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The Sino-US Trade War: Survival, Domestic Reforms and the Belt and Road Initiative

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Abstract

In July 2018, President Donald Trump stated in an interview with *CNBC* that he is willing to impose tariffs on all USD 505 billion worth of Chinese exports to the US. At the time of this writing, this has not become a reality. While it is strikingly clear that China cannot match the US in a tit-for-tat tariffs fight due to an imbalance in import volumes in favor of the latter, China can and has made some tactical decisions in its imposition of tariffs. For example, many of the tariffs levied on US goods target products which originate from states that have voted for Trump. At the same time, many of these products – such as soybeans – China can procure in other markets. This paper does not explore how China can mobilize the extent of its geoeconomic tools to gain an advantage in this developing trade war, as this has already been widely covered in the media. Instead, comprising two parts, this paper examines how China can use the pressures created by this trade war to better advance its grand strategy. In the first, against the backdrop of the regime's survival, the trade war can be used to leverage and increase the pace of its domestic reforms, which will be critical to the long-term sustainability of its financial sector and economy. In the second part, this paper explores how China can push forward its geopolitical ambitions – notably, the Belt and Road Initiative – in the vacuum left behind by the trade war and the Trump Administration at large.

Keywords: *Belt and Road, grand strategy, reforms, trade war, Chinese economy*

1. Introduction: Structure of Opportunity for More Ample Reforms?

On September 24, 2018, the US imposed a 10% tariff on USD 200 billion worth of annual Chinese imports, with the tariff rate rising to 25% beginning January 1, 2019. In addition, the US has threatened further duties on USD 267 billion worth of goods should China retaliate – which it did. Coming into effect on September 24 as well, China enacted 10% tariffs on USD 60 billion worth of US goods (Associated Press, 2018). This, at the time of writing, has been the latest scrimmage in the ongoing 2018 Sino-US trade war, and the largest round of tariffs imposed on Chinese imports by the US.

Since the first shot of the trade war – on March 9, 2018, the US enacted 25% tariffs on steel and 10% on aluminum from all nations – mainstream media like that of *CNBC* and *Bloomberg* have duly pointed out that the ratio of US goods imported by China versus Chinese goods imported by the US is simply too low for China to win in any tit-for-tat tariff battle (Li, Zhang, and Hart, 2018). According to the Office of the United States Trade Representative, in 2017, the US imported USD 505.5 billion worth of goods from China and exported only USD 129.9 billion – more than a three-fold difference. This economic reality effectively renders a tariff-focused strategy for China impossible. This paper does not explore how China can gain an advantage against the US in this trade war using various geoeconomic means – such as currency devaluation or targeting imports produced by President Donald Trump's voter base, with soy possibly being the best case (Taheripour and Tyner, 2018), as this topic has already been duly covered in mainstream media, industry press, and recent academia (Li, He and Lin, 2018; Zheng, Wood, Wang and Jones, 2018). The paper does, however, explore China's opportunities for domestic reform amidst this economic battle.

From the beginning of 2018, China has launched an economy-wide continuous series of reforms aimed at further liberalization and stabilization, as well as the strengthening of its financial sector – such as the tightening of insurance regulations aimed at tackling local governments' debt exposure announced on January 18 by the country's insurance regulator, which later merged with the banking regulator in order to create the "super ministry" that is the China Banking and Insurance Regulatory Commission (中国银行保险监督管理委员会 – CBIRC)[1].

These reforms come against the backdrop of China's ongoing economic transition and China's new economic head, Liu He (刘鹤)[2], who appears to be mainly following in his predecessor's footsteps – for now. Since the 1980s, China has pursued an export-led economic development model (EOI) with incremental reforms (gradualist approach) allowing the once closed country to slowly integrate with the global economy (Naughton, 2007, 2018; Yang, 2004). While this path has worked wonders for the Chinese economy and consolidated the rule of the Chinese Communist Party (CCP) – by way of performance-based legitimacy, it has also produced a substantial amount of negative economic externalities, such as high levels of non-performing loans (NPL)[3] and skyrocketing real estate prices[4]. As a result, the CCP has vowed to shift from this economic model to one more balanced with an emphasis placed on domestic consumption and innovation, which necessitates a wide range of economic reforms[5].

While these ongoing reforms since the beginning of 2018 were likely to be rolled out regardless of the trade war, it is unquestionable that the latter has imbued the reforms with a new sense of urgency and legitimacy[6]. Furthermore, the trade war pressures give President Xi Jinping additional clout within the CCP to strong-arm and push forward reforms[7] which, given a different set of circumstances, may not have been politically viable. As such, this paper examines how China can exploit the pressures emanating from the Sino-US trade war to pursue domestic and international objectives that fit within the overall Chinese grand strategy. The first section identifies the objectives of Chinese grand strategy within the country's domestic and international environments. From this, the subsequent two sections examine how the trade war can aid in China's pursuit of these objectives. In terms of limits and scope, this article, insofar as it deals with recent events related to the ongoing trade war between the US and China, aims at articulating current political risks and opportunities in a very unsettled international environment. As such, listed ideas and positions are posited as possible outcomes.

2. China's Grand Strategy: Political Survival Masked as Economics

While the CCP has not published any authoritative white papers outlining or defining a national strategy for the country (as it is "crossing the river by feeling the stones"), the latter's objectives can be distilled by examining the nature of the Chinese regime and large policy objectives already mandated by the CCP. Viewed within the scopes of China's domestic and international environments and examined in further detail below, we emphasize that all of its strategic objectives are of an economic nature, and are vital for the survival of the Chinese regime[8].

