing's jurisdiction.

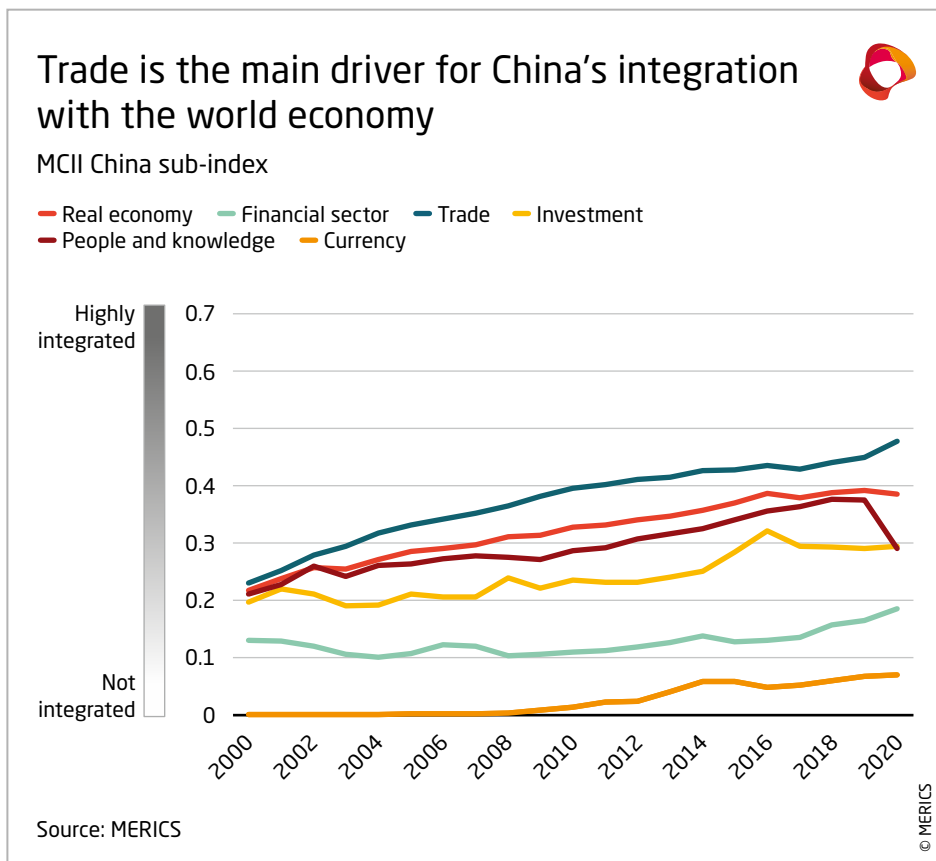
Tracking integration: The shifting dynamics of China's opening up

Exhibit 15



China's integration into the world economy has been a rather continuous process over the past two decades. But this is showing signs of leveling off and reaching a ceiling at much lower levels than the US or Japan. Shifts in the Xi era do not bode well for continued integration. A growing gap between de jure and de facto integration indicates that, despite the announcement of numerous measures to open up, these are no longer creating actual change as in previous years. To capture the dynamics and shifts in China's internationalization process we have developed the MERICs China Internationalization Index (MCII) and benchmarked it to the United States and Japan.

Starting in 2016, de facto integration in the MCII comes to a standstill despite the de jure index leaping from 0.4 to 0.51. The MCII continued to rise, reaching a new peak of 0.31 in 2020. The MCII reconciles apparently conflicting views that China has been disconnecting from the world over the last few years while at the same time it has become more important to the global economy. Indeed, the sub-index of the integration of the Chinese economy in globalization from a Chinese perspective plateaued from 2006 to 2016, while the sub-index for the importance of China for the rest of the world steadily increased.



The index is designed to capture the development of China's integration with the world using nearly 50 variables and a dozen sub-indexes. For each of the variables, the importance relative to China and the world is measured. Sixty percent of the weighting is attributed to the real economy, including the flow of trade, investment, people, and knowledge. The remaining 40 percent measures the level of integration in the financial economy, including equities, loans, bonds, and currency. The range of the index and subindexes is from 0, meaning no integration, to 1, meaning full integration. The latter is calibrated on the maximal value encountered by G20 countries, with some adjustments when specificities makes such a generalization inappropriate. *François Chimits*

The globalization that has driven China's engagement with the world is undergoing a structural break, with new risks and opportunities for China to shape its own position. To understand the direction China is taking in its relationship with the rest of the world, it is critical to examine its changing patterns of trade, investment, technology and finance. Two case studies at the end of this chapter cover how an emerging global tech leader in the EV space, BYD, as well as the old state-owned national shipping champion, COSCO, contribute to the strategic goals of Beijing at home, but especially overseas.

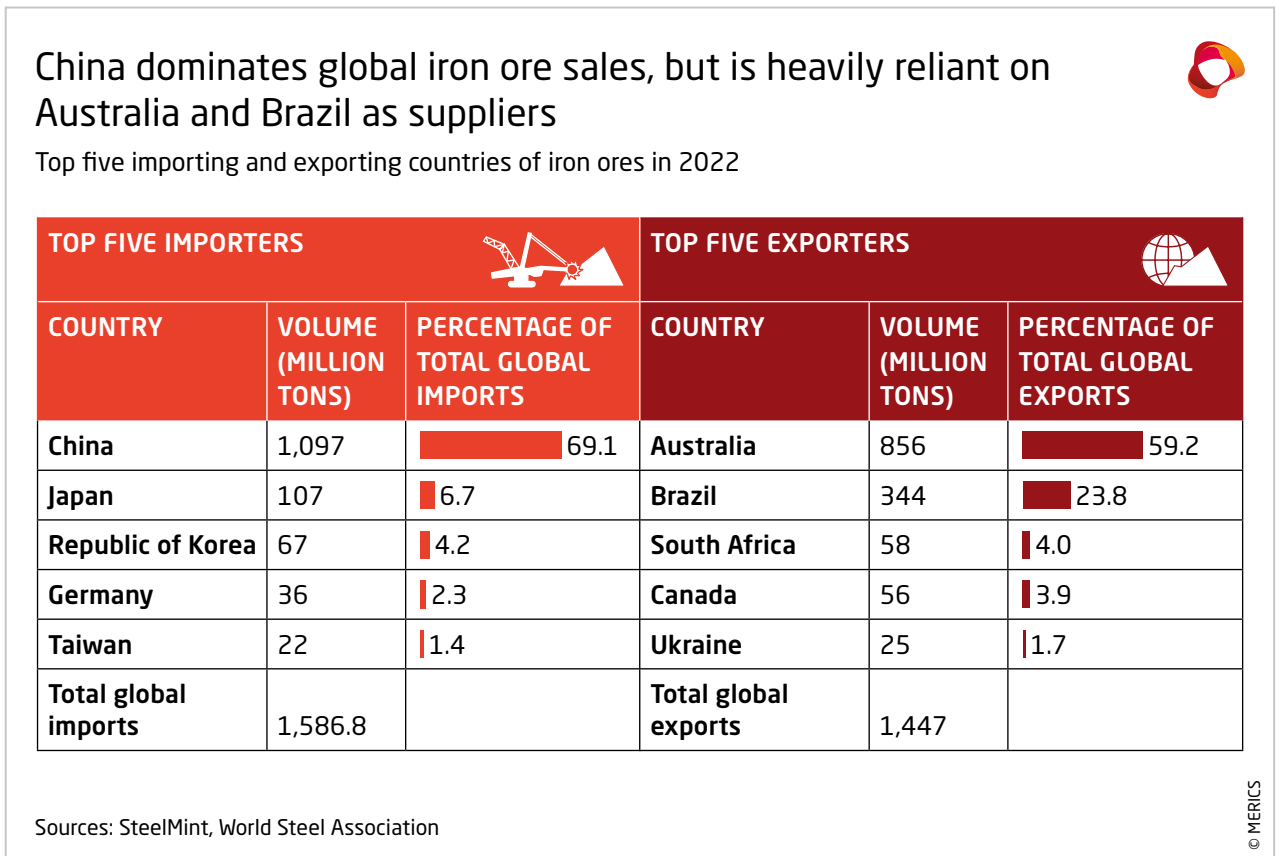
6.1 TRADE: CHINA WANTS TO DEVELOP NEW EXPORT MARKETS AND INCREASE DEPENDENCIES ON THE CHINESE MARKET

