

**The Resurgent Role of the State in China's Economy:
Experimentation, Domestic Politics, and U.S. Policy**

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The role of the party-state in China's economy has expanded in recent years, with state finances and political control extending well beyond the firms directly owned by Beijing. These trends have led some in Washington and beyond to believe that all Chinese firms are doing the bidding of the Chinese state. To best address economic interaction and competition with China, however, policymakers should understand the motivation for and limitations of the state's expanded economic role. The party-state is driven to seek more power over firms because of its own anxiety about domestic political stability and control rather than as part of a strategic plan. Moreover, the state's economic intervention generates significant waste and countermeasures on the part of Chinese economic actors who continue to pursue their own objectives.

Policymakers should avoid reading every Chinese firm's action as strategic and be careful not to overreact. For example, many of the manifestations of Chinese programs like the Belt and Road Initiative and Made in China 2025 that most alarmed policymakers in the West are in fact unintentional and undesirable externalities of expanded state power without mechanisms for central coordination. U.S. policy on economic competition with China should embrace institutional rules and multilateral cooperation to preserve predictability and rule of law for U.S. firms and international firms doing business in or with the United States. Economic policy should also avoid viewing all interactions as relevant to national security and instead carefully weigh the costs and benefits of excluding Chinese firms from U.S. markets and vice versa.

Few factors have loomed larger over the souring of US-China relations in recent years than economic competition between the two countries. Several trends predate the election of Donald Trump and certainly the Covid-19 pandemic, including China's growing technological capabilities and ambitions, a resurgence of the Chinese party-state's role in the economy, a general turn toward political tightening and power centralization under President Xi Jinping, accumulating frustrations within the U.S. and globally about the uncomfortable fit between China's domestic economic practices and global trade rules and norms, and China's expanding

international role (e.g. the Belt and Road Initiative) and the anxiety it provokes. A combination of feelings that economic engagement with the PRC failed to generate anticipated reforms in China and/or convergence with a western economic model¹ and new anxieties generated by novel forms of state economic interference and global ambition in China (e.g. Made in China 2025, Thousand Talents) have led many in the U.S. to argue for everything from decoupling the two economies to challenging China's global reach and economic strength in various corners of the world. These concerns are bipartisan. Nancy Pelosi, for example, joined calls for Europe to exclude Chinese firms from 5G telecommunications infrastructure in 2020, and the Biden administration has clearly identified China's "economic abuses" as a source of conflict and requiring coordinated action with allies to confront.²

¹ Kurt Campbell and Ely Ratner, "The China Reckoning," *Foreign Affairs*, March/ April 2018.

² See "Press Briefing by Press Secretary Jen Psaki, January 25, 2021." <https://www.whitehouse.gov/briefing-room/press-briefings/2021/01/25/press-briefing-by-press-secretary-jen-psaki-january-25-2021/>.

There is indeed a resurgence of the state’s role in the economy, which has led some to herald the “end of an era” of economic reforms,³ but many of the frameworks used to describe that role (such as “state capitalism,” for example) misunderstand fundamental tensions and realities in the Chinese economy with respect to its ambitions, capabilities, and strategy—and therefore the very nature of competition with China. Many observers have taken the CCP’s renewed role in the economy to mean that any action of a Chinese firm is part of a calculated plan designed by Beijing. This is not the case; rather, much of China’s resurgent “state capitalism” is a reaction to perceived threats, both domestic and foreign. Moreover, the CCP’s domestic and international economic goals are pursued through experimental, adaptive, and flexible “campaign-style” policies rather than premeditated plans with central coordination. To avoid misinterpreting China’s strategic goals and/or overreacting in counterproductive ways, policy on economic competition with China should be based on an understanding of important domestic economic tensions and the nature of Chinese policymaking. Specifically, economic policy toward China should be structured by flexible and strong domestic institutions, such as The Committee on Foreign Investment in the United States (CFIUS), avoid “zero-sum” competition in interactions with third-party countries, focus on strengthening domestic and transnational institutions that push Chinese firms to compete fairly and transparently while permitting American firms to also compete, and bolster efforts at home to ensure American companies remain at the frontier of new technologies and new markets.