2.1. Domestic Objectives

We begin with an assessment of China's present domestic environment. The backbone of China's grand strategy is the survival of the CCP (Logic of Political Survival [LPS]) (Gallagher and Hanson, 2013). Drawing on a general view of authoritarian resilience (Nathan, 2003; Dickson, 1997, 2016), the legitimacy of the CCP is grounded in the continuous provision of socio-economic goods to the Chinese populace, on its ability to build institutions – that can serve and address public grievances – and to vouch for them, and on its capacity to co-opt large segments of the population (e.g. the "party class", new middle class, etc.). This is, in turn, achieved through economic growth which, in the past four decades or so, has brought an unprecedented number of people out of poverty. However, as the coastal regions of China developed rapidly under the export-led economic model, leaving behind central China and mainly the resource-rich west, growth – while still impressive – has slowed down in the past few years, forcing the CCP to lower its GDP growth targets[9]. The important point to note is that a substantial economic slowdown, let alone a recession, produces wide-ranging socio-political problems for the CCP, which are further aggravated by the sheer size of the population. For example, under the current export-led economic model, a significant slowdown of growth could mean massive layoffs, especially in the richer coastal regions (such as Shenzhen back in 2008)[10], leading to social resentment, unrest, and dissent on a massive scale that are further exacerbated by dysfunctional (or simply absent) social security and welfare programs. As such, this type of situation is not tenable, in the long run, for the "Organizational Emperor".

Should the CCP fail to provide the populace with a continuous stream of socio-economic goods, the Party-State might face a regime crisis[11], directly impacting its resilience let alone its survival. And while the CCP could use heavy-handed repression tactics against a dissenting populace (yet unlikely scenario), the root of the problem remains that the Party-State draws legitimacy mainly from its ability to steer and provide economic development[12]. As a result, continuous economic growth, which would be achieved through the ongoing economic transition, is a crucial strategic objective for China as it is inextricably linked to the resilience and survival of the regime. This is the central focus point of China's grand strategy, and subsequent strategic objectives are derived from this.

The second objective in China's grand strategy is the implementation of reforms, specifically economic reforms, which chiefly aid the economic transition via two channels. Firstly, one set of these reforms are aimed at liberalizing various aspects of the Chinese economy, especially in the area of foreign direct investment and ownership. These types of reforms will not only help China transition into a more balanced economic model, but they will also aid in the regime's pursuit of international strategic objectives, which are further discussed below. Secondly, another set of these reforms aid the economic transition by soothing externalities accumulated from decades of relying on the export-led model. As previously noted, this economic transition has not been an easy task. The aforementioned path allowed China to achieve nothing short of an economic miracle, enjoying decades of double-digit GDP growth, and most importantly, gave the CCP political consolidation and legitimacy that other authoritarian regimes could only dream of. However, over-reliance on EOI has allowed socio-economic and socio-political problems to metastasize. Notably, state-owned banks dominated and continue to dominate the domestic financial landscape, providing morphine-like injections of capital to prop up failing or, at best, inefficient and bloated state-owned enterprises (SOEs) in the export sector, rendering domestic competition lethargic and further increasing the sector's barriers to entry for private companies, all of which to keep some of the 1990s ideals alive (e.g. the state as the main employer, high rates of employment versus efficiency[13]). At the same time, the shadow banking industry (Allen, Qian, Tu and Yu, 2018; Shen, 2017)[14], which had been booming until industry regulations clamped down on its development very recently, reveals the difficulty of securing loans from mainstream financiers for private companies that do not have the upfront collateral required by state-owned banks. Having rapid economic growth outpacing regulations creates ample room for economic and financial risks to build up – in October 2017, China's outgoing central bank governor Zhou Xiaochuan (周小川) warned that the country faced a possible "Minsky Moment"[15] – a sudden collapse of asset values due to an abrupt drop in investor confidence.

More concerning is that state-owned firms and their many subsidiaries and affiliated entities along the massive supply chains in the Chinese export sector have become a substantial political force in the country, if not downright sub-factions themselves. They exercise considerable economic and political leverage (especially on provincial and local governments[16]) and are, in general, opposed to the reforms aimed at economic transition. Furthermore, as wealth spread and accumulated at a rapid pace, corruption and rent-seeking activities spread like wildfire in China's politically intertwined economic system (Ngo and Wu (eds), 2008). It comes as no surprise that since taking office in 2013, two hallmarks of the Xi Administration have been to stamp out corruption and roll out reforms aimed at strengthening industry regulations. As such, the second objective in China's grand strategy can be summarized as implementing reforms which aid in the country's economic transition.

2.2. International Objectives

We now move onto China's role on the global stage, and the objectives of its grand strategy as laid out within the international environment. It is important to remember that these objectives, while seemingly global at face value, remain inextricably attached to the country's economic interests, and by extension, the CCP's political survival. China's primary global objective is the Belt and Road Initiative (BRI) – essentially a massive infrastructure project aimed at connecting China by rail, road, and ports, to the rest of Eurasia and parts of Africa. Under the guise of international cooperation and the "Peaceful Rise" (和平崛起) slogan, the BRI – if it comes to fruition – can alleviate a multitude of pressures bearing down on the Chinese economy (e.g. new markets for Chinese goods, primary resources, heavy chemical industries and other forms of "dirty" manufacturing).

Firstly, the BRI will allow many underdeveloped regions of the world, such as central Asia and parts of Africa, to become better connected to the global economy at large. As these parts of the world develop at a faster rate, rising GDP per capita levels in these countries will demand more consumer goods, thereby creating new markets for Chinese exports. The mismatch between manufacturing growth in China and GDP growth in developed economies has been a critical problem for China's export-led model for a number of years now. Effectively, the developed economies of the world cannot absorb Chinese exports, especially consumer goods, at a pace which matches the output of the latter. The BRI can alleviate some of this pressure and allow a more smooth transition away from exports. At the same time, China will gain access to these resource-rich emerging economies. As many large parts of China remain underdeveloped – notably, the central and western regions – the country's future development will require a constant flow of raw materials. The BRI in this case provides China with many new and cheap channels to import these resources. On the other hand, since much of the immense infrastructure demands will be shouldered by China, the BRI will also act as a channel for the Chinese economy to unload much of its excess production of industrial materials, such as cement and steel[17].

