FOREIGN AFFAIRS
6-12-2022

The New China Shock

How Beijing's Party-State Capitalism Is Changing the Global Economy

By Margaret M. Pearson, Meg Rithmire, and Kellee S. Tsai

Beginning in the late 1970s, China's opening to global markets caused an explosion of optimism and trade. Economic interdependence with China, many said, was the pathway to peace and prosperity, in Asia and beyond. Ties between American businesses and the Chinese economy anchored the relationship between the United States and China and were seen as evidence that China was being "pacified by globalization." Some observers confidently declared that the Chinese Communist Party (CCP) was "playing our game" in the neoliberal world economy. Immanuel Kant's assertion that "the spirit of trade cannot coexist with war" became received wisdom once more.

That has changed in the past 15 years or so. Decades of policy that encouraged cross-border flows have been rapidly reversed as the United States and other nations have erected unprecedented barriers to Chinese capital and trade flows in the name of national security.

This shift was driven largely by the CCP's changes to China's model of political economy, which began to appear incompatible with global capitalism. In the wake of the global financial crisis of 2008, China began to move away from the market-based approach that had shaped its economic policies for three decades, and toward something that might be termed "party-state capitalism," which involves a high degree of CCP control over strategic sectors of the economy. This has led to significant changes in the U.S.-Chinese economic relationship, as both sides have made efforts to secure supply chains, screen inward and outward capital flows, diminish the power of global firms, and reorganize alliances to protect against economic coercion. The effects of this dynamic go well beyond the U.S.-Chinese relationship: the economic arms race between Washington and Beijing has changed the shape of global capitalism.

PARTY-STATE CAPITALISM

In the 1980s and 1990s, China embraced market mechanisms, including foreign investment and some autonomy for private businesses, as solutions to economic problems. In recent years, however, this has ceased to be the case. Instead, as political and economic challenges have arisen, the CCP's response has been to assert itself and exercise its power.

From around 2005 to the mid-2010s, the CCP reacted with concern to what it regarded as a set of domestic and international threats. The so-called color revolutions in eastern Europe, domestic unrest in Tibet and Xinjiang, and the Arab Spring led an increasingly paranoid CCP to adopt a strategy of "preventive repression." Meanwhile, the party's leadership became increasingly anxious that China's overreliance on low-end manufacturing and dependence on foreign technology would compromise the country's security. These concerns escalated in 2014, when the former U.S. National Security Agency contractor Edward Snowden revealed that the NSA had spied on the Chinese telecom giant Huawei. Thereafter, the CCP became obsessed with risk management. The party's fear of financial instability, strengthened by the global financial crisis of 2008 and China's domestic debt woes, led it into a cycle of failed reform attempts as leaders searched for a way to avoid the potential economic and social instability associated with market forces.

Beijing's leaders seem to believe that they have found a solution with a shift to party-state capitalism, an evolution that has seen the CCP adopt an increasingly heavy-handed approach to strategic sectors of the domestic political economy. This represents a dramatic reversal. One of the defining features of Chinese reforms that began in the late 1970s was a willingness to experiment with creative solutions to socialist-era constraints on private-sector development. Informal finance supported the growth of China's manufacturing capacity led by tens of millions of private small and medium-sized enterprises, as local governments competed for foreign direct investment to promote local economic development. As China became the world's factory, the state concentrated its attention on the "commanding heights" of the economy in strategic sectors, such as finance, telecommunications, natural resources, defense, and shipping.

Today, however, the regime's economic activism extends well beyond those sectors. Beginning in 2013, the government began passing a steady stream of laws on cybersecurity, national intelligence, and data security that grant authorities immense power, requiring firms and individuals to assist the state on security issues. In 2015, the government purchased minority stakes in around half of all the private firms listed on the Shanghai and Shenzhen stock exchanges. In recent years, the CCP has made massive investments in the Chinese economy though initiatives including Made in China 2025, which mobilizes government capital to support advanced technology sectors, with a particular focus on semiconductors and artificial intelligence.

Meanwhile, political imperatives have come to trump economic ones. Multinational corporations, once greeted with a red carpet in China, are now subject to political pressure if they cross the CCP's redlines. In 2019, when Daryl Morey, the general manager of the Houston Rockets basketball team, tweeted in support of protestors in Hong Kong, Chinese media outlets declared that they would no longer broadcast the team's games. The National Basketball Association quickly distanced itself from Morey's remarks, but that wasn't sufficient to placate the CCP. NBA games disappeared completely from Chinese broadcasts until 2022, costing the league hundreds of millions of dollars. Domestic business elites are treated even more harshly if they criticize the government: some are imprisoned, and others have their empires dismantled.