³ Carl Mizner, *End of an era : how China's authoritarian revival is undermining its rise* (Oxford University Press: New York, NY, United States of America), 2018; Nicholas R. Lardy, *The state strikes back : the end of economic reform in China?* (Washington, DC: Peterson Institute for International Economics, 2019).

What is the role of the Chinese state in the economy?⁴

For much of the 1990s and 2000s, the focus of the role of the state in China's economy was limited to "state-owned enterprises" (SOEs), the one hundred or so large firms owned directly by the central state in Beijing as well as the many hundreds more firms owned by lower (i.e. provincial and municipal) levels of the state. Before and after China's accession to the WTO, international and domestic observers debated the probability of privatizing SOEs, and some even anticipated that Xi Jinping's anti-corruption campaign would pave the way. A few years into his term, however, it became clear that state ownership over the "commanding heights" would be a lasting feature of China's economy. For the centrally-owned SOEs, their leadership is appointed by the Organization Department of the CCP, and their assets are managed by the State-owned Assets Supervision and Administration Commission (SASAC).⁵

The role of SOEs has always been a sore spot in discussions over trade practices, as the U.S. and other countries have alleged that state firms at all levels (i.e. central and local) benefit from subsidies or preferential credit and market arrangements. But, the CCP's intervention in the economy is not limited to the firms majority-owned by central or local-level SASACs, and, in fact, many of the thorniest problems in U.S.-China economic relations no longer involve firms that are designated as SOEs. Below are some changes worth understanding.

First, the state's financial presence in the economy extends well beyond its majority ownership in state firms. In recent years, and especially under Made in China 2025 and following China's stock market crisis in 2015-2016, the Chinese state has extended its equity

⁴ This section draws heavily on Margaret Pearson, Meg Rithmire, and Kellee Tsai. "Party-State Capitalism in China." HBS Working Paper 21-065. November 2020. https://www.hbs.edu/ris/Publication%20Files/Party-State%20Capitalism%20in%20China%204.16.21_50e84643-faa0-4e84-add0-f0f0d7b4b323.pdf.

⁵ Wendy Leutert, "The Political Mobility of China's Central State-Owned Enterprise Leaders," *The China Quarterly* 233 (2018): 1-21; Kjeld Erik Brødsgaard, "Politics and Business Group Formation in China: The Party in Control," *The China Quarterly* 211 (2012): 624-648.

ownership in the economy as a minority investor in a wide swath of companies. The state's expansion of its role as investor has at least three manifestations: state capital funds for industrial upgrading, central state investments in non-state-owned firms, and local state capital positions in the private economy.

China's most recent industrial policy, Made in China 2025, has called for comprehensive upgrading and localization of China's manufacturing capabilities. The primary means of implementing the policy has been the creation of "government industrial guidance funds" (政府产业引导基金, or "industry funds") in strategic sectors, such as semiconductors, artificial intelligence, and electric vehicles, among others. Funds are initially supplied by the state at many levels—central ministries, provincial or municipal governments, and so forth—but matched by private funds and managed by private capital management companies. Take semiconductors as an example. In 2014, the State Council called for the creation of multiple professionally managed private equity funds to make equity investments in the sector on behalf of the state, a model Beijing had piloted (with the Ministry of Industry and Information Technology (MIIT)'s encouragement) in 2013 with two private firms to serve as managers of the Beijing Integrated Circuit Industry Investment Fund with \$1.2 billion in target capital.⁶

By 2018, more than a dozen such funds had been established by governments at various levels, including MIIT's own National Integrated Circuit Industry Investment Fund with initial capital of \$21 billion. By some estimates, more than \$160 billion in government funding would

⁶ China State Council, "Guideline for the Promotion of the Development of the National Integrated Circuit Industry", <https://members.wto.org/CRNAttachments/2014/SCMQ2/law47.pdf>, accessed December 2018; Ministry of Industry and Information Technology, "Public Announcement on Selecting Management Companies for the Private Equity for Integrated Circuit Industry Development," (关于北京市集成电路产业发展股权投资基金遴选管理公司的公告) December 18, 2013, <http://www.miit.gov.cn/n1146285/n1146352/n3054355/n3057643/n3057649/c3625593/content.html>.