Secondly, the BRI acts as a conduit for China to export its currency, allowing a faster route to RMB internationalization (Sun and Payette, 2016; 2017). In tandem with China's growing economic clout, this topic has gained much traction in the past few years, especially with the inclusion of the RMB in the International Monetary Fund's special drawing rights currency basket in 2016. Academic literature on international currencies widely points to a number of economic benefits for the issuing country: the exchange of fiat currency for goods; the ability to borrow from global markets in the country's own currency; ease of trade settlement between countries holding that currency; and most importantly, decrease reliance on the dominant USD (Cheng, 2015). The latter point is of special interest to Chinese policymakers as the country's vast USD reserves accumulated over the course of decades has become equal parts hedge and risk[18]. Following the 2008 financial crisis, China has echoed the concerns of other major economies on the world's reliance on the USD, especially with regard to whether or not the US implements "responsible" monetary policy[19]. In the case of RMB internationalization, the BRI will connect China to developing countries with low liquidity, unstable currencies, and which are oftentimes deep in debt. This provides China with a prime opportunity to offer the RMB as a reserve currency for these countries. On the other hand, in the relatively more developed east and southeast regions of Asia, China has an opportunity to pitch the RMB as a regional currency, which would mark a significant milestone for the currency's internationalization. However, this last point is very dependent on the diplomatic acumen of the CCP.

Finally, the BRI can provide some additional benefits for China – technology transfers and the opportunity to enshrine the Chinese stock market as a new center for price settlements of various commodities. Upon examining the routes of the BRI, China and Western Europe are placed on the opposite extremities of this project. Connecting these two large markets by rail, road, and sea will further increase the interdependency between these two markets by improving the flow of goods, capital, and people. As a result, the two regions will be better placed to find areas of multilateral cooperation, be it economic, political, or in the realm of science. In any case, warmer relations between China and Western Europe increase the chances of economic windfalls for the former in shape of technology transfers. Already, China has moved to reform some of its strict policies governing foreign investment in a number of its protected sectors; this, coupled with further interconnectedness with Western Europe, presents China with a crucial opportunity to attract and absorb foreign know-how. And briefly, the East Asia region has long suffered from price shocks in many of the world's key commodities – notably, crude oil – especially since these countries are generally oil poor[20]. Since this region is geographically distant from the settlement centers of the world's two largest crude oil benchmarks – the West Texas Intermediate (WTI) crude and the Brent crude – its crude oil demands are different from those regions primarily serviced by WTI and Brent. Reliance on WTI and Brent has rendered countries in this region vulnerable to sudden expansions or contractions in global oil supplies[21]. With China's growing appetite for petroleum, which will continue to grow as the country shifts away from coal, coupled with China's position along the BRI as a major import destination for natural resources, and the rising status of Shanghai and Shenzhen as major regional stock markets, China can consolidate market pressures to establish a new regional crude benchmark price opposite Tokyo[22]. Evidence of China's attempt at establishing a crude oil benchmark can be traced back to March 2018 (right after State Council's reshuffling), when the Shanghai International Energy Exchange, an energy derivatives-focused subsidiary of the Shanghai Futures Exchange, launched RMB-denominated crude oil futures (Xinhua, 2018b). While this is also further evidence of China's recent financial sector reforms, the Shanghai-traded futures are still in their infancy. However, looking beyond crude oil, China is also a major producer and importer of widely traded metals, such as gold, silver, aluminum, copper, iron, and platinum. The sheer volumes of Chinese imports and exports of said metals will only increase as the BRI develops, and this again provides momentum for China's stock markets to establish benchmark prices, which would in turn be beneficial for resource-rich developing nations to bring their commodities to an accessible market.

2.3. Political Survival

How, then, do these strategic objectives help the CCP and, by extension, China thrive as a one-party state? China is and will remain an export giant. As such, a major component of the BRI is to connect the relatively isolated markets of central Asia and parts of Africa, thereby opening up and developing these economies so as to allow Chinese exports to be absorbed – both in terms of goods and capital. However, as previously explained, the many failings of this export-dominant model have allowed a plethora of cancerous issues to grow – at times uncontrolled –

throughout the Chinese economy. Naturally, an economic transition to a more balanced model by increasing imports and consumption, along with timely reforms, is critical for the regime's survival. On this front, too, the BRI provides many opportunities for China to capitalize on. As much as the BRI is about opening up new markets for Chinese exports, it is equally focused on attracting imports – raw materials from the developing economies, and technology and expertise from the developed markets[23]. At the same time, the BRI provides an impetus to China's ongoing reforms; that is, in order for the BRI to be realized, the Chinese economy must open up. The pace, however, will depend on ever-changing domestic and global conditions.

3. The Sino-US Trade War: Domestic Pressure and Global Realignments

3.1. The Xi Administration's Domestic Opportunities

The Sino-US trade war has already inflicted damage on both sides. Farmers and workers in metal industries in the US have felt the effects of tariffs put in place by their own government, while the Chinese and Hong Kong stock markets have seemingly entered into a bear market (i.e. a market in which asset prices are falling) (*Bloomberg*, 2018b) alongside a depreciating RMB. From the beginning of this trade war, the US rhetoric has remained on the offensive criticizing unequal trade policies on China's part, and the Xi Administration appears to be on the defensive, constantly playing catch-up with tariffs. Yet at the same time, up until recently, China was seen as playing the "strong nation" card (厉害了， 我的国). In turn, this slogan, upheld by Wang Huning (王沪宁), exacerbated tensions with the US. Wang's "mistake" created a rift in the CCP between those who have practical political experience, such as Wang Qishan (王岐山) and Hu Chunhua (胡春华), and those, like Wang, who do not, fueling unrest among the population. Wang Huning underestimated Trump's reaction and attitude towards China, which could be considered as a major shortcoming for the head of China's top think-tank (Payette, 2018). Since then, Wang has been somewhat "isolated" and retrenched to party work and to his new position (as of August 2018) on the "rule the country by law" committee (中央全面依法治国委员会)[24].

