A U.S.-China Rapprochement

By Lyric Hughes Hale

Is diplomacy back?

Unannounced, U.S. National Security Advisor Jake Sullivan and China's Foreign Minister Wang Yi met in Malta in September. According to the official U.S. readout,

> *The two sides discussed key issues in the U.S.-China bilateral relationship, global and regional security issues, Russia's war against Ukraine, and cross-Strait issues, among other topics. The United States noted the importance of peace and stability across the Taiwan Strait. The two sides committed to maintain this strategic channel of communication and to pursue additional high-level engagement and consultations in key areas between the United States and the People's Republic of China in the coming months.*

Speculation was that this was preparation for a possible Xi-Biden Summit at the APEC meeting in San Francisco in November.

A few days later, Sullivan and U.S. Secretary of State Antony Blinken both met with China's Vice President Han Zheng on the sidelines of the UN General Assembly meetings in New York, providing additional momentum for a summit. Wang will now visit Washington in October, becoming the highest-ranking Chinese official to visit the capital since the pandemic began.

Following on U.S. Secretary of Commerce Gina Raimondo's successful visit to Beijing, this is all good news, signifying that critical communications channels are functioning. However, serious challenges remain for both Xi and

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Biden. Biden's weak polling and Xi's unexpected cabinet shifts mean both sides might not be negotiating from positions of domestic strength.

The official revelation that the balloon shootout that scuttled Blinken's trip to Beijing earlier this year was in fact a false alarm is another signal that tensions have eased. What is fueling U.S.-China diplomatic rapprochement?

U.S. RECOVERING, BUT NOT CHINA

The answer is simple. The Chinese economy is not recovering as rapidly as was expected, while prospects for the U.S. economy seem to be improving. Chinese consumers are exhibiting a different behavior pattern than American consumers post-covid. China's "Dual Circulation" is not working and dependence on exports has risen. "Common Prosperity" has come to mean less prosperity for everyone.

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Lack of Chinese consumer confidence could mean that U.S. GDP growth could exceed China's this quarter. The Atlanta Fed Nowcast on September 14 estimates third quarter U.S. GDP growth at 4.9 percent. China's 2023 target is an optimistic 5 percent.

The United States and China face shadow banking risks and are likely to hold interest rates steady this month. Higher oil prices could depress growth in both countries.

While the dollar is seeing continued strength, the People's Bank of China is struggling to keep the yuan from weakening beyond ¥7.3 to the dollar. Amid capital flight, currency traders will be watching to see if intervention continues, or if the PBOC is merely shadowboxing to imply that devaluation is unwelcome. A weaker yuan would be a boost to Chinese exports, but China wants to avoid being called a currency manipulator.

Chinese equity markets also appear to have government support, even if it only amounts to jawboning. Chinese policymakers realize that they need to revive foreign direct investment, but on balance, government policy intervention has made it tough to invest in China while at the same time making it tough to short. The likely scenario is that the Chinese economy will muddle along within policy guardrails, and forecasts of an imminent economic collapse are overdone.

However, if one large economy, for example China or Japan, or even a smaller trading partner suddenly and steeply devalues, we could see a wave of competitive devaluation and a race to the bottom, similar to what happened during the Asian financial crisis of 1998. All Asian economies are much more intertwined, especially with China, than they were twenty-five years ago. So the effects could be far worse.

China's relations with Europe seem to be deteriorating. The European Union will take action against Chinese electric vehicle makers, claiming that state subsidies amount to dumping. But contradictions, even within the same industry, emerge. Ironically, the Volkswagen plant in Portugal, deprived of parts due to flooding in Slovenia, was able to restart manufacturing due to the intervention of a Chinese supplier—a perfect illustration of how global supply chains are still fragile.

ROOT CAUSES

China's property bust cannot be analyzed on a standalone basis. One thing China needs to get right is local taxation to support local institutions so that local bureaucracies do not become real estate investors or investment houses—which is just what has happened. The implementation of local property taxes on a nationwide basis would be the single most bullish signal imaginable.