become available to the domestic Chinese semiconductor industry through these funds.⁷ The industry funds, and therefore the scale of state capital for industrial upgrading in China, has expanded rapidly in recent years. Estimating the size of the funds is not straightforward, since many funds are announced with target figures, much of which is to be matched by private investors. One report cites 442 such funds set up in 2016 alone with a goal of raising 3.6 trillion RMB.⁸ Another cites \$1.7 trillion USD in more than 2,000 total government-backed investment funds, which is equal to one-third of the assets in the global private equity market.⁹ The role of state capital—rather than state firms—in guiding industrial policy in China presents a set of questions and challenges that are unaddressed by a traditional focus on the “state sector.”¹⁰

State shareholding companies at central and local levels have also brought state financing to a wide swath of non-state-owned firms, but with a less strategic logic than the goals of industrial upgrading. In November 2013, at the Third Plenum of the 18th Party Congress, a Central Committee decision on “comprehensively deepening reform” formally encouraged the establishment of “state-owned capital operation companies” (国有资本运营公司) to shift from “managing enterprises” to “managing capital.”¹¹ In July 2014, the first two official “state capital investment companies” were established under two SASAC-managed SOEs, COFCO (a food

⁷ Note that the fund totals are “targets” for both state-provided capital and matched private contributions, so it is quite difficult to know how much money is actually available. Gorgon Orr and Christopher Thomas, “Semiconductors in China: Brave new world or same old story?”, McKinsey & Co, August 2014, <https://www.mckinsey.com/industries/semiconductors/our-insights/semiconductors-in-china-brave-new-world-or-same-old-story>.

⁸ Douglas B. Fuller, “Searching for China’s Technological Champions: What Past Structural Flaws and Policy Failures Tell Us about the Likelihood of Success for Current Policies,” *EAI Working Paper*, 2019.

⁹ Robert Atkinson, “Testimony of Robert Atkinson at Hearing on “Made in China 2025 and the Future of American Industry” *Senate Small Business Committee*, 2019.

¹⁰ Hao Chen and Meg Rithmire, “The Rise of the Investor State: State Capital in the Chinese Economy.” *Studies in Comparative and International Development* 55, no. 3 (September 2020): 257-277.

¹¹ State Council. “Decision on Major Problems of Deepening Reform.” 《中共中央关于全面深化改革若干重大问题的决定》 November 15, 2013. http://www.gov.cn/jrzq/2013-11/15/content_2528179.htm.

processing company) and SDIC (an investment holding company).¹² A year later, a state directive on SOE reform explicitly encouraged state capital into private firms: “state-owned capital invests in non-state-owned enterprises in various ways” to “focus in public services, high-tech, eco-environmental protection, and strategic industries... and non-state-owned enterprises with large development prospects and strong growth potential.”¹³

The expansion of state capital into the larger economy became large-scale with the state’s response to the stock market crash of 2015. After monetary easing and massive entry of new participants in equity markets in 2014 and the first half of 2015 drove the Shanghai stock exchange to double and Shenzhen to triple in market capitalization, the bubble burst in June 2015. To assuage lasting damage from the collapse, government intervention took the form of massive equity purchases on the part of a “national team” of shareholding and securities firms who collectively made over 1.3 trillion RMB worth of purchases between June and September 2015. Eventually, the state was a minority shareholder in over half of all listed firms, and retained positions in hundreds of firms five years later.¹⁴

Second, the state has increased its political controls over private firms. The CCP under Xi has amplified its political control over economic actors in formal and informal ways that have led external observers to conclude that, in the words of Senator John Cornyn (R-TX), “there is no

¹² State capital investment companies are called 国有□本投□公司 in Chinese. SASAC. “SASAC Held Press Conference on the ‘Four Reform.’” 《国务院国资委举办“四项改革”试点新闻发布会》 July 15, 2014. <http://www.sasac.gov.cn/n2588020/n2588072/n2591426/n2591428/c3731034/content.html>

¹³ State Council. “Guiding Opinions on Deepening Reform of State-Owned Enterprises.” 《关于深化国有企业改革的指导意见》 September 13, 2015. http://www.gov.cn/zhengce/2015-09/13/content_2930440.htm.