As we have already mentioned in the introduction, China simply cannot match the US in this tit-for-tat battle of tariffs due to the difference in bilateral trade volumes. At the time of this writing, the impact of the US tariffs on Chinese goods has yet to be fully realized in the latter's economy. However, there is undoubtedly substantial domestic pressure on the Xi Administration to bring a conclusion to this trade spat before the Chinese economy takes on any serious damage – which many market analysts are predicting to be in 2019 (*CNBC*, 2018a). In as much as the Sino-US trade war is weighing down on the Xi Administration, especially if we consider the possibility that much of the reason for its escalation could be due to internal mistakes (Payette, 2018), it also gives the administration ample firepower to push forwards many reforms and regulations that help China's economic transition, but would otherwise face opposition from the manufacturing and the export industry. The reforms and regulations can largely be separated into two camps defined by their objective: aiding economic transition or economic stability and resilience. Naturally, many of these reforms and regulations have elements of both, but let us not get lost in the weeds, it is the major direction of these policies that matter most.

On the side of helping China's economic transition, the government, since the beginning of 2018, has made progress on further opening up its domestic market to foreign capital on a number of occasions. For example, in July, tariffs on nearly 1,500 consumer goods, automobiles and automobile parts were cut – in some cases, by more than half of their original rate (Xinhua, 2018a), And again, in November, China released another round of cuts in consumer goods tariffs, this time on products ranging from machinery, electrical equipment and textiles (Reuters, 2018d), The effects of these cuts were almost immediate: in August, China's automobile imports rose 70% with Japanese and European vehicles leading the charge (Nikkei, 2018), Likewise, as this paper explores further down, insofar as these reforms help open up China's domestic market, they also play an indirect geopolitical role as well. For example, in June, Sino-French relations hit a high note when China announced it would import more farm produce and civilian aircrafts from the European country (Reuters, 2018b).

As we have noted earlier, a major component to China's economic transition is the expansion of its import volumes. At least on this front, these reforms have been relatively successful thus far in helping China attract foreign capital and products, as well as consolidating its trade networks while a trade war goes on with the US – thereby making good on its pledge to defend international trade and globalization. However, it is important to keep in mind that the trade pressure exerted by the US has helped the Chinese government tremendously in being able to reduce its import tariffs. Under the export-led economic model, protecting its domestic industries from foreign competition was absolutely paramount for China (and for previous states which followed the productivist model), as the absence of world-class technology and quality meant that Chinese industry could hardly compete against foreign firms if the latter moved into China unfettered. If domestic industries failed to develop, China's economy would fail to develop by extension[25], thereby creating a regime crisis for the Party-State. Consequently, Chinese firms have enjoyed the protection of the government against foreign competition since the beginning of the Opening Up and Reform period[26] – thereby creating informal groups and allowing certain political factions to deepen their roots in some sectors[27], ultimately hampering efforts at reform. Of course, as these domestic firms became lucrative and profitable from exports, rent-seeking behavior (corruption) spread. At the time, the latter took a backseat to economic development. However, the Xi Administration has, since 2013, been hard at work cleaning up the rust left behind by decades of unfettered economic development. The anti-corruption campaign, led in first instance by Wang Qishan, has cleared many of Xi's enemies[28] and provided his administration with plenty of firepower to push forth reforms that otherwise would have faced strong opposition in the past, as seen during the Hu-Wen decade.

Now, the Sino-US trade war gives this current government even more clout to push reforms – that is, reform or suffer massive economic damage. As such, with a rising middle class[29], China needs to attract imports, and while cutting tariffs may seem like a superficial fix to an urgent problem, it does fall in line with China's approach to economic reform; that is, as Deng Xiaoping famously said, "crossing the river by feeling the stones" – incremental changes with a reactive approach[30]. In a sense, these tariff cuts are the Chinese government's way of testing the waters of this new round of reforms, and are a good way to hedge against the risks of this Sino-US trade war. That being said, once this trade spat calms, more deep-reaching reforms targeting the structure of the Chinese economy will likely be implemented. However, these structural reforms can only come after a more stable economy has been consolidated.

China's reforms aimed at economic stability and resilience are arguably more important than those aimed at aiding economic transition. Just as decades of unfettered economic growth allowed corruption to spread through the ranks of politicians, military officials and businesses, it has also built up substantial structural risks within the Chinese economy, drastically increasing the system's exposure to internal and external shocks. There is effectively one encompassing structural risk – debt. The massive amounts of corporate and sub-national debt accumulated within the Chinese economy are an urgent matter, directly threatening the success of the country's ongoing economic transition. However, debt is symptomatic of deeper issues at work: economic inefficiency, misguided policy, and shadow economic activity – chiefly, shadow finance[31]. The latter has become a threat to the viability of the current financial and economic system (e.g. high levels of insolvency, bankruptcy, assets shortage risks) (Li, Hsu and Qin, 2014) and yet remains of crucial importance for some parts of the formal economy (e.g. SME [small and medium enterprise] capitalization) (Lu *et al.*, 2015).

The Xi Administration's other great campaign is that of nationwide deleveraging[32]. Since 2009, all of the major state-owned banks have slowly but surely cleaned up their balance sheets thanks in no small part to Zhou Xiaochuan (CEIC, n.d.). However, in recent years (mainly since 2013), their NPL ratios have rebounded slightly, possibly due to massive investments earmarked for the BRI, but these levels have remained well below their pre-2009 peak (above 5-6%). Regardless, insofar as the deleveraging campaign has been a practical operation in financial prudence, it has also allowed the government to implement many reforms that will yield a long-term benefit for the health of the Chinese economy, and 2018 has so far been a great year for financial regulation in the country.