Despite some failures, most Chinese savers have not yet lost faith in local banks and trusts, causing them to move their money to state banks *en masse.* As is the case in the United States, local lending is critical to dynamism and new business formation, which has fallen off a cliff in China.

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A Repeat of 1998

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—L.H. Hale

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China is now groaning under the increased burdens of anti-corruption campaigns within its complex economy, inextricably tied to the global macro environment. Entire sectors such as healthcare are at a standstill. Policy chokepoints have proliferated throughout the economy.

Corruption is not about ethics in a system that cannot function if the rules are obeyed. It is about inadequate institutions. In other words, when everyone is corrupt, no one is corrupt, and inevitable and universal infractions merely present an opportunity to punish political opponents. However, the rub is that the policy effects are now global, not just local, in an interlinked financial system with multinational companies operating across borders.

As some observers watch China stumble, they seize upon the failures of communism or authoritarianism. In my view, China's current difficulties are not caused by its system of government, which after all existed during China's great economic boom. Instead they are the result of institutional weaknesses that were masked during a period of high growth as reforms were unfortunately delayed.

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Do these economic woes mean that China's leadership will use economic weakness as an excuse, for example, to attack Taiwan? Probably not. M. Taylor Fravel of the Massachusetts Institute of Technology discusses this possibility in a recent issue of *Foreign Affairs:*

> *Chinese leaders have rarely, if ever, started a conflict purely as a diversion, even during moments of domestic crisis. That is, in part, because the Chinese state has more control over public opinion and society, including protests, than do other governments. When the Chinese economy falters, the danger is not diversionary war. It is that China's leaders will feel weak and become more sensitive to external challenges, potentially lashing out to show strength and deter other countries from taking advantage of their insecurity.*
>
> ["The Myth of Chinese Diversionary War," September 2023]

INTERNAL POLITICAL DYNAMICS

Taking this rather contrarian view one step further, it is doubtful that the sackings of Defense Minister Li Shangfu, as well as the Rocket Force generals and probably many others we don't know about, are directly related to Taiwan.

In China's return to a personality-driven political environment, personnel changes are more probably about loyalty to the current regime. It is more likely that Xi took these actions to command internal discipline and bolster his own security. His personal safety might also be a factor in decisions about his sparse international travel schedule.

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All of which brings up an under-appreciated risk. Recent reports by the few travelers who visit China say that it is virtually impossible to access the internet outside the country now.

An economic policy that focuses on self-sufficiency reminiscent of Mao also points to China closing itself off to the world. Will it do so in the dramatic way that it has during its history? If so, Chinese passivity could play a bigger part in slowing global growth than the aggression feared in Washington.

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In order to assess the risks that China poses to global growth, it is critical to understand the interplay of factors in the evolution of its domestic economy. Lack of institutional reform, whose consequences were once confined within China's own borders, can now impact markets and industry sectors around the world, from commodities to currencies to technology.

Although recent diplomatic overtures are positive, leadership changes in both the United States and China could play unexpected roles, affecting the health of both the global economy and peaceful geopolitics. It is essential for stakeholders to understand the dynamics of the situation in China today in order to build a more effective and constructive relationship. This is a better approach than saying, as President Biden did last month, that China is a ticking time bomb waiting to lash out.

Fravel ends his *Foreign Affairs* piece with a proviso:

> *If China's economic woes get worse, its leaders will probably become more sensitive to perceived external challenges, especially on issues such as Taiwan. Increased pressure on China could easily backfire and motivate Beijing to become more aggressive in order to demonstrate its resolve to other states despite its internal difficulties. In times of domestic unrest, China may lash out, but that reflects the logic of deterrence, not diversion.*

Hopefully, the Xi-Biden summit in November can set a new tone for the relationship between the world's two largest economies that will benefit rather than hamper global growth. ◆