Growing trade ties have long been the key driver for China’s global integration. China overtook the US as the biggest trade partner of 71 percent of the world in 2021.⁸⁷ Gaining access to the large Chinese market is an irresistible lure to deepen ties with China, including through new bilateral or regional trade agreements. After years of booming trade with advanced economies, export volumes are nearing saturation, but with 40 percent of China’s exports going to the EU, US, and Japan in 2022, developing new export markets is still an uphill battle. Regional trade deals like the Regional Comprehensive Economic Partnership (RECEP) and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) are useful for Beijing to build regional supply chains and markets, especially in Southeast Asia where more geopolitically neutral countries in its immediate neighborhood are less likely to sign on to what China perceives as US containment efforts.

How China integrates with the world will be crucial to measuring its development

China is still heavily dependent on a few Western countries for high tech but also for key commodities (e.g., US for soy or Australian iron ore and coal). While self-sufficiency is a feasible solution for reducing tech dependencies, diversification efforts facilitated by the BRI are a key for commodities that China lacks (e.g, Brazil for soy and iron ore) – after all, no effort from Beijing will make iron ore spontaneously materialize within China’s borders (see Exhibit 17).

Exhibit 17



China is now focused on deepening ties with the Global South. China's strategic engagement with emerging countries expanded its global economic footprint and helped to improve food security and access to raw materials including ones critical for the energy transition. Starting December 1, 2022, China reduced trade restrictions on nine African countries for over 8,000 items and the pursuit of trade deals in Latin America for market access and securing commodities.⁸⁹

China has much to gain from providing better market access, especially for exports of commodities and lower value products, while competition in higher value goods with advanced economies will likely impact the trade structure. However, during a meeting of the Central Finance Committee (中央财经委员会) in May 2023, it was stressed that China should not give up on low end industry and instead transform it, as it provides an important foundation for manufacturing.⁹⁰

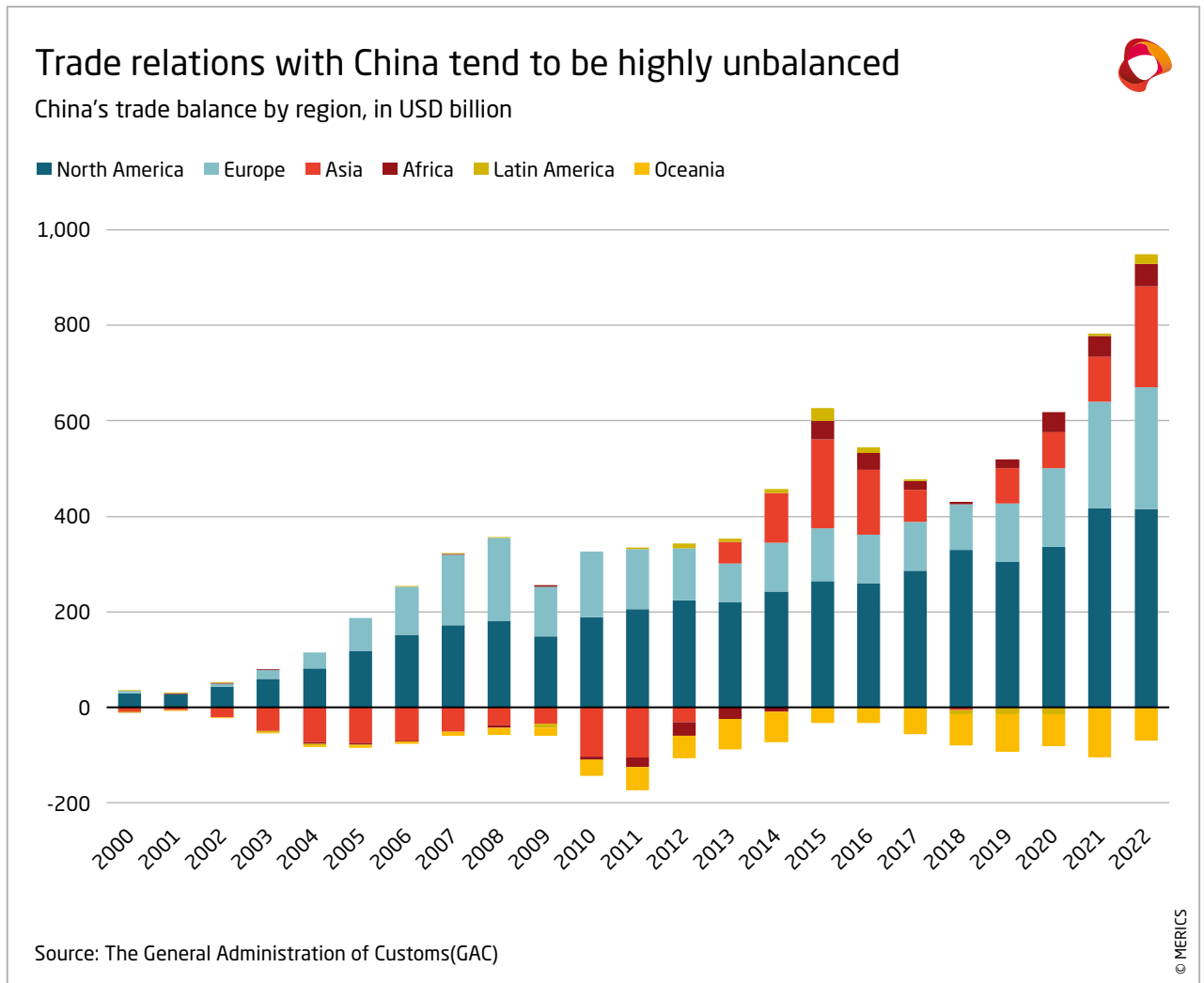
China has a trade deficit with only around 20 countries