One major structural change was the merging of the country's insurance and banking regulators into one superagency in April (CBNE, 2018). The CBIRC now has oversight over both sectors, allowing for more effective regulation as financial products are oftentimes intertwined in both businesses. Of course, this merger is also aimed at tackling much of the shadow finance activity that occurs in China's banking and insurance sectors. The creation of this superagency follows a concentrated crackdown effort on the country's fast-expanding shadow finance sector, which previously found a niche in China's then poorly regulated banking, insurance, mobile payments, peer-to-peer (P2P) lending[33], and the recent cryptocurrency industries – all of which have now been hit with new regulations (*Business Insider*, 2018).While this crackdown has inevitably driven large numbers of companies to bankruptcy and spooked investors, the long-term advantages for the economy as a whole are clear, with regard to financial stability. Further, in April, China's central bank, now under the direction of Yi Gang (易纲)[34], announced new regulations on the massive asset management industry, which has also grown at a rapid pace in recent years due to the country's tough capital controls (Reuters, 2018a). These comprehensive rules ultimately change the industry at a structural level, covering regulations such as leverage limits, banning implicit guarantees, and closing loopholes on arbitrage. The end goal, clearly, is to further improve the financial sector's stability and resiliency. And in another move to rein in corporate debt, the National Development and Reform Commission (NDRC)[35] – also known as the "small State Council" (小国务院) – announced in June that real estate and infrastructure companies, as well as local governments, will have their funds raised from offshore bonds limited to repaying existing debt, banning them from using such proceeds to invest in domestic property projects and replenish working capital (*South China Morning Post*, 2018). This appears to be a very timely regulation as the US Federal Reserve's aggressive interest rate hikes have left many firms in developing economies that borrow in USD insolvent, bankrupt, or on the verge of one or the other (Inman, 2018). Finally, China's sub-national government debt – which as of October could be much higher than what is publicly disclosed with Standard & Poors' analysts estimating at about USD 6 trillion (*CNBC*, 2018b) – has long been a major structural risk for the Chinese economy. Insofar as Xi's develeraging campaign has been about state-owned banks cleaning up their balance sheets, the other major target of the campaign consists of local governments (*Bloomberg*, 2018a). In order to tackle this issue, the government has implemented a number of reforms. For example, in September, the Chinese cabinet released new guidelines on deleveraging for 30 state-owned firms (Reuters, 2018c). However, these guidelines also address local government debt indirectly by prohibiting authorities from hiding financial liabilities through issuing corporate bonds. These guidelines follow an earlier set published in August which ordered local governments to find exactly how much debt has been accumulated over the past three years that has not been listed on their balance sheets, and accordingly create risk control plans (*China Daily*, 2018). Despite these efforts, there is still much concern over local government debt, especially since the pressure created by both the trade war and the BRI has created a need to simultaneously maintain economic growth while further consolidate financial stability. And in a rather contradictory move, in August, the banking and insurance regulator proposed to lower the risk weighting of Chinese banks' holdings of local government debt from 20% to 0, thereby signaling encouragement to stockpile on these bonds (Caixin, 2018). As reforms and regulations targeting local government borrowing are still developing, the situation remains both problematic and delicate as the central government must balance financial risks with the overall growth of the country. Needless to say, the Sino-US trade war is a major test for the CCP, and while it has created pressure for domestic changes in China, it has also created changes in the international landscape opening up new channels of opportunity for the Middle Kingdom to capitalize on.

3.2. Global Shifts

Global politics has shifted greatly since the 2016 US election. The Trump Administration has since shown the rest of the world that, ally or opponent, no one can predict what the president will do next and how he will respond to changing conditions. Consequently, we have seen a realignment of global geopolitics. An aggressive Trump and, by extension, US, has pushed various states into awkward positions.

Firstly, Sino-Russian relations have gained a new momentum as both states have become increasingly suspicious of the Trump Administration, given how hostile the latter has been to global economic interests (Bin, 2018) – not to mention the debacle that is Russian meddling in the 2016 election, and now, the unraveling of a highly sophisticated Chinese corporate espionage scheme stretching back years and possibly jeopardizing both US companies and the government. Sino-Russian relations have ebbed and flowed since the Sino-Russian split, but have seemingly reached a new high as emphasized by their recent large-scale joint military exercises.

However, the two states still have ample reason to remain cautious when dealing with one another, and it remains to be seen whether the forces of cooperation are stronger than those of competition in the Sino-Russian context. On one hand, China needs Russian oil and gas, just as Russia needs Chinese capital. Further, in a neighborhood full of states worried about China's rise, Russia remains a relatively more reliable ally as its concerns seem to mostly be preoccupied by NATO and its European borders. Just as much, the BRI's success is also heavily dependent on a friendly Russia. On the other hand, Russia already faces geopolitical pressure along its European borders, and its Middle East ventures have seemingly disappointing returns. Given the recent unpredictability of the US, especially if Robert Mueller's investigations draw damning evidence of Russian interference in the 2016 elections, and further threats from Islamic terrorism which could flood in from Central Asia, Russia's geopolitical position may be threatened. As such, Russia must remain vigilant of China's rise and intentions, especially if the BRI does prove to be a success and a rekindling of Sino-US relations sets the groundwork for a 21st century containment strategy against Russia. The same is true for China: poor relations with Russia could severely hamper efforts at an economic transition as the BRI would be stalled and oil and gas flows could be cut. However, despite these concerns on both sides, China ought to maximize this opportunity made in large part by Trump's election to pursue Sino-Russian relations to the highest possible extent and particularly focus on expanding the part of the BRI that runs through Russia. Any success, in terms of economic gains, that can be derived from the Russia route will help dispel some suspicion over China's intentions with the BRI, which will be critical to the overall success of the project.