¹⁴ Chen and Rithmire, “The Rise of the Investor State: State Capital in the Chinese Economy.”

real difference between a Chinese state-owned enterprise and a ‘private’ Chinese firm, in terms of the national security risks that exist when a U.S. company partners with one.”¹⁵

A major source of concern has been legislation to formalize an enhanced role for the state vis-à-vis firms involved in sectors or activities related to national security. The 2015 National Security Act gives broad powers to the state to intervene in firm affairs in issues related to national security, also very broadly defined. Also in 2015, President Xi elevated the “civilian-military fusion” policy to national strategy.¹⁶ The “civilian-military fusion” strategy aimed in part to build a modern and efficient military by involving the private sector in R&D, manufacturing, and logistics, and to benefit the wider economy through commercialization of military technology.¹⁷ The strategy called for the breakdown of legal and institutional barriers between commercial and military technology to strengthen R&D coordination between military research institutes, state-owned defense companies, universities, and the private sector.¹⁸

The space for independent action on the part of economic actors has narrowed in equally palpable but less formal ways. With the onset of Xi’s anti-corruption campaign, thousands of government officials have come under investigation for their ties to business. A cursory glance at formal allegations of party and government personnel shows that the vast majority are accused of improperly aiding businesses, nepotism, bribery, and so forth. Moreover, high profile firms and businesspeople have come under fire for everything from financial mismanagement to asset expatriation to corruption. For example, Anbang Insurance, founded decades ago by people close

¹⁵ *From the Senate Committee on Banking, Housing, and Urban Affairs, January 18, 2010.* U.S. Department of the Treasury, <https://www.banking.senate.gov/hearings/cfius-reform-examining-the-essential-elements>, accessed December 2018.

¹⁶ The National People’s Congress of the People’s Republic of China, “习近平出席解放军代表团会议”, March 12, 2015, http://www.npc.gov.cn/npc/xinwen/2015-03/13/content_1925190.htm.

¹⁷ Xinhua News Agency, “中共中央、国务院、中央军委印发《关于经济建设和国防建设融合发展的意见》” July 21, 2018, http://www.xinhuanet.com/politics/2016-07/21/c_1119259282.htm.

¹⁸ *Ibid.*

to political elites, was effectively nationalized in 2018, and Xiao Jianhua, founder of the large Tomorrow Group and alleged “banker to the ruling class,” disappeared from Hong Kong in 2017 and has yet to be formally charged.¹⁹

The “Resurgent” Role of the State in China’s Economy: Myths and Realities

The enhanced role of the state and the party in China’s economy have raised legitimate concerns, particularly among China’s trade partners and countries that host Chinese investment, about Chinese firms bidding on behalf of the state regardless of official ownership. The actions of Chinese firms outside China’s borders are increasingly received with suspicion. Fear that American interaction with Chinese firms is inseparable from doing business with the CCP is a major rationale for “decoupling.” These fears are based on real trends and risks, but policymakers should also comprehend the very real limitations of the state’s command over the economy in China and the sources of those limitations. Understanding the reach and limitations of state power will help policymakers better understand the costs, benefits, and effectiveness of various policies aimed to address competition with China.

First, a fixation with domestic politics and security is the core reason for resurgent state power in the economic realm. Frequently, in fact, new forms of state economic involvement come from political weakness rather than strength.²⁰ For obvious reasons, the crackdown on economic actors —such as well-connected bankers and firms like Anbang— is a reflection of the CCP’s desire to recover party discipline and manage systemic economic risk. Amid the

¹⁹ Sui-Lee Wee, China’s Entrepreneurs Squirm Under Xi Jinping’s Tightening Grip, *The New York Times*, October 23, 2017, <https://www.nytimes.com/2017/10/23/world/asia/china-xi-business-entrepreneurs.html>.