China's trade structure will need to considerably change, becoming less export driven and relying on more diversified import structures beyond commodities and high tech. Growing trade is often accompanied with a growing trade deficit due to China's dominance in manufacturing. China has a trade deficit with only around 20 countries – all commodity exporters with the exception of South Korea, Taiwan, Singapore and Switzerland. But the sheer size of the Chinese market remains the government's biggest driver for deepening economic ties. For emerging economies, it provides a welcome alternative to Western markets, while for advanced economies deeper trade should act as a bridge over the growing political divide (see Exhibit 18).

6.2 INVESTMENT: CHINA WANTS TO BECOME A KEY INVESTOR IN EMERGING ECONOMIES AND ATTRACT HIGH-TECH INVESTMENT

China has been a long-term recipient and beneficiary of foreign investment and continues to open access by trimming its negative list that restricts foreign investment in certain sectors and revising the catalogue for sectors that encourage foreign investment. Slower growth prospects, geopolitical risks and a more restrictive political environment has tarnished China's appeal for many foreign companies. Coupled with a weaker global economic outlook, foreign direct investment (FDI) in China fell to a 25-year low in the first half of 2023.⁹¹ FDI now more than ever is focused on helping close technological gaps and improve supply chain resilience. This means companies in high-tech sectors can expect red carpet treatment to onshore high value-added production and R&D. The importance and concern of dwindling FDI has let the State Council released a new set of measure aimed at attracting high quality investment in August 2023.⁹²

During the last decade, China has started to establish itself as a major investor overseas. Initially, Chinese investments were focused on developing countries. The BRI, launched in 2013, and the Asian Infrastructure and Investment Bank (AIIB) in 2015 were prominent efforts in Xi's ambition to strengthen China's position in the world. China does provide an attractive alternative for many developing countries – and one that does not tie investments to issues of human rights or environmental protection. Central elements of the BRI and the AIIB have been their emphasis on financing and infrastructure projects to meet their transportation, communication and energy infrastructure demands in foreign countries. But there are also examples of dedicated development zones such as the Sihanoukville Special Economic Zone in Cambodia.



Despite criticism of being a potential debt trap and pushback in some regions amid disappointment about delivering on pledged investments, the initiatives have yielded tangible results. China is seen as a partner for economic development for a wide range of projects from infrastructure to dealing with climate change.

In developed countries, Chinese companies have also started to gain traction as an investor. In 2016, Chinese firms invested a record EUR 47.5 billion in EU27 and the UK.⁹³ However, investment has steadily slowed. In 2022, Chinese investment in Europe was only EUR 7.9 billion, down 83 percent from the 2016 peak. The decline is caused by tightening capital restrictions in China – to prevent investments in non-strategic areas such as football clubs or real estate – and political and regulatory pushback in the US and Europe that has made it more difficult for Chinese firms to conduct merger and acquisition (M&A) transactions, especially in critical infrastructure and technology assets. As in 2022 M&A fell to its lowest levels since 2011 (EUR 3.4 billion), record greenfield (EUR 4.5 billion) has become new bright spot of Chinese investments in Europe, albeit fragile for now because this has targeted only a few sectors, primarily EV batteries.

Despite China's surging outbound investment in the last decade, investment relations between liberal market economies (liberal market economies) and China remain heavily uneven. While companies from those countries continue to invest heavily in China, the same

is not true in the reverse. By 2021, European firms have invested an aggregated EUR 233.6 billion in China which is more than three times the amount that Chinese firms have invested in Europe (EUR 69.9 billion).⁹⁴

China's role as a global investor is likely to increase but will be met with more competition as liberal market economies roll out new development projects in response to the BRI. The investment structure will need to shift more from infrastructure and M&A to greenfield investments, increasing the international exposure of Chinese companies. As of now China's investment in manufacturing in ASEAN, for example, significantly lags those of the US, EU or Japan (see Exhibit 19).

6.3 TECHNOLOGY: CHINA WANTS TO EXPAND ITS FOOTPRINT TO BECOME A GLOBAL PROVIDER

China has become an indispensable location for high-tech companies

China can still tap into global knowhow via its overseas students or by acquiring crucial licenses. For example, the MCCI sub-index on intellectual property rights (IPR) imports reached 0.52 in 2020, indicating a high level of integration. Access to foreign IPR is essential for China to continue to expand its industrial capabilities. But China has already evolved into a viable provider for technology, issuing IPR of its own, with strong growth since 2017 (see Exhibit 20). Companies from Huawei to Xiaomi are household names in the area of consumer electronics. Chinese companies can provide a wide range of products from 5G networks to high-speed railway systems and energy solutions (including green tech).

Xi's visit to Saudi Arabia in December 2022 was a demonstration of China's attractiveness as a development partner. The deal signed included commitments on developing hydrogen energy, data centers and EV factories in Saudi Arabia. Digital companies have expanded their footprint as technology providers from artificial intelligence, e-commerce and mobile payment applications to communication, smart cities and surveillance equipment. In November 2022 alone, China completed e-commerce agreements with Laos, Thailand, Singapore and Pakistan (see Exhibit 20).

China's growing technological clout is a result of its improved innovation capacity. High-tech companies in liberal market economies now consider it essential to be part of the Chinese innovation ecosystem by expanding R&D capacity to safeguard their global competitiveness.⁹⁵ It is an indispensable location for foreign companies, especially in dynamic sectors like digital applications, smart manufacturing and electric/autonomous vehicles. China will leverage its growth potential and improved position in the high-tech sector to make it an irresistible market for high-tech companies.

Maintaining access to technology remains vital for China's future ability to innovate. China is successfully engaging abroad to help create demand for Chinese technology. While its engagement in emerging countries is more focused on government-to-government relations, China is increasingly building on ties to companies in liberal market economies. In an attempt to tie them into China's innovation system, they hope to make international access to technology more resilient.