The second global realignment is that of Sino-European relations. The two regions have had a similar experience dealing with the Trump Administration: both are long time trading partners of the US who have been the target of Trump's allegations regarding unfair trade practices. Regardless of whether or not those allegations have any truth to them, the Trump Administration did indeed put its money where its mouth is and slapped tariffs on various goods coming from the European Union and China. While the EU has long remained suspicious and fearful of Chinese capital and has been lukewarm towards the BRI, the region has now warmed up slightly to the Middle Kingdom. Of course, this may be due to a variety of domestic factors, such as the financial ticking time bomb that is Italy (*CNN*, 2018), the political attrition as fallout from the lack of any real progress on Brexit, and the recent wave of populism sweeping over the region. However, it is well within reason to include the Trump Administration's stance on trade as part of the reason for the

EU's recent change of attitude towards China. At least on a rhetorical level, the EU and China share a united front on the issue of global trade and globalization; that is, they have brought unprecedented wealth to many parts of the world and are a net benefit to all states involved, and that global cooperation and a rules-based international system ought to remain the status quo. This, of course, stands in stark contrast to Trump's rhetoric of "America First" and his blasting of globalization, as well as the frequent mentions of how the US has been ripped off by its trading partners.

The EU, however, remains in a rather awkward position. On one hand, its suspicions towards China are not unfounded at the least – as previously mentioned, the recent unraveling of China's corporate espionage scheme feeds into this suspicion; and the fear of Chinese capital buying up assets across the EU remains a common sentiment. At the same time, the EU – and China, too – has learned that the US, once the champion of a rules-based global system, can fall to domestic populism and lash out at its long-time allies and partners. In short, no individual or state is safe from Trump's ire, and what is more troublesome is that no one can seemingly predict what this administration will pull out next. The EU's worries are further amplified by the fact that China has not, outside of its rhetoric, made any strong gestures of how it will act as a superpower, and as such, China's intentions remain shrouded in mystery to outside observers and states. However, the global economic system must go on, and the EU must choose between sticking by its Atlantic ally or taking a chance at potentially forging a new alliance with a rising superpower that seemingly acts different from the US and Russia. In this case of Sino-European relations, China has much room to maneuver, and the potential gains are massive with little downside. For one, China can pursue new trade deals or renegotiate existing ones with the EU, now that the US has shown itself to be unreliable. In exchange, China can offer up more of its domestic market access to the EU, given that China will need to do so anyway for its economic transition. Further, China ought to leverage this period of uncertainty between the US and the EU, as well as the friction between the UK and the EU over Brexit, to pitch the BRI in a better light and be forthcoming about its role as superpower. If China is indeed for a rules-based global system as its rhetoric has time and time again broadcasted, then it must play a more active role in upholding this system. Whereas Russia needs reassurance from China on a geopolitical level, the EU needs reassurance on a leadership level – that is, it needs to know, or at least be satisfied, that an influx of Chinese capital or the interconnectedness that would be brought forth by the BRI between China and the EU will not be for some nefarious political objective and that China will not abuse its influence to meddle in the EU's domestic functions.

A final global shift is that of the smaller states in China's local cluster. Neighboring states, such as Vietnam, Malaysia, Thailand, and Cambodia have watched China's rise with suspicion and have been very reluctant to participate in Chinese-led initiatives. However, as with Russia and the EU, these neighboring states – especially South Korea and Japan – are also now placed in a position on the fence. On one side stands an unreliable US with a failed attempt at a pivot to Asia that has also turned inwards; and on the other a continuously rising China with an ambitious infrastructure project, but fielding an ever-growing military. These states could swing either way, and must watch carefully how the undercurrents of global politics shift. A key issue, for example, would be whether or not the US will return to a normal state of affairs – that is, whether the Trump Administration survives for another four years in 2020. However, this is further complicated by the possibility of an impeachment stemming from the Mueller investigations which will salt the wounds of an already divided American society. These states will of course reach their own conclusions on such issues; China can nonetheless play an active role in shaping how neighboring states perceive it. On this front, China needs to be extremely careful in how it deals with territorial disputes in the South China Sea. On one hand, territories are a matter of pride and nationalism for China. On the other, outright aggression and disregard for other states involved will do little to further the BRI. In recent years, we have seen how these smaller states have responded negatively to the BRI[36]. For example, in early 2017, the Sri Lankan government's leasing of the Hambantota port drew ire from locals as protests erupted in the region. In a similar vein, both Pakistan and Malaysia have moved to curtail Chinese investment in their respective countries following leadership changes in 2018 – Mahathir bin Mohamad in Malaysia and Imran Khan in Pakistan (Schwemlein, 2018)[37].

That being said, China's unchallenged economic clout – both in terms of export and import volumes – in the region offers it a unique opportunity to act as an organizing force for the Asia-Pacific. Just as these local states have become uneasy at the BRI, they also require economic windfalls to further develop their economies and hedge against rising US interest rates. For example, even as Pakistan has moved to curtail Chinese investments, it has simultaneously moved to conduct bilateral trade in RMB in October this year out of necessity to ease mounting financial pressures on its economy (*VOA*, 2018). However, while the project's ambitions are grandiose, they need to be grounded in reality; that is, as we have seen with regard to the growing negative sentiments to the BRI, China will need to spend much more effort courting the states in its local cluster to realize this project – insofar as these neighboring states are all united in their pursuit of economic interests, they are also united in their mutual distrust of China, and a divide and conquer strategy may not work to the Middle Kingdom's advantage in this case. Dealing with its neighborhood, China must realize that as much as everyone is worried about their own economy, they also worry about how China acts as a regional power.