²⁰ For other arguments about China’s core interests being the CCP’s own security, see Jessica Chen Weiss, “A World Safe for Autocracy?” *Foreign Affairs*. July/August 2019; Weiss and Jeremy Wallace, “Domestic Politics, China’s Rise, and the Future of the Liberal International Order.” *International Organization*, (2020 forthcoming).

encouragement of firms to “go out” between 2013 and 2016, large amounts of capital fled China not necessarily for strategic investment in the developing world or technological acquisition in the developed world but for “secure” assets in places where assets were perceived to be safe from the CCP itself. Regulators have been repeatedly surprised in recent years by economic and financial risks that seem to appear suddenly. For example, the 2015 stock market crash wiped out a year’s worth of gains in public equities and seemed precipitated by financial innovations and novel technologies that were unknown, and at times incomprehensible, to regulators. The extent of asset expatriation in 2015-2016 was discovered to threaten the value of the RMB; a sudden float of the currency in August 2015 generated a rapid collapse in its value, the opposite of what many observers would have expected. This collapse and general capital outflows reflect domestic and foreign anxieties about their prospects in China, and prompted regulators to adopt measures to discipline outward capital, including controls on certain sectors imposed in 2016-2017 and limitations on borrowing for foreign investment.²¹

The growth of state investment may also come from a position of weakness, namely the party-state’s inability to understand and monitor corporate finance. Corporate debt levels have grown substantially (as a percentage of GDP, by more than 60 points) since the global financial crisis that began in 2008, and regulators have become more vocal in their concerns about risk in China’s financial system.²² While it may be inevitable that many see a strategic logic in state investment, and indeed at times there is (see below on semiconductors), it may instead be fear of financial instability or pursuit of a monitoring mechanism that leads different levels of the state to hold equity positions in non-state-owned firms. As a minority shareholder, state actors have

²¹ Meg Rithmire. “Varieties of Outward Capital: Domestic Political Status and the Globalization of Chinese Firms.” *HBS Working Paper* 20-009. https://www.hbs.edu/faculty/Publication%20Files/20-009_6c9e3091-9950-4a2b-baa2-633e823eca47.pdf. June 2019.

²² Ma Guonan, “China's high and rising corporate debt: Examining drivers and risks,” Mercator Institute for China Studies, August 22, 2020, <https://merics.org/en/report/chinas-high-and-rising-corporate-debt>.

greater and more direct insight into firms' financial practices as well as a mechanism for stabilizing firms, sectors, geographies, and markets more generally. The phenomenon of widespread shareholding is new and begs for further empirical research, but it is possible that the state is investing in firms not because they trust firms to act as agents of the state but precisely because they do not.

Second, the CCP pursues its strategic goals in domestic and international economic policy through a familiar "policy style" that prioritizes experimentation, learning, flexibility, and adaptation, all under the party-state's own hierarchical watch.²³ Unlike the sort of rules-based system that has characterized the "global liberal order" internationally and tends to prevail in advanced capitalist democracies, the PRC embraces pervasive uncertainty and prefers campaign-style governance to institutions that delineate clear rules and structure expectations. Take two examples from high-profile economic efforts: Made in China 2025 and the Belt and Road Initiative (BRI). Both of these programs are campaigns rather than policies, meaning they are essentially amorphous mobilizational efforts with little to no central coordination and no precise means of implementation or review.²⁴ As such, actors within China, including bureaucrats and their agencies and firms of all kinds, endeavor to pursue their own interests while aligning as closely as they can to the state's strategic goals, and the state then adapts its practices and directions in real time. This means that not all actions Chinese firms take, even those that appear to be part of China's strategic goals, are directed or even desired by Beijing.

²³ Sebastian Heilmann. *Red Swan: How Unorthodox Policy-Making Facilitates China's Rise*. Hong Kong: CUHK Press. 2018.

²⁴ Yuen Yuen Ang, "Demystifying Belt and Road," *Foreign Affairs*, May 22, 2019; Min Ye, *The Belt Road and Beyond: State-Mobilized Globalization in China: 1998-2018*, (Cambridge University Press, 2018).