Exhibit 19

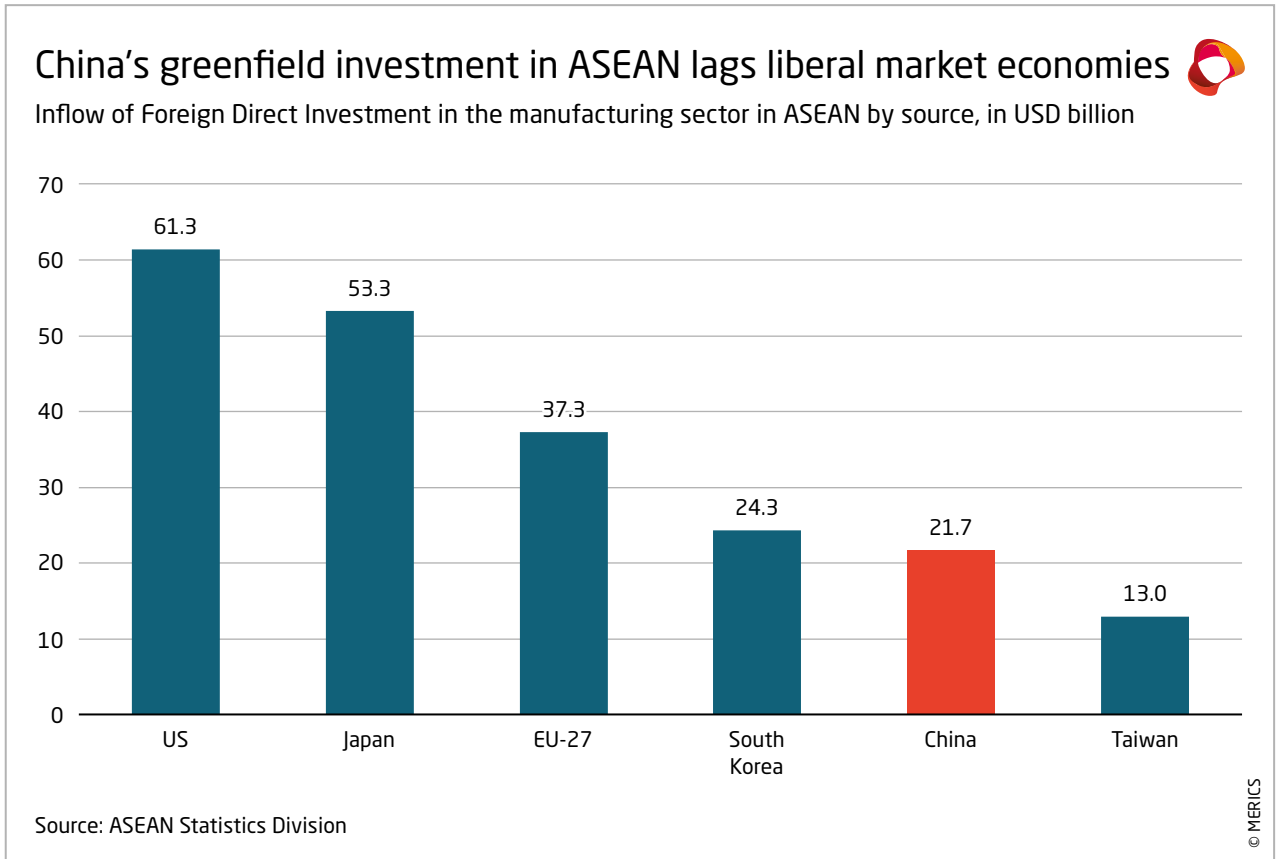
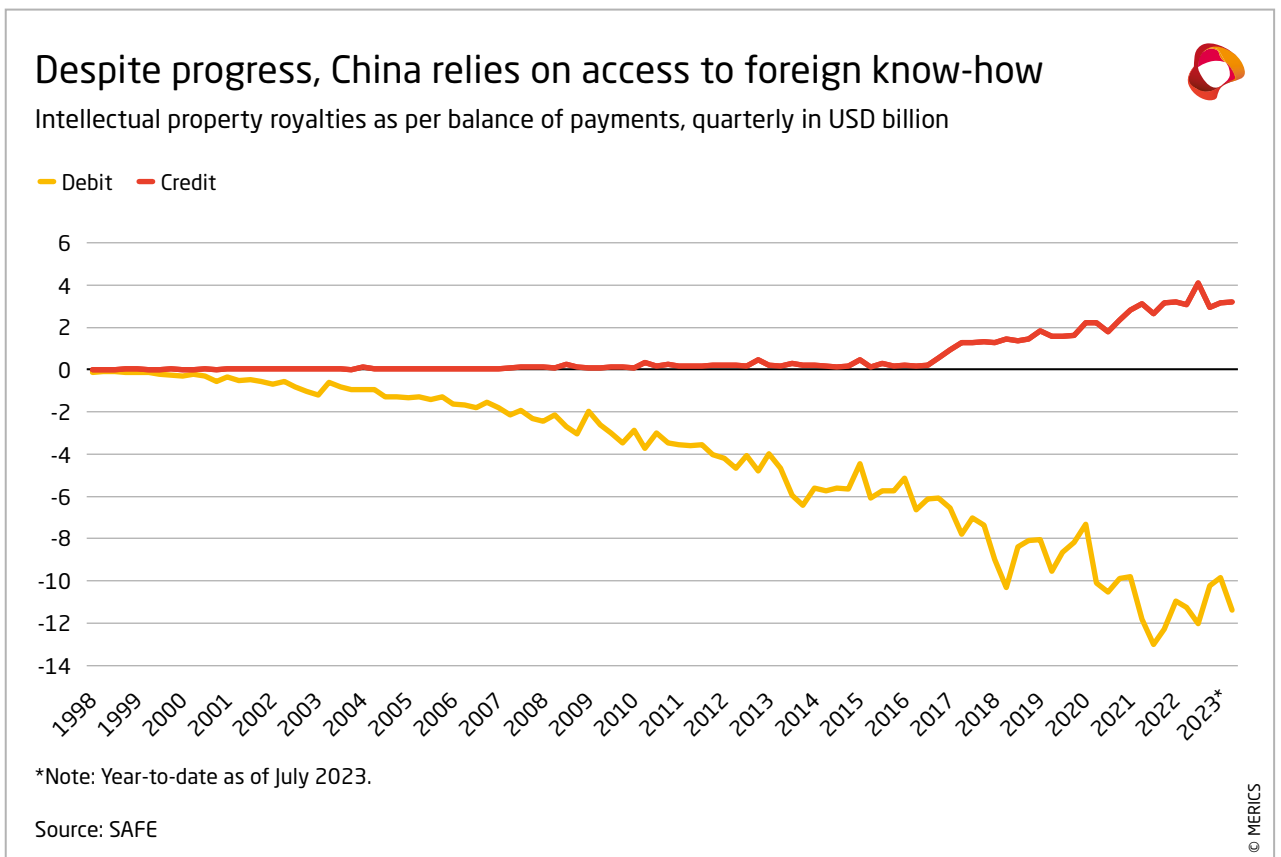


