

China's Economic Crisis and Its Foreign Policy

by George Friedman - October 5, 2021

China has reached a critical point that many countries often reach and that, however painful, is cleansing in the long term. Consider what happened to the mighty United States during the Great Depression. Tragic though it was, it cleared the way for a new economic and social model. The crisis started through optimism – a new economic dynamic emerged that was so successful it created the illusion that it was eternal. Eternity bred recklessness and thus created massive imbalances. The economy reached the limits of one model and then passed through the crucible that led to the emergence of a new one.

Such crises tend to belie the underlying social and political problems at work. The cycle works like this: A great deal of wealth is lost by people who nevertheless remain wealthy. Much less is lost by the lower classes, but their loss is existential. The lower classes, we learn, need to be cushioned. The political system must assure social and political stability while at the same time managing capital allocation. As it manages capital, it appears to favor the rich, thereby increasing unrest. The New Deal generated a massive populist movement demanding that the rich be soaked. The upper and upper-middle classes see such programs as a violation of their principles and interests. In the U.S., it is not clear what would have happened had World War II not generated state-driven industrialism and thus ended unemployment.

China is in the midst of a systemic failure based on the increasingly irrational allocation of capital driven by market forces and state policy. It now faces an extended period in which the economy is shaped less by markets than by the state, and the state, which should be making long-term decisions regardless of short-term pain, understands that maintaining a society leads to demands that it function in a different time frame. Chinese President Xi Jinping isn't kidding when he focuses on a "share the wealth" policy.

This will affect the entire world. After all, the Great Depression didn't just ruin Americans. There was a global expectation that China had abolished the business cycle, and the growth of 40 years would become the growth of 80. Parallel to this exuberance was the belief that China was emerging as the dominant global power, building a global system based on investment and confronting the United States via its vast technological capabilities.

The key to China's global strategy was to invest money in a wide range of countries, sometimes

lending to states, sometimes to influential individuals and corporations. The Belt and Road Initiative was a mechanism for this. As a way of transporting goods between Europe and China, it was farfetched. The distances, insecurity and cost of land transport compared to maritime transport made it operationally hard to fathom. Over the years, that route has failed to fully materialize. But what did materialize was a system of financial dependencies based on Chinese investment that made China appear far wealthier than it was. It was the foreign policy equivalent of its internal capital allocation – increasingly untenable but politically effective. Money does buy friends. But loans generally need to be repaid, and many recipient countries are so indebted to China that they are having a hard time getting square.

This strategy worked until it failed. Countries clamored for Chinese money. Beijing assumed they wouldn't want to default, which would make them subordinate to China in global affairs. But sometimes not paying debts is the best strategy, which means China has had less leverage than it appeared. In a way, China's promiscuous foreign investments and loans parallel the internal process of reckless confidence.

Not quite yet, but very soon, China will have to consider a new relationship with the world. It will continue to be a great power, but the period of widespread investment will be limited by financial realities that will affect its foreign policy and its financial practices.

The fundamental question is China's relationship with the United States. On the one hand, the U.S. remains a major importer of Chinese goods. U.S. demand for greater access to Chinese markets seemed urgent as China surged, but it is less critical in the midst of a major downturn. China's concern now is economic as U.S. tariffs might become more significant than they were. The problem that China is facing is a collapse of social cohesion and a loss of confidence in the system. Inequality without hope is dangerous, which is why the current crisis opened with a massive assault by the state on wealthy tech entrepreneurs. The Communist Party of China wants to mitigate the damage of what it undoubtedly saw coming. Nothing is more stabilizing than the wealthy brought low.

Also potentially stabilizing is a national emergency in which a state appears to be successful in saving the nation and compares its success to economic failure. This is not an uncommon strategy for staggering nations. Germany used this strategy in World War II, at once unifying the country and opening the door to wealth through victory. But the German example shows the problem with the strategy. If war brings misery as well as defeat, then what good was the strategy? For the United States in World War II, this strategy energized the economy and triggered a massive new cycle of growth.

It's not an accident, then, that China chose to send fighter planes into Taiwanese air defense zones this weekend. Obviously, if you are planning an invasion, you don't telegraph your hand; you strive for secrecy. But if you're trying to make it appear that, regardless of economic problems you remain a great power, this is a useful approach. At this point, I assume that the Chinese public has not lost all confidence in the state, and that it sees the incursion as an exercise of state power. The rest of the world may see it as such too.

The normal process in markets and in public opinion in general is to vastly miscalculate both success and failure. China is a large, complex power. But over the past decade, China's power has been vastly overestimated. As China moves into its next cycle, its power will be vastly underestimated. The United States is alternatively viewed as a superpower and then a declining power. Public opinion is a poor guide for judging national power. China is now entering a period most powerful nations go through, and a worshipful world will now exercise contempt. With contempt comes an appetite for changes in foreign policy. But in the case of China, I see the risk of war, minimal in the past, disappearing along with vast amounts of money China used to make itself seem a global power.

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