4. Conclusion

At the time of this writing, China and the US are still locked in this trade war, with no clear ending in sight. Fortunately, we remain at the stage of tariffs, which means that the more devastating geoeconomic tools have not been deployed by either side, despite Trump's repeated accusation of Chinese currency manipulation – which the US Treasury has recently refuted (U.S Department of the Treasury, 2018). Insofar as this trade war has the potential to inflict incredible damage to a fragile global economy and further erode trust between the world's two largest economies, it has also provided China multiple avenues of opportunity.

While China's one-party state must survive through a continuous provision of socio-economic goods to its populace, it can use the trade war's economic pressure to push forward unappetizing reforms to reorient its decades-long export-led development model towards a more balanced economy with an emphasis on imports and consumption. Years of reliance on exports has infected China with a plethora of challenging issues which threaten to derail its economic success and ultimately, the hard-earned political consolidation of the CCP. Of course, the ruling party is undoubtedly aware of these issues and would have rolled out these reforms despite the trade war. However, the latter imbues these reforms with a sense of legitimacy and urgency.

On China's geopolitical chessboard, the trade war – and the Trump Administration's general hostile attitude towards the rest of the world – has created a rather awkward situation for many states. On one side is an essentially rogue US that has fallen to the flames of populism, rebuked its traditional allies, praised dictators, and become hostile to an international system it once built and chaired. On the other, a nominally communist China that has made repeated remarks on the global stage about how it will uphold a rules-based international system and champion free trade. Now that the US has more or less fallen as the once reliable pillar for many small states, China's BRI seems like a positive-sum project with no strings attached. However, while China's rhetoric seems welcoming at face value, its increasingly aggressive posture and actions in its local neighborhood have made the global community adopt a very skeptical and guarded stance. Whether or not China can use the trade war as a gateway to winning diplomatic and thereby, economic, gains will depend entirely on the astuteness of the CCP. However, China has thus far placed much of its chips on the success of the BRI, which is intrinsically tied to the success of its economic transition. China will need to understand that mutually beneficial economic gains between itself and other states is not sufficient for bilateral and multilateral cooperation. Its image on the global stage – which is ultimately a way for states to assess how China will operate as the new superpower – is just as, if not more, important.

Notes

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1. Currently under the direction of Guo Shuqing (郭树清), an ally of former premier Zhu Rongji (朱镕基) and an associate of the central bank's ex-governor Zhou Xiaochuan.
2. Liu He, Xi's main "economist", is currently part of the Politburo, vice-premier and director of the small leadership group on finance and on the economy. Liu, who has long experience inside the Planning Commission and the subsequent Development and Reform commission, is said to "imitate" the style of Zhu Rongji even if he was not necessarily one of Zhu's top picks for leadership positions in the 1990s.
3. Mainly the result of the early reform era (1978-1983) policies of blind lending to newly formed state-owned enterprises (SOEs) and town-village enterprises (TVE) – or simply lending to keep them afloat in order to maintain high levels of employment – NPLs have "pushed" the privatization of former SOEs back in the mid-1990s but have also been a key problem for China's entry into the WTO in 2001. NPLs, sometimes

"forgotten", are making a comeback as Chinese companies enter the international market and pursue listings on stock exchanges (i.e. pressure to declare bad debt to prospective investors). According to the CBIRC, the current NPL ratio sits at 1.8% (more than USD 220 billion).

4. In some parts of Hebei, according to our local source, local cadres are helping locals to secure loans to buy real-estate even if they cannot afford it only to supply housing market production (i.e. sustaining the bubble) (Zhao *et al.*, 2017). Furthermore, NPL were found to have a negative impact on real estate prices (Wan, 2018).
5. Far from being a new idea at this point, a domestic-focused economy has been discussed since the 11th five-year plan (2006-2010) and again in the outline of the 12th (2011-2015). At the time, when energy production and consumption was the main issue, the plans suggested a strong turn towards domestic production in contrast to external dependency.
6. On September 30, 2018, China's finance ministry announced that, effective November 1, tariffs on a wide range of textiles and metal products, including steel, will be cut down to 8.4% from 11% (Reuters, 2018e).
7. To this effect, this point of view runs contrary to the prevailing opinion that "Xi is under pressure" or that "Xi is facing discontent inside the Party". Factionally speaking, none of these two statements can be deemed true simply because of the sheer number of allies Xi has placed on the provincial political scene (i.e. governors and party secretaries alike), inside the party structure (e.g. organization department, united front department, party schools, etc.) and in the overall state administration (e.g. State Council, leading ministries and bureaus) since 2013 (thus tossing aside or simply jailing – by way of the anti-graft campaign – "old" political opponents such as Jiang Zemin's (江泽民) men and Hu Jintao's (胡锦涛) "tuanpai" (团派). As such, Xi is by far the most powerful figure inside the CCP at the moment, and dissent or pressure from other factional groups is improbable at best.

8. An earlier discussion of this topic back in 2015 for the French National Defense journal (Sun and Payette, 2015).
9. It is believed that under current circumstances, this will be one of the first generations (the one that entered the job market in the 2000s) who will fare worse than their parents.
10. During one instance, more than 60 000 workers in the IT sector were laid off in Shenzhen during the 2008 crisis (Lüthje, Hürtgen, Pawlicki and Sproll, 2013).
11. In contrast to a simple "political crisis" or a "party crisis" which does occur in some Western democracies, thus leading to elections.
12. As the logic was that the party was best suited to control and distribute economic development in China.
13. Similar in many fashions to the Japanese model back in the late 1980s (Sakikawa, 2012).
14. For some, like Karry Lai, shadow banking could represent as much as RMB 65 trillion (Lai, 2018).
15. On September 7, 2018, in an interview with *Bloomberg*, Zhou echoed his earlier warning and stated that while the Sino-US trade war has a limited impact on the Chinese economy considering the latter's size, market sentiments could change suddenly and wipe out investor confidence (*Bloomberg*, 2018c).
16. Local governments as in prefecture-level cities, counties or even township-level entities. This is more likely to happen in resource-rich regions as an SOE or TVE may be one of the sole employment providers (as proven by the case of coal in some parts of Shanxi, or of both ferrous and non-ferrous metals in Inner Mongolia) and tax payers. Considering the dire situation of many of these localities (i.e. drastic budget cuts affecting payroll and all forms of local investments), not pandering to these SOEs or TVEs is simply not an option. Lastly, up until recently, many of these sectors (mining, oil, and even grain in Anhui, for example) were tied to Jiang's

ancien régime, wherein individuals allowing for corruption and rent-seeking spaces were, in most cases (but not all), first-, second- or even third-degree allies of Jiang's lieutenants, such as Su Rong (苏荣), Ni Fake (倪发科), and Chu Bo (储波).