Exhibit 20



6.4 FINANCE: CHINA WANTS TO PROVIDE AN ALTERNATIVE TO THE USD-DOMINATED FINANCIAL SYSTEM

After years of promises and the opening of China's financial markets in theory, real capital flows are now materializing. Strict capital controls remain in place, but China has expanded existing channels and introduced new ones to connect (e.g., Hong Kong Stock Connect or the Shanghai-London Stock Connect) its financial markets with the world.⁹⁶ While in the past financial integration was mostly a one-way street with Chinese purchasing equities (including of Chinese companies listed abroad) and bonds (including US treasuries), the picture is now becoming more balanced. The sophistication and complexity of China's financial system has greatly improved, creating an additional pull for foreign investors to participate. This includes issuing CNY-denominated bonds in China and expanding offshore financial markets.

Existing capital account restrictions and growing political risks are likely to keep liberal market economies' investors underinvested in China relative to its share in the global economy. But gradual financial integration is likely to remain a key driver for China's global economic ties as it provides alternatives for advanced and emerging economies alike.

The CNY's internationalization will likely accelerate, but with limitations

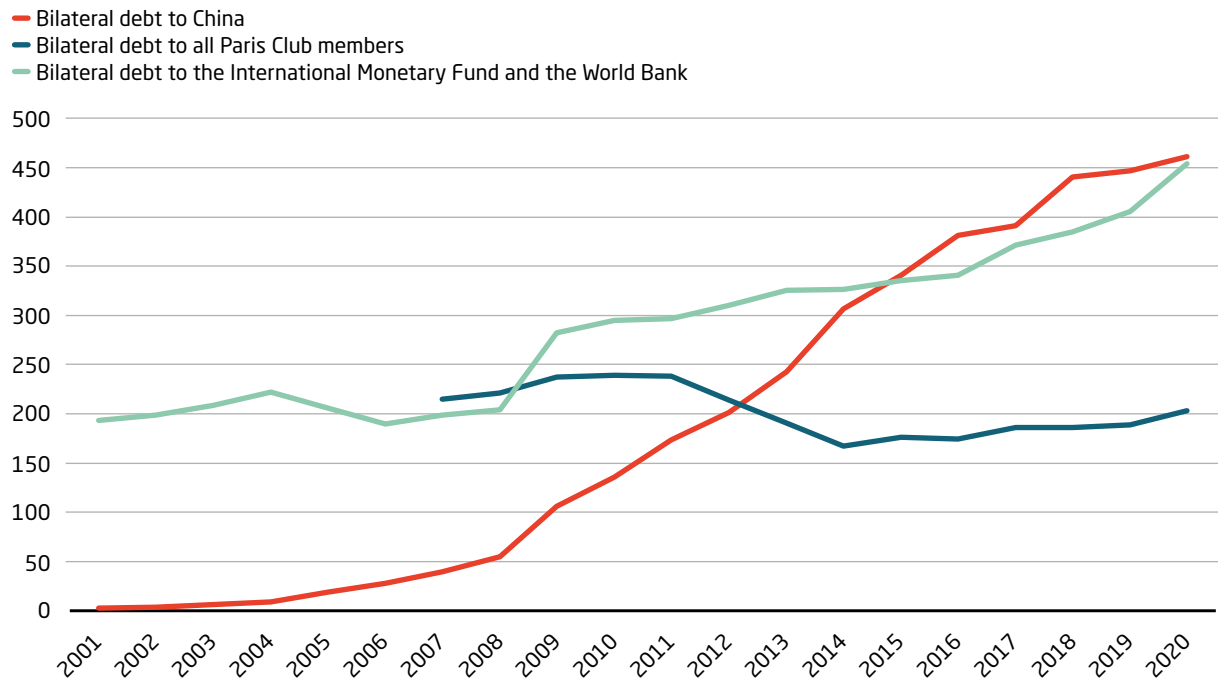
China is also actively trying to break USD dominance in global trade settlement. New hope rests on the introduction of the e-CNY, the PBOC's digital currency, as well as CHIPS, the alternative to the current global payment system SWIFT. For Russia, this has provided a helpful alternative, as the Chinese currency was used for 17.9 percent of settlements in 2021, up from 3.1 percent in 2014.⁹⁷ In 2023, agreements with Saudi Arabia, Argentina, and Brazil aimed to increase use of the CNY for trade with China (e.g., via swap agreements between the central banks). The CNY's internationalization will likely accelerate but with limitations, as this would require China to give up its strict capital account controls.

The emphasis on infrastructure-driven investment has also turned China into a major loan provider, providing USD 450 billion in net lending as of 2020 (see Exhibit 21).⁹⁸ Consistent with its narrative of championing the Global South, most of the lending has gone to developing countries. As a major lender, China can project more financial might, but it is also not risk free. Debt defaults pose a substantial external risk to its financial system.

China overtakes Paris Club and even the IMF and World Bank in loans



Bilateral debt of low and middle-income countries, in USD billion



Methodology: Data for 2000 to 2017 are from Horn et al. (March 2021 update), which were then extrapolated based on the trends observed in the World Bank international debt statistics for low- and middle-income countries. Chinese data are based on trends of total bilateral debt to China, while from IMF & World Bank it is derived from multilateral lending, and for the Paris Club it is the residual official bilateral debt excluding China.

Sources: Horn et al. "China's overseas lending" (2021), World Bank, authors calculations

Case Study: COSCO, the embodiment of China Inc., is going global

Jacob Gunter

As a shipping service provider and port operator, COSCO plays a key role in Xi's international ambitions. The state-owned shipping giant has grown considerably in the last decade and has a truly global footprint.

COSCO IS DIRECTLY MANAGED BY THE PARTY STATE AND ENJOYS CONSIDERABLE SUPPORT IN ITS STRATEGIC ROLE

State-ownership: As one of the 97 central SOEs owned and managed by SASAC (which reports to the State Council in Beijing), COSCO is under the direct control of the party-state. While much of the company's day to day business is done on normal market and commercial terms, it is critical to understand that COSCO does not operate with a fiduciary responsibility to shareholders, but rather with the strategic goals of Beijing in mind.

Protected home market advantage: China allows foreign shipping companies to perform only international shipping services in China, reserving its domestic shipping and transshipping services exclusively for Chinese-flagged vessels owned by Chinese companies. Meanwhile, COSCO can provide all shipping types in Europe, either directly or through local subsidiaries.