Made in China 2025, as laid out in 2015, targets ten priority sectors²⁵ for industrial upgrading and development of domestic capabilities, mostly in response to concerns that China should not depend on external markets, and particularly the U.S., in sensitive parts of value chains for critical and frontier technology. The main vehicle for encouraging growth in those sectors is providing seed capital from the state (in the form of the industrial guidance funds discussed above) with the hope that private sector capital follows government investment.

The experience of the semiconductor sector shows how the actions of firms can complicate the state's strategic goals. As funds were established at various levels of government to invest in all stages of the integrated circuit supply chain, local funds began a buying spree to acquire foreign companies and list them in China where they could get a higher multiple.²⁶ The strategy was to target companies with strong links to and a high market share in China in high-growth sectors, such as smartphones.

After several successful acquisitions of U.S.-based firms (ISSI and Omnivision in 2015), domestic competition within China complicated the overseas acquisition strategy. One firm, Tsinghua Unigroup, made such aggressive international moves, including an informal but very public offer for Micron, which supplies the U.S. military, that CFIUS began to look at all Chinese tech investment with greater scrutiny, “muddying the waters” for all of its domestic competitors.²⁷ Tsinghua Unigroup, a state-owned firm headed by Zhao Weiguo, an entrepreneur who bought a 49% stake in the firm in 2009 and is said to have connections to Xi Jinping,

²⁵ The ten priority sectors include 1) new advanced information technology, where semiconductor belong; 2) automated machine tools and robotics; 3) aerospace and aeronautical equipment; 4) maritime equipment and high-tech shipping; 5) modern rail transport equipment; 6) new-energy vehicles and equipment; 7) power equipment; 8) agricultural equipment; 9) new materials; 10) biopharma and advanced medical products.

²⁶ PE Daily, “集成电路的海外并购机遇”, December 18, 2015, https://news.pedaily.cn/201512/20151218391573_all.shtml see also <http://www.eefocus.com/component/353581/r0>, accessed December 2018.

²⁷ Interview, industry lobbyist, Washington, D.C., December 2018. See also (Dou and Clark 2015).

transformed from an ailing tech services and Chinese medicine purveyor to China's largest chipmaker in a few short years. The deal not only failed but triggered a congressional overhaul of CFIUS and heightened scrutiny of Chinese firms' activities in technology sectors worldwide. Zhao retired abruptly in 2018 after spending \$100 billion in less than five years on acquisitions in the semiconductor industry.²⁸ Many speculate he was forced to retire because his overly ambitious use of state (and private) capital contributed to significant backlash against China's internationalization.

The strategic ambitions of the BRI have been a source of controversy and perceived threat, and some of the most alarmist interpretations of the initiative have centered on the experience of Sri Lanka, where an SOE (China Merchants Group) purchased a long-term lease for Hambantota seaport on the southern tip of the island nation in 2017. Accounts range from reporting that China "seized an asset" after Sri Lanka "defaulted on its payments"²⁹ to "debt-trap diplomacy" (in the words of Mike Pence) or "How China got Sri Lanka to Cough up a Port" (a *New York Times* headline). The last two interpretations in particular assume that the handover of the 99-year lease was the end move in a long game designed at the outset of the project. A close look at events in Sri Lanka and the dealings between various Chinese firms there and the Sri Lankan government, however, tells a different story.

Construction in Hambantota began in 2007 on a niche port offering services for non-containerized cargo. Upon Mahinda Rajapaksa's successful end to the country's three-decade civil war, the president pursued a "phase II" of the port—located in his home district—for containerized cargo, promising to bring "big ships" to the relatively poor southern region. For

²⁸ Sun Congying and Yang Ge. "Microchip Magnate Retires, Citing Heavy Workload." *Caixin*. April 11, 2018, <https://www.caixinglobal.com/2018-04-11/microchip-magnate-retires-citing-heavy-workload-101232960.html>.

