China's Foreign Policy Under Xi Jinping: Implications for Latin America

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China's foreign policy is shaped primarily by two factors that are central to the legitimacy of the Chinese Communist Party: economic development and nationalism. This creates important linkages between domestic politics and foreign policy that have implications for Latin America.

September 2016 is a good time to look at this question because it marks the fifteenth anniversary of the completion of China's negotiations to join the WTO. It is also 8 years since the deepening of the Global Financial Crisis, which forms a mid-way point between WTO entry and the present. Next year will also be the CCP Congress, when a new leadership will be put in place around Xi Jinping, who will presumably serve for another five years.

Over this period China has followed the economic model of development pioneered by Japan, South Korea and Taiwan, moving from what economists call the 'resource mobilisation' stage of development to a new stage of pursuing economic efficiency. Whether this succeeds will determine the balance of economic and geopolitical power in the remaining years of Xi Jinping's leadership.

WTO entry, regional multilateralism and domestic reform

The links between domestic economic reform and foreign policy became particularly clear around the time of China's WTO entry. Domestically, entering the global trade system provided leverage to force through radical domestic reforms to deal with the economic and political crises of the first stage of reform, an opening that began in the late 1970s. The main political problem that had to solve was the reform of inefficient SOEs in order to upgrade industry.

This had important implications for foreign relations and the global economy. One reason was attempt reform the SOEs by singling out the best to as National Champions that could be fostered to become multinational corporations under the 'Going Out' strategy.

At the same time, China took most observers by surprise by taking a role in regional multilateralism by announcing an ASEAN+China FTA. Its purpose was to secure access to resources for China's export sector.

This had important implications for security and foreign policy because it took the leading role away from Japan and isolated Taiwan. It also increased China's ability to exercise its influence over the sea lanes linking it to the Middle East and Europe, vital for its access to energy and trade.

These measures were also important for maintaining the export led model of economic growth that had been pursued since the late 1970s. Resources could be imported from the SE Asian states that were needed to manufacture products in for export to the US and EU.

This could work so long as demand in the US and European markets was strong. The SE Asian states benefited from high commodity prices. But they also became increasingly dependent on China. This in turn gave China additional leverage over those states when disputes later developed over maritime territorial claims.

The period 2001 to 2008 was thus highly successful for China's leaders, both economically and in foreign policy. WTO membership made China the manufacturing centre of the world and this created foreign policy power. The Chinese leadership under Hu Jintao took advantage of this position to advocate the doctrine of a Harmonious World, a 'good neighbour' policy in its own region and alignment with the Global South – starting with Africa then moving on to Latin America. According to this policy, China should be seen as an economic benefactor, providing soft loans and aid with no conditionality. As China's economy continued to grow, the Global South prospered from rising commodity prices.

These policies, however, also sowed the seeds for serious problems that would become more evident after 2008.

Linking domestic problems and international relations

Central to these problems was the determination to mobilise resources to support the export-led model of growth. This required measures that distorted China's economy and contributed to the serious imbalances in the global economy that became apparent in 2008.

Particularly important were the polices of financial repression (artificially low domestic interest rates and controls on the export of capital), used to maintain a low value for the RMB. This kept consumption low by depriving domestic savers of the fruits of their savings. It also created imbalances with the US as dollars earned from exports were taken out of the domestic economy through purchases of US assets and securities. This flooded the US with capital that was lent to US consumers, becoming a main cause for the real estate bubble that burst in 2008.

While China was thus gaining a leading position in its own region, frictions developed with the US over trade and currency. This was also a growing issue in Europe as Chinese labour was kept artificially cheap by financial repression, which added to unemployment in advanced economies.

The domestic problems arose because the export-led model depended on a very high level of investment. This came partly from state banks directing investment to inefficient SOEs. While there were large inflows of FDI (encouraged as much by the low level of the currency as by low labour costs), the most productive firms were under the control of foreign firms and investors. In most of the economy labour productivity remained low.

The reforms also caused growing political and social divisions. Many Chinese social scientists now see one of the biggest political problems of the ‘China Model’ is the rise of interest groups, ranging from SOEs, to ‘Princelings’, private entrepreneurs, the newly propertied middle class and the military. All had a stake in maintaining the system whereby capital is directed towards their own interests rather than allocated by the market.

Particularly serious has been the property bubble, which grew out of a massive transfer of capital from state to households through urban property privatisation 1998-2003 (with no capital gains tax). Many sections of the population who lacked connections or capital did not benefit. Particularly hard hit was rural society which was not given the opportunity to buy houses. Results of this can be seen in conflicts over agricultural land, the waste of savings in the property bubble and the emergence of the disenfranchised ‘floating population’ of peasants who move to cities where they have not access to social welfare, health and education. Meanwhile, local governments have exacerbated the situation by appropriating agricultural land for development. This inequality reached a peak in 2008-9 when the GINI coefficient hit 0.49.