17. This is especially important for SOEs, which are the preferred contractors for BRI infrastructure projects. Chinese SOEs employ vast portions of the population and are considered crucial for national security, but are generally inefficient – to say the least – and have in recent years faced mounting economic pressure from both the market and the state to trim down and deleverage. However, the BRI has breathed new life into many Chinese SOEs allowing them to extend their corporate lifespans a little longer to work on infrastructure projects (Watts, 2018).
18. While China's currency basket – of which the RMB is pegged to – comprises most of the world's major currencies, the overwhelming role the USD plays in the RMB's exchange rate is undeniable. The relatively low liquidity of the EUR, CAD, or the SGD, versus the USD means that changes in those currencies affect the RMB much less.
19. We are referring to the Triffin Dilemma. Formulated by Robert Triffin in the 1960s. The dilemma posits that the issuer of an international currency runs into a conflict of economic interests between its short-term domestic policy objectives and the long-term demands of those countries that hold the currency in its foreign exchange reserves, and by extension, the interests of the global economy (McKinnon, 1996).
20. With the possible exception of China, which has a number of large oil fields. However, they are not sufficient for the country's needs (Payette and Mascotto, 2011), and at the end of 2013, China became the world's largest net importer of petroleum. Furthermore, while the South China Sea has large deposits of petroleum, the region remains hotly contested among the bordering countries (US Energy Information Administration, 2015).

21. While crude oil is indeed traded on the Tokyo Commodity Exchange, the volume of contracts pales in comparison to those of WTI and Brent (TOCOM, n.d.).
22. Tokyo's crude oil futures have so far failed to establish themselves as the regional benchmark. This may be due to a variety of reasons, including Japan's low domestic demand for crude, and the relatively low liquidity of these contracts versus WTI or Brent.
23. Most studies on the BRI focus on the regional/international impact the later will have on the new leadership role that China will have to assume or on how the BRI is actually a new grand strategy aiming at becoming the new superpower (Beeson, 2018; Schortgen, 2018; Clarke, 2017). We are leaving out the literature dedicated to political risk (in terms of foreign investment, local investment, special insurance, etc.) as it is not relevant to our discussion.
24. However, some observers noted that perhaps the policy research center of the Central Committee, still headed by Wang at the moment, should be led by one of Xi's men instead of someone who still represents the Jiang era.
25. Thus being in clear reference to what can more or less be expected of a state following some theoretical tenets of the "developmental state".
26. Mirroring the experience of Japanese *zaibatsu*s (財閥) shielded by the MITI (Ministry of International Trade and Industry) back in the early 1980s.
27. In this case, we mainly refer to sectorial factions like the Oil Faction, led by (during the 1980s onwards) Zhou Yongkang (周永康) – which still has roots in the oil sector today; the Inner Mongolia Faction, previously led by Chu Bo and its local mining industry; and many other regional subgroups led by party members in Qinghai (oil), or in Guizhou (mining). In turn, natural resource extraction and transformation had become the turf (rent space) of several individuals tied to Jiang's *ancien régime*.

28. Most of the high-profile targets who were put under investigation and sentenced had ties to the systematic corruption set by the gradual approach to domestic reforms back in the 1980s. As such, clearing the slate might have prevented, and we generalize here, further pressure on an already fragile economic system.
29. As Chen Jie pointed out, this class, despite not being necessarily "pro-democracy" (in part because it owes its place and wealth to the party), are rather "pro-law" and "pro-procedural formalization". They might be agents of the status quo, but at the same, the party needs to provide more social and economic goods to the latter to ensure co-optation (Chen, 2010).
30. Which has been the way in which reforms have been implemented since 1978: enacting tentative reforms and projects followed by unintended consequences and adjusted by subsequent new reforms and adjustments. The creation of the Shenzhen Economic Zone back in the 1980s and even the incremental privatization of land communes in central China followed this pattern.
31. Some of these issues have been previously tackled in the academic literature (Taylor-Armstrong, 2016).
32. As Chan argues, deleveraging will need to be accompanied by more in-depth structural supply-side reform in order to actually be impactful (Chan, 2018).
33. Lots of issues have already been assessed in the academic literature when it comes to P2P lending (Lin, Li and Zheng, 2016).
34. Yi Gang, part of the "reformers", was also one of Zhu Rongji's protégés and an ally to both Zhou Xiaochuan and Guo Shuqing, current CBIRC chief (Payette, 2017).
35. The NDRC is currently directed by He Lifeng (何立峰), one of Xi's Fujian-based allies.

36. On the other hand, when it comes to larger states like India, some have argued that the BRI could benefit the latter and could even promote cooperation between the two states (Baruah and Mohan, 2017).
37. Other recent works have underlined the tensions between the BRI's objectives (in terms of regional infrastructure and investment) and smaller states (Deepak (ed.), 2018), while others, like Chen Shaofeng (2018), have argued that changes in local elites' perspectives highly depend on the degree of trust (towards China), local leaders' ideology (pro- or against China) and local social responses (social unrest vs. acceptance).

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