²⁹ Evan Osnos, The Future of America's Contest with China, *The New Yorker*, January 6, 2020, <https://www.newyorker.com/magazine/2020/01/13/the-future-of-americas-contest-with-china>.

both phases, financing was provided by China Exim bank at commercial rates that matched global rates (LIBOR) at the time: around 6% in 2007 and 2% in 2009 for phase II. The SOE that built the port was China Harbor Group, which also began a \$1.4 billion direct investment in a real estate project in Colombo. As loans from China and Chinese presence in Sri Lanka inevitably became politicized (the country has had a thriving, adversarial, multi-party democracy for the better part of a century), Rajapaksa was challenged for the presidency by a candidate who ran in part on questioning the country's financial relationship with China. China Harbor Group allegedly funneled money to the Rajapaksa campaign, but he lost surprisingly and narrowly in January 2016. The new administration suspended approvals for the real estate project and attempted to renegotiate the terms for the Hambantota port. China Exim bank would not change the terms, but offered to solicit bids from Chinese firms to invest in the port, relieving the Sri Lanka Port Authority which was suffering with a port it could not commercialize. The goal of the Sri Lankan negotiators was to wrangle a deal with the highest possible equity going to the Chinese side: they accepted an offer from China Merchants for 85% equity in the port at the same price that Sri Lanka paid China Harbor to build it.³⁰

Sri Lanka never defaulted, and if Chinese firms had an interest in keeping Rajapaksa in office, it was likely because of their interests in real estate rather than a strategic interest in the port. Yet global observers tend to assume that all SOEs exclusively do the bidding of Beijing, focus on infrastructure and other type investments that have presumed ties to national security and ignore other investments that affect and complicate firm interests, and fail to appreciate contingency and miscalculation on the part of Chinese actors. Hence a 12-year, multiphase process of investment in a port in Sri Lanka that began six years before the BRI was declared and

³⁰ These insights based on Meg Rithmire and Yihao Li, "Chinese Infrastructure Investments in Sri Lanka: A Pearl or Teardrop on the Belt and Road?," HBS Case 719-046, 2019.

involved several different Chinese firms and a very surprising Sri Lankan presidential election has been reduced to “getting Sri Lanka to cough up a port.”

With the BRI, we are observing a “recalibration” precisely because the CCP has become wary of Chinese firms engaging in global activities that may subvert its interests. The regime has complained that many firms were behaving like “unchained horses” and is experimenting with new mechanisms to expand its control of the BRI. These include a newly formed office under the National Development and Reform Commission (NDRC) to ensure global investments approved by the Ministry of Commerce align with the state’s global objectives, and newly vested authority in the Ministry of Commerce to decide whether projects can be considered for funding through BRI mechanisms and to suggest contract partners (e.g. instead of lenders, like the ExIm bank, making those suggestions).

The trajectories of both the Made in China 2025 and Belt and Road campaigns show how China’s economic goals and the means used to pursue those goals can change and adapt. If U.S. observers and policymakers treat every action of a Chinese firm as an act premeditated by planners in Beijing, they risk misunderstanding both China’s strategic goals and how relationships within the state and between the state and firms affect the realization of those goals.

Third, diverse interests and preferences still exist in Xi’s China under a resurgent state, although they are not as vocal as advocates of reform and liberalization were under the Hu-Wen and Jiang-Zhu administrations. That power has been recentralized under Xi and that the autonomy of the non-state sector has been stifled does not mean that the diverse and complex Chinese economy and society have universally converged on Xi’s preferences or vision of an emboldened party-state. In the years since the crisis and during a reconfiguration of China’s growth model, there is evidence that new coalitions have formed around the issue of

internationalization of Chinese firms. Barry Naughton suggests that “new opportunities for lobbying and new interest groups have sprung up,” roughly coalescing into those that prefer “financial reform and opening” – essentially a liberalization of China’s financial sector to inward and outward portfolio investment – and those that prefer “government international influence.”³¹ This is a new manifestation of the state versus market struggle that has characterized China’s economic policy for decades, but one that involves activities of Chinese firms beyond China’s borders and therefore both shapes and is shaped by other countries’ politics and China’s foreign relations.