At the same time as the export led model was causing domestic problems it contributed to the imbalance in the global economy. By 2008 Investment had reached an historically un-precedented proportion of 41 percent of GDP, far more than the levels achieved by Japan, S Korea, Taiwan in their phases of resource mobilisation. The current account surplus (which includes services) reached a peak of nearly 9 percent of GDP in 2007. At the same time the US current account deficit rose to just under 6 percent.

The Great Rebalancing

The 2008 crisis can thus be seen as the start of a process of rebalancing both the Chinese and the global economies. Change was forced on China when the collapse of the financial systems in the US and Europe led to 20 percent fall in China’s exports in 2009. 23 million workers lost their jobs.

When the Chinese government realised it could not rely on export markets, however, its response was a massive increase of domestic investment. An initial US$590 bn grew to probably over double that figure over the next two years. Much of it was through loans (largely local government) which just lead to more inefficient infrastructure investment. Rather than reduce investment, it grew from 41 percent of GDP in 2008 to 46 percent in 2010-13.

This failed to address the two key, interlinked problems of the mobilisation development strategy: productivity and household consumption.

Labour productivity growth has fallen steadily since 2008 (USD 7,318) and is now back to 1999 levels. It is less than one tenth of productivity in the US, EU, Japan (this will be a big problem as the population ages). Whereas 3 to 4 dollars created one dollar of growth before 2007, this rose to 5 dollars by 2013. According to the OECD, between 2008-12, three quarters of growth from capital accumulation, and less than a quarter from productivity growth.

One reason for this low productivity is that capital is diverted to export industries and infrastructure rather than though household consumption. In China household spending has been less than 40 percent of final demand in recent years, compared to 60 to 70 percent in developed countries. While there is conspicuous consumption in China, it has been largely focused on luxury goods and on section of the urban population. This is again reflected in the GINI coefficient, which has only been reduced from 0.49 in 2008-9 to 0.47 in 2014. The top 10 percent of households own 85 percent of assets.

Xi Jinping's strategy

These developments show a failure of the aspirations of the Five Year Plan (2012-17) and the 'Decision' of the Third Plenum of the 18th Congress in 2013 to try to shift the economy from resource mobilisation to efficiency. Measures that have been introduced include some liberalisation of interest rates, reforms to the fiscal system to make local governments more accountable, some liberalisation of banking system – with the emergence of private banks.

There have been some positive outcomes. Reliance on exports has declined since 2008 and is back to 1990s levels. In 2013 the value of services was greater than combined value of industry and construction for the first time (in 2014 services were 48 percent of economy, industry and construction were 42 percent). Housing construction has slowed. GDP growth was 6.9 percent in 2015 and jobs were being created.

However, it seems that the reforms have now come to a halt and may even be reversing due to domestic political problems. First, it is unclear how committed Xi is to moving towards economic liberalisation. This is encapsulated in the 3rd Plenum 'Decision', which emphasised that market forces would play a *decisive* role but also reaffirmed that the state sector should have a *dominant* role.

This reflects again the strength of entrenched interest groups. Particularly important are local governments which have poured money into SOEs and even into overseas real estate. Particularly controversial is the attempt to use private enterprises to reform the SOEs through joint ventures. While this is supposed to make the SOEs more efficient, however, it tends to drag down the private firms. More important is that creates political problems as workers resist 'privatisation'.

This became particularly evident when workers in Northeast China took violent measures to resist the role of the private sector in the steel industry in 2008. Yet such regions are most in need of reform. While China as a whole can claim to be growing, regions like the Northeast are in recession. Yet these are the foundation of Communist Party Support.

Xi's economic reforms have thus been stalled by political obstacles. Too many interest groups benefit from the resources allocated under the mobilisation strategy by using privileged access to resources for SOEs and through property accumulation. The result is low productivity and growing debt, which surged to 230 percent of GDP in 2013 – most of it due to local governments and SOEs. Yet much of the infrastructure needed for resource mobilisation has already been constructed. Chinese capital thus needs to look overseas. Yet the biggest problem in the global economy is lack of demand. Policies are thus needed to create export markets.

Implications for foreign policy:

The domestic situation in China has complex implications for foreign policy and China's international relations more generally. The most salient initiatives under Xi Jinping have spanned economic and security arenas.

These are the establishment of the Asian Infrastructure Investment Bank (AIIB) and the BRICS Bank (or New Investment Bank), plus growing assertiveness in China's maritime territorial disputes. Such initiatives are too often treated separately by academic observers, but they grow out of the same set of domestic problems, centred on the need to maintain stability in the struggle for power and resources amongst interest groups.

Take the Belt Road Initiative (BRI). Originally launched as 'One Belt One Road' by Xi Jinping during a tour of Kazakhstan and Southeast Asia in 2013??, this is presented as a way to develop international trade and development. Yet Chinese commentators make it clear that its aim is also to export China's excess industrial capacity. In addition to this, it is said to have the geopolitical purpose of exerting Chinese control over the Eurasian landmass and the oceans according to the geopolitical theories of Mahan and Mackinder.