Cheap state financing: Research by the Washington, DC, think tank Center for Strategic and International Studies (CSIS) shows that China's shipping industry benefitted from USD 127 billion in financing from state-run financial institutions in 2010-2018.

Subsidies: The same CSIS report identified at least USD 58 billion in direct subsidies to the shipping industry in 2010-2018.

BRI support: As one of the key players in BRI port projects, COSCO benefits from privileged access to BRI contracts in ports themselves during procurement and thus also cements itself as a partner for corresponding shipping services.

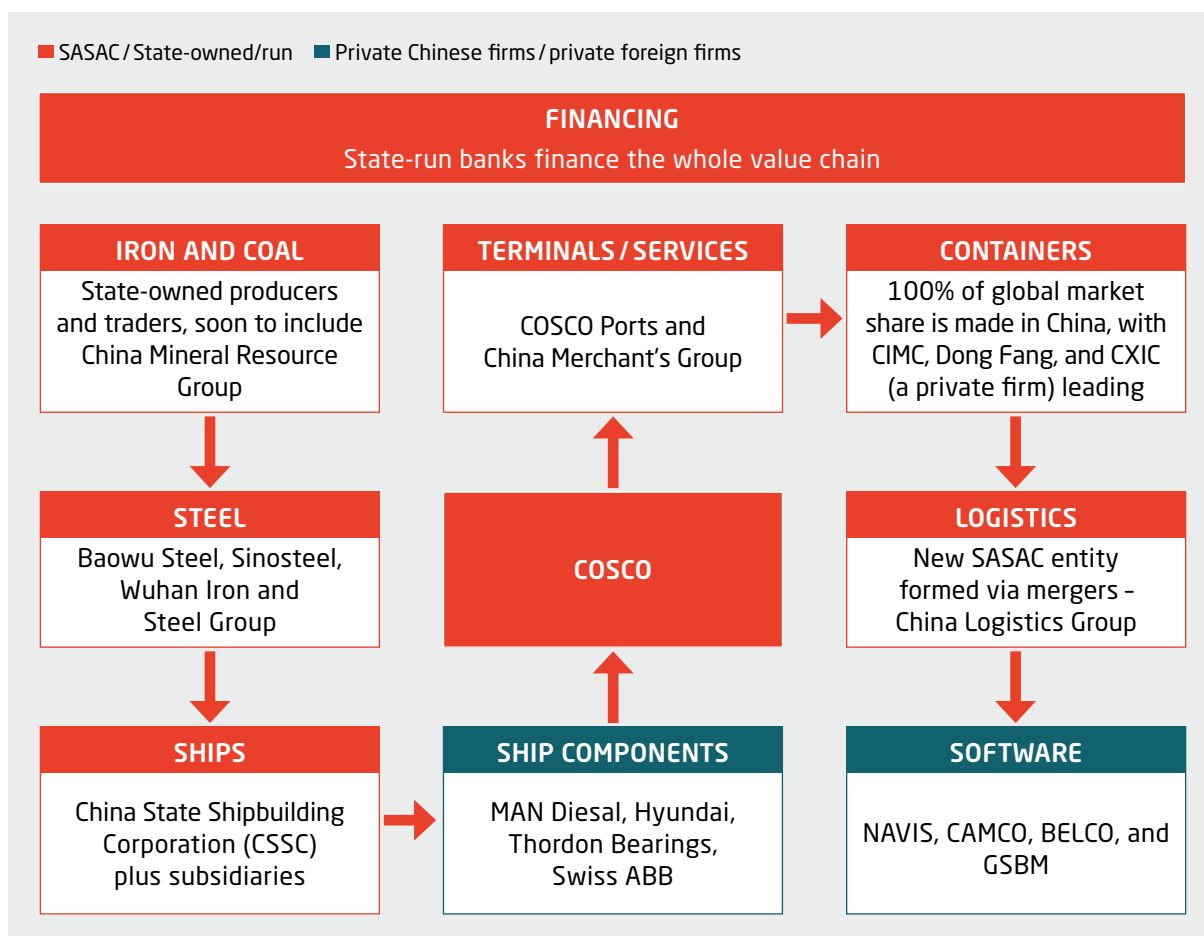
SASAC-directed equity injections: SASAC can coordinate and facilitate the sale of equity between SOEs to raise funds for specific projects – something that could be done in normal financial markets, but which benefits the seller because SASAC makes the political case to purchasers, rather than having to make a case to a market full of potential investors. This happened in 2017, for example, to raise funds for ship purchases (from the SASAC-owned shipbuilding monopoly), when COSCO sold equity to eight other SOEs. Importantly, this can happen the other direction – with COSCO having the burden of being commanded to invest in other SOEs.

SASAC's vertically integrated value chain: COSCO is one of the 97 centrally owned SOEs under SASAC – the holding company and manager of those firms. Both upstream and downstream, many of COSCO's suppliers and customers are state-owned, many specifically SASAC-owned. This opens up possibilities for coordination to pass along subsidies through lower prices from suppliers or higher prices from customers to support COSCO. Importantly, support can be directed to COSCO, but it can also be demanded from it (see Exhibit 22).

COSCO is just one link in a long state-owned value chain



Except components and software, major value chain segments are SASAC or other state-owned/run



Sources: MERICS, company annual reports

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FULLY ALIGNED WITH BEIJING, COSCO CAN ALMOST FREELY ADVANCE XI'S STRATEGIC GOALS

COSCO is a critical player in Beijing’s overseas ambitions and has greatly expanded its fleet as well as its investment footprint in ports all over the world. The company enjoys extensive support in its protected and heavily subsidized home market and has successfully projected the abroad. It can fiercely compete for market share without the same fiduciary responsibility for shareholder returns European shippers face. Importantly, some of COSCO’s port investments and its large footprint in some developing markets are potential avenues for Beijing’s economic coercion toward others, as the sudden divestment or suspension of shipping operations could seriously impact trade. So far, COSCO has advanced Beijing’s interests overseas with little pushback. But the shift in attitudes in the EU from COSCO’s earlier investments in European ports (which were met with little scrutiny) to stronger pushback, for example over a deal in the port of Hamburg, suggests this may be changing.

Case Study: BYD is taking China's EV revolution overseas

Gregor Sebastian

With Beijing's support, electric vehicle-maker BYD is on a path to become the global industry leader, helping Beijing achieve its long-standing goal of being a manufacturing powerhouse with some of the world's biggest automotive brands. BYD is deeply integrated in automotive supply chains and is not only assembling components made by suppliers but actually producing high-value components like batteries, IGBT chips and engines. BYD is thus integral to Beijing's campaign to achieve technological self-reliance and move up global value chains. It also plays a key role in Beijing's internationalization efforts, going global (along with the whole EV ecosystem), and becoming a high-value export, an investment vehicle in overseas markets, and a technology provider to both developed and developing markets.