This has led to a blurring of the line between the party-state and private firms, which has caused deep suspicion among western policymakers, who fear that the often opaque presence of the CCP turns Chinese companies into potential political actors. Whereas Chinese private firms were once hailed as the potential protagonists in the story of China's political liberalization, now, in the words of Senator John Cornyn, Republican of Texas, who has sponsored several measures to decouple the U.S. economy from China, "there is no real difference" between a private Chinese firm and the Chinese state. Instead of forces for cooperation, Chinese firms are seen as potential weapons.

BUILDING BARRIERS

The perceived threat of Chinese firms has led other wealthy nations to erect defenses, managing their own economies with a fixation on national security. Although many local jurisdictions and business interests are hungry for investment, including from China, many developed countries are establishing new investment screening mechanisms or strengthening existing ones. Each month brings new restrictions on exports to Chinese firms. The United States, long viewed as the champion of free flows of capital and goods across borders, is now considering outbound review mechanisms—capital controls on U.S. firms and investors—to prevent U.S. interests from becoming entangled with Chinese firms.

These moves are mostly defensive, and are designed to keep Chinese businesses out of critical parts of the U.S. economy. Some of these initiatives may be self-defeating, however. For example, the U.S. Department of Justice's China Initiative, which sought to prosecute potential Chinese spies in American universities and companies, likely repelled a generation of talented Chinese scientists from coming to the United States. By the same token, decoupling from China in clean energy by avoiding its renewable energy products and low-carbon technologies may do more harm than good.

Washington has also gone on the offensive. The CHIPS and Science Act, and elements of the Inflation Reduction Act, both passed this year, take unprecedented steps to channel investment into priority sectors, including directing federal funding toward technological advancement. These pieces of legislation bear a remarkable resemblance to Made in China 2025.

Beijing's attitude, meanwhile, is primarily defensive. The CCP's leaders regret their country's historic dependence on foreign companies for important products, including semiconductors. They do not want China to spend the coming decades manufacturing low-end items for export. They want domestic champions and domestic technology. Their policies were developed to catalyze self-reliance. The wisdom of this approach was seemingly confirmed as the United States and others began to use their influence to try to contain China and its firms.

But this is not the approach of a regime ready to walk the world stage confidently. The CCP is the opposite—a leadership obsessed with its own weaknesses and fearful of the difference between its economic profile and that of its competitors. At the same time, the CCP has transformed from a responsive, if illiberal, regime to one increasingly reliant on repression and techno-surveillance.

SHOCK TO THE SYSTEM

The effects of the economic "China shock" are well known: in the first decades of China's reform and opening, the emergence of a large economy with low labor costs had a profound impact on manufacturing jobs in the West. With the entrenchment of party-state capitalism, the West is experiencing a political China shock, as governments move to erect barriers to Chinese investment and to jump-start their own countries' industrial policies. Some reactions may be sustainable, such as investment in critical technologies, so long as the political will remains. Others, such as expansive reviews of outbound investment, are less likely to succeed, as investors will constantly seek out workarounds, creating a never-ending game of cat and mouse with regulators.

Like the oil shocks of the 1970s and the rise of the knowledge economy in the 1990s, China's embrace of party-state capitalism has created a once-in-a-generation inflection point. Western governments should use this decade to rethink the role of the state in the economy—and the rules of capitalism, more broadly. Some options include transnational and collaborative rules around standards, openness to trade and capital flows in high-tech sectors, and interdependence with China. Some have already taken steps in this direction. One example is the Transatlantic Trade and Technology Council, an EU-U.S. collaborative effort to set rules for trade and technology, to address the security implications of China's model.

Undoubtedly, as the United States and other countries consider how their governments can better guide transnational commerce and competition with China, conflict will arise with allies over new forms of industrial policy and the optimal design of the institutions that govern trade and technology. If each country goes it alone to protect its national interests, the prosperity produced by decades of globalization may be jeopardized. But China's unique challenge to global capitalism also creates opportunities to reevaluate priorities and address security concerns. Handled thoughtfully, this political China shock may catalyze a new era of prosperity, and grant a renewed legitimacy to transnational capitalism.

- MEG RITHMIRE is F. Warren McFarlan Associate Professor of Business of Administration at Harvard Business School.
- MARGARET M. PEARSON is Dr. Horace V. and Wilma E. Harrison Distinguished Professor in the Department of Government & Politics at the University of Maryland.
- KELLEE S. TSAI is Dean of Humanities and Social Science and Chair Professor of Social Science at the Hong Kong University of Science and Technology.