Equally important is that it has now been rechristened the BRI because it has grown from one road between China and Europe and one sea-lane between China and the Middle East to become a spider web of routes going off in all directions.

The explanation for this lies not so much in economics as in the need to accommodate the demands of key interest groups. SOEs benefit from finding outlets for their excess capacity that is no longer need for large domestic infrastructure projects. These work with local governments, every one of which has developed its own BRI strategy.

One of the most interesting examples for Latin America is that of Macao. At present the Special Administrative Region is developing a BRI strategy that will maximise its links with the Portuguese speaking world. Brazil thus becomes a post on the maritime Silk Road. Equally important is that the advocates of BRI in Macao see it as a way to use their own excess capital, which has come from gaming. Some 80 percent of the territory's GDP is derived from casinos, whose main customers are the nouveau riche and well-connected from mainland China.

The circle of capital from SOEs to well-connected individuals to Brazil via BRI via Macao can thus be seen. It seems unlikely that this will contribute to solving the basic problems of low productivity and lack of consumer demand in China. It is also far from clear whether this transfer of surplus Chinese capital will be good for receiving economies such as Brazil, unless it goes into high quality investments.

This close relationship between interest groups and the allocation of resources also has implications for the internationalisation of the Renminbi. While the government has promoted this since the financial crisis as a way to spread risk and reduce the power of the United States, its most significant opponents are domestic. This is because internationalisation is inconceivable without a well-functioning capital market that is integrated into the global financial system. The transparency and efficiency that this requires is antithesis to those inside the Chinese system who benefit most from the misallocation of resources.

The other way in which China's domestic problems spill over into foreign policy can be seen in the combination of economic strategy with nationalism. This is already an element of the BRI. But it is more disturbing in the rise of maritime assertiveness. This phenomenon is more than mere geo-strategy, however. It has more complex domestic political dynamics.

History provides examples of previous cases of late-industrialising powers that have turned to nationalism as a way to divert attention from domestic problems. In addition to this, nationalism can be used to build coalitions between interest groups that benefit from economic change but resist political reform.

From this perspective it is possible to understand Xi Jinping's ideological policy of opposing Western influences and holding large military parades as part of his measures to concentrate political power in his own hands. It often goes unnoticed that the 'Strong Army Dream' is a component of his ideology of the 'China Dream'.

This can appeal not only to elements of the military but also to parts of the urban middle class who do not want to see the transfer of capital to those who have been left behind by the boom years. It is thus significant that the most wealthy coastal cities are exempted from the policy of increasing urbanisation and liberalisation of the *hukou* household registration system, which only applies to cities with a population of less than 3 million.

Conclusion

It has been argued above that China's domestic politics and international role are still shaped by problems that have their seeds in the country's acceptance as a member of the global economic system sixteen years ago. The financial crisis brought these problems into relief. Rather than deal with the structural problems that have linked China's imbalances with the destabilisation of the global economy, however, the government has reverted to its safe zone of relying on investment in infrastructure and creating and developing export markets.

Whether this succeeds will depend to a large degree on whether demand recovers in the US and EU. Even if this does happen, however, China's determination to continue to export its over-capacity through export-led policies is likely to lead to trade wars and crises in diplomatic relations and security issues. Far better would be for China to increase global demand by raising its own level of household consumption. If this means running a trade deficit, then welcome to the club of advanced industrial nations!

If China does move in this direction it can only be good for its relations with the Global South. Instead of relying on the export of commodities to China, growing consumer demand will boost indigenous industries, such as food and wine, which are already continuing to grow as the price of commodities such as copper falls.

At present, however, projects such as BRI show that old habits die hard. The same can be said of initiatives such as the sponsoring of Chinese enterprises, such as textile manufacturers, to locate in Latin America. This is not a solution to anybody's problem because it merely increases over production and threatens to displace indigenous enterprises.

This course is liable to continue, however, unless China's leadership is able to permit a more significant degree of economic and political liberalisation. The country's continued failure to take a lead in any cutting-edge field of technology is a consequence of the way in which intellectual creativity is stifled by a leadership that lacks the confidence to loosen its grip on power.

This need not mean the collapse of China. More likely is the kind of stagnation that has beset Japan since it clung to its export-focused economic model well past its sell-by date. Yet the only way that China can adapt to the demands of a greying population is to increase labour force participation and worker productivity significantly, and fast.

In conclusion, the current stalemate in China means that it is unlikely to be the super power of tomorrow or that its economy will overtake the US economy in GDP. Aspirations for global leadership, such as RMB internationalisation, will be severely constrained. The direct consequence of this will not be severe for Latin America, because China will still be an important source of trade and investment. Far more serious are the consequences for China's neighbours as the leadership looks to nationalism to build support while the economy stagnates and domestic divisions grow deeper.