BYD BENEFITTED FROM AMPLE SUPPORT

Local government protection: Wang Chuanfu has remarked, “without Shenzhen, of course there would be no BYD.”⁹⁹ Indeed, the local government has not only promoted the rise of BYD through preferential policies such as encouraging research institutes to partner with the firm, but it has also established joint ventures with BYD and designed tailor-made subsidies that excluded other carmakers.^{100 101 102}

Protected home market advantage: China shielded Chinese battery makers, including BYD, from overseas competition by making EV purchasing subsidies contingent on the use of battery makers on a whitelist.¹⁰³ Only Chinese battery makers were on the list before it was discontinued.

Cheap state financing: BYD has repeatedly benefited from credit from state-owned policy banks that often hand out capital to such strategic firms. In 2008, the China Development Bank gave BYD a loan and a year later the Bank of China handed it USD 2.2 billion.^{104 105}

Subsidies: The central government's purchasing subsidies have enabled BYD's EV business model – the firm received CNY 32.9 billion in purchasing subsidies in addition to the CNY 5 billion in direct (and publicly known) subsidies to the firm.^{106 107}

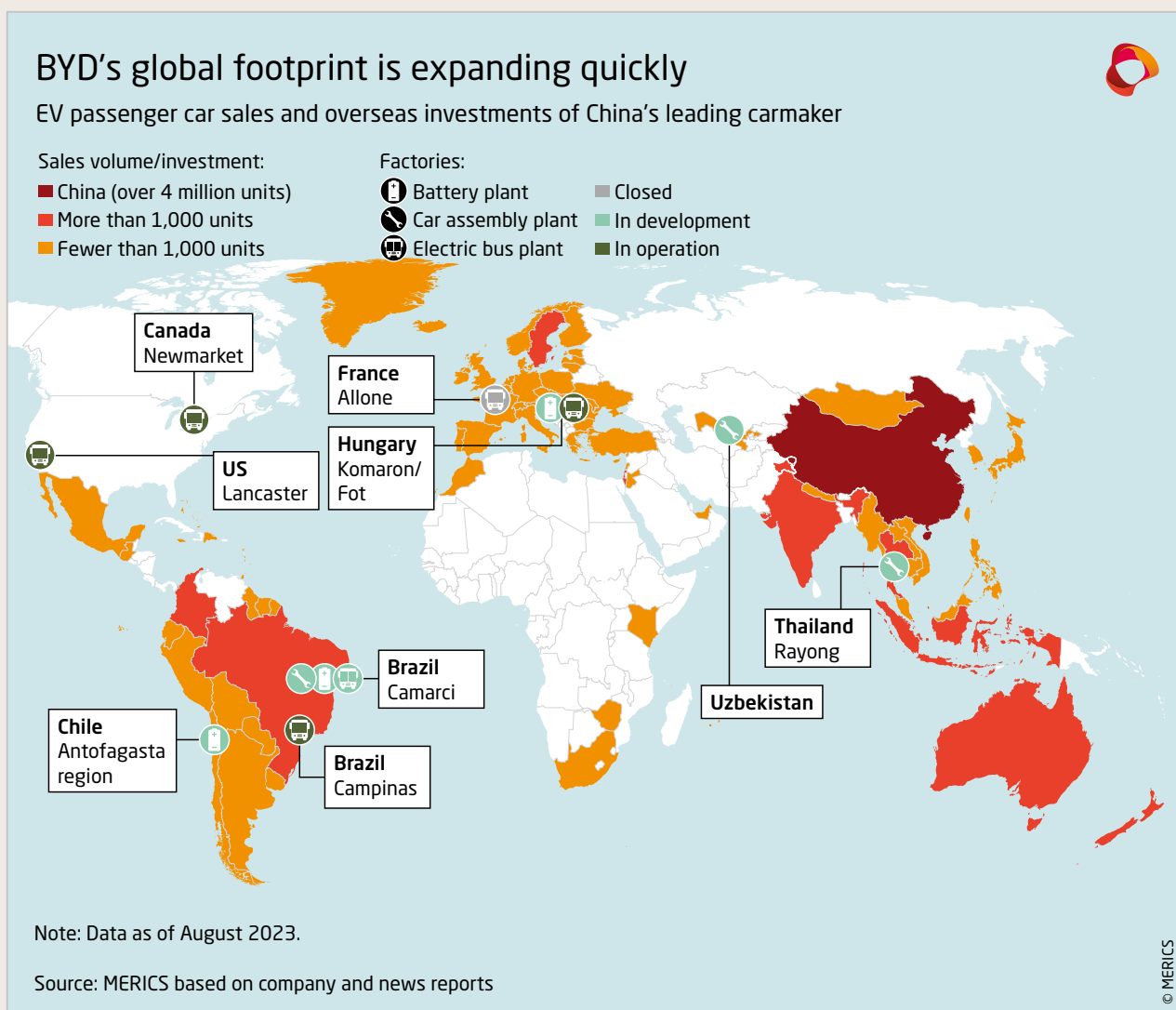
Upstream support and state-owned partners: BYD has also benefited from close collaboration with and support from state-owned or state-supported suppliers. Since 2020, the firm has had an R&D collaboration with state-owned steelmaker AnSteel.¹⁰⁸ BYD and its subsidiaries such as FAW Fudi New Energy Technology also have several joint ventures with state owned enterprises, potentially further ramping up the firm's production capacity and R&D capabilities. BYD also benefited indirectly from cheap financing for firms involved in mining and raw material refining necessary for battery production.

BYD'S GLOBAL FOOTPRINT SUGGESTS SUCCESS IN BEIJING'S EV AMBITIONS

Beijing has been very effective in supporting BYD's rise, which is directly linked to government support. Without Beijing's protection and nurture, it is unlikely that Chinese car and battery makers like BYD would have thrived as much.

In turn, BYD is also helping Beijing achieve its industrial policy goals. The company is helping China move up global value chains and reduce the country's reliance on foreign technology, like internal combustion engines, as well as oil imports. What's more, BYD is helping Beijing gain overseas economic and political influence. The firm is dominating important overseas electric bus markets, for instance in South America, and is now supporting China's rise as an EV exporter (see Exhibit 23).

Exhibit 23



7. Beijing struggles to balance economy and ideology

7. Beijing struggles to balance economy and ideology

Over the past decade Xi Jinping was able to progressively expand his own vision for China's economic system by reconfiguring it with the ideological principles outlined in the previous chapters. In 2023 the economy is – again – under much stronger guidance of the party – and economic policy making is beset by growing distrust of liberal market economies. The implementation of Xi's economic priorities are in full swing in pursuit of achieving the 2049 vision of the great rejuvenation. But clearly it is not all smooth sailing and Xi's third term looks to be off to a rocky start.

It is becoming inherently difficult to reconcile economic interests with political ones and becoming obvious that pursuing geopolitical priorities comes with a price on the economy. The expectations of a swift return to pre-pandemic consumption patterns within Chinese households have been thwarted while private companies are struggling. It seems as if the leadership underestimated the profound impact of the confluence of factors from zero Covid, the crackdown on the dynamic tech sector and real estate - as well as rising geopolitical risks.

After decades of improvement in livelihood the outlook is changing for some

As the economy is absorbing the policy-medicine the party-state prescribed it is causing side effects for the different actors:

- **Society:** After decades of improvement in livelihood the outlook is changing for some. There is a risk of parts of China's youth being part of the first generation since the start of the reform process that sees its development stall. Record levels of youth unemployment and poor wage prospects have resulted in growing disillusion. While growing nationalism might counter this to some extent, accepting hardship for the greater good of nation will be a difficult sell for many.
- **Bureaucracy:** Compared to the start of Xi's first term, party and government officials are operating in a very different ecosystem. The anti-corruption campaigns, the return of ideology, an increasingly top-down and campaign-style approach to policy making have diminished the incentives for policy-making experimentation at the local level. Officials that must do their job while wearing their political hats will likely continue to decide that doing what is ideologically right is more important than what might actually work in their ecosystem, or worse yet, that they will choose inaction out of fear that the consequences of any steps they take will yield the wrong results.
- **Chinese companies:** Many private companies are at odds with the direction of economic policies – while without doubt some companies also flourish as they fully embrace the priorities. There is a real risk of many highly innovative and productive economic actors choosing to hold their heads down by not being willing to take on entrepreneurial risk if the prospects of returns are limited if they are not aligned with the strategic priorities of the party. Similarly, the many export-oriented SMEs that have thrived over the past decades serving liberal market economies might also be at odds with politics increasingly getting in the way of business.

Foreign firms need to strike a balance between de-risking and localization

- **Foreign companies:** Lower growth prospects and changing market environment are forcing foreign companies to make strategic adjustments on how they position themselves in the Chinese market. Many need to strike a balance between de-risking and localization in a way that does not undermine their competitive position. While China continues to court foreign companies, especially in technological areas it needs, companies are increasingly at risk at being caught up in opaque national security regulations or punished for actions of their home government.

RECENT ECONOMIC POLICY ADJUSTMENTS DO NOT MARK A RETURN TO MORE LIBERAL ECONOMIC POLICIES

In response to the struggling economy, the party released a range of policies aimed at alleviating concerns of private and foreign companies as well as households over the summer of 2023. They seem to be geared towards alleviating concerns over the direction of the economic system. Some the most noticeable measures include:

- **14th July 2023, on the private sector:** “Opinions of the Central Committee of the Communist Party and the State Council on Promoting the Development and Growth of the Private Economy” (中共中央 国务院关于促进民营经济发展壮大的意见),¹⁰⁹
- **31st July 2023, on consumption:** the “General Office of the State Council Forwards the Notice of the National Development and Reform Commission on Measures to Restore and Expand Consumption” (国务院办公厅转发国家发展改革委关于恢复和扩大消费措施的通知),¹¹⁰
- **13th August 2023, on foreign investment:** “Opinions of the State Council on Further Optimizing the Foreign Investment Environment and Enhancing the Attraction of Foreign Investment” (国务院关于进一步优化外商投资环境 加大吸引外商投资力度的意见),¹¹¹
- **4th September 2023, on the private sector:** “Private Economic Development Bureau” (民营经济发展局) by the National Reform and Development Commission (NDRC) is newly established.¹¹²

The policies embrace fair competition, market-oriented restructuring, stronger rule of law, efforts to boost consumption as well as more opportunities for foreign companies. Such measures are a recognition of how implementing Xi’s the party’s economic principles has affected sentiment of the private sector and households. The efforts to shore up economic growth revive more reformist language and contrast the efforts aimed at strengthening party oversight. However, the oft-billed “pragmatism” of such measures and language are not yet likely to be indicative of a sea change in Xi’s approach to economic governance. Rather, these steps are matters of tone and timing.

As the third plenum approaches more such language can be expected for as long as China’s economy continues to struggle. In an effort to improve business sentiment the importance of markets and openness will be stressed. The aim is to soften the impact that economic actors are feeling as they settle into the new normal of Xi’s geopolitically focused political economy. But akin to what was said in the 2013 third plenum, the words need to be seen in the larger context of Xi’s visions for the country and the role the party has in it.

The policy direction set during the third plenum will be a test and an opportunity to evaluate the attempt how the leadership tries to reconcile trade-offs between strategic priorities and sufficient economic growth. At the moment the adjustments are more symbolic than substantive. A meaningful shift of policy direction would likely demand far more economic and social pressure. Nevertheless, the recent measures to reinforce the private sector are reminders that the leadership is not immune to market sentiment and that the party struggles to sell its policy objectives to all its subjects.

Success of course is not certain. There is the risk that the ideological streamlining of the economy fails, forcing for more substantial policy adjustments in the future. But for now, the overall direction is rigorously following the path Xi has set out over the past ten years. Even in times of lower growth it seems more likely that Xi will force his vision on economic actors and limit any adjustments to minor concessions.

The events currently unfolding might be as impactful as China's integration into the world economy in the early 2000s. But the economic and geopolitical context has dramatically shifted from integration to competition – if not conflict – with liberal market economies. China's future reforms and opening must be seen in the context of Xi Jinping's strategy for its next stage of development. Instead of again engaging in wishful thinking about China's development path as was done in 2013, Europe and other liberal market economies will need to accept the systemic differences and work out a pathway for mutual existence – that includes accepting the systemic challenge and preparing for competition.

The overall direction is rigorously following the path Xi has set out

Dealing with China and the structural break of today's globalization should be seen as a wake-up call for Europe. It presents an opportunity and will require the courage to break through decades old thinking. Policymakers and corporate boardrooms continue to take a defensive posture as they face the dilemma of responding to a changing China. European policy is focused on measures to defend the common market from distortions from and dependencies on China, while C-suite discussions are about how to defend their footprint in the China market.

All actors would do well to adopt more offensive postures that coolly calculate what will be necessary to compete with China in third markets. For corporates, that means assertive strategies to secure market share in third markets and to wrestle with increasingly advanced competitors. For policymakers, that means strengthening ties with third countries and building the framework necessary to support European exports and investors in markets beyond Europe's jurisdiction. In other words: pursue in other markets the kind of strategies Europe applied to China after it began reform and opening up.

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