It is especially worth noting that many of China’s most competitive firms, including small and medium enterprises (SMEs), firms with arms-length relationships with the state, and firms that rely on global suppliers and customers, are especially frustrated by the prospect of increased “government international influence.” They are frequently joined in this position by reform-minded bureaucrats, and especially regulatory authorities charged with monitoring and mitigating financial risks associated with political pushes for firms to expand globally. As a representative from one such firm put it: “Now every Chinese company is assumed to have state backing and some sort of national motive, but of course we have none of those things. We bid to invest in early-stage ventures, but no one wants to be bought by any Chinese company, even though we are headquartered outside of China. When the government pushes global acquisitions, it goes too far, and we are the ones who suffer. All of the private tech firms hate these policies.”³² Economic reformers, like former Minister of Finance Lou Jiwei, publicly criticized the Made in China 2025 effort: “I was against it from the start...The negative effect is to have

³¹ Barry Naughton, 'China’s international political economy—the changing economic context ' in Ka Zeng (ed.), *Handbook on China’s International Political Economy*, (Edward Elgar Publishing: Cheltenham, UK, 2019), 21.

³² Interview, private firm executive, Boston, MA, May 2018.

wasted taxpayers' money.”³³ Rather than a heavy government push in technology and deploying state capital to pursue global acquisitions, reformers and competitive firms prefer liberalization of capital markets so that productive firms can better access capital, and China's technology sector can grow through market allocation of resources. In their view, the combination of government involvement and financial protection has channeled government resources to preferred firms, either state or crony, with the effect of harming competitive firms' internationalization efforts.³⁴

To be clear, the voices of those who prefer an attenuation of the state's role in the economy have been silenced in recent years. Unfortunately still, it is difficult to imagine that the situation will change in the short term, as long as the party-state and the central leadership remain intolerant of dissent and convinced that an active role for the state in the economy is required for stability and political security. Nonetheless, policymakers in the U.S. should be attuned to openings for debate about liberalization within China and aware of how international actions weigh into those domestic struggles. For example, efforts perceived as aiming to exclude all Chinese firms from regional or international markets only embolden voices arguing that there is no point in playing by global rules that were never meant to let China grow prosperous and powerful.

Smart Economic Policy to Address China's Resurgent State

Ultimately, the state's renascent role in the economy is quite real. Decades ago, scholars and policymakers alike articulated a view that the expanding private sector might demand further economic and political liberalization and membership in the global trade and investment

³³ Lo Kinling, “‘Made in China 2025’ all talk, no action and a waste of taxpayers' money, says former finance minister Lou Jiwei,” *South China Morning Post*, March 7, 2019.

³⁴ These insights drawn from interviews with several technology investors and firm personnel in Beijing and Shanghai, June 2017.

community would constrain the Chinese state. For now, those expectations have given way to the reality that the party-state refuses to be disciplined by rules, domestic or international, or by markets. That said, as I have emphasized, a resurgent state is not an omnipotent or omniscient state, and therefore observers should not misread all actions by Chinese firms as strategic nor should we assume homogenous preferences in China for a resurgent state and an eclipsed sphere of autonomy for private firms and actors. What does viewing the state's role in the economy as resurgent, but nonetheless constrained, mean for policy positions toward China?

First, the U.S. should renew its commitment to institutional rules and frameworks of fair competition and treatment and make clear that the U.S. is open for international business. The “America First” tenor of the Trump administration, as well as the very substantive actions regarding a number of the U.S.’s international commitments, jeopardized the world’s sense that the U.S. is committed to global cooperation and coordination. It is clear that the Biden administration wants to offer reassurances and restore these commitments. Regarding China and addressing China, some clarity should be offered to both China and allies. It is nearly impossible to convince Chinese actors, whether hardliners or reformers, that there is utility to “playing by the rules” if the rules constantly change and power is wielded against Chinese actors or firms arbitrarily. Although China has changed substantially and many of our global institutions, such as the WTO, were never designed to address a political economy like China’s,³⁵ it is worth noting that many *domestic* institutions in the U.S. have risen to the challenge.

One way of viewing the interactions between Chinese firms, the Chinese state, and the U.S. market in the context of semiconductors and CFIUS is understanding that the institutions did work: when Chinese firms targeted U.S. firms with dual-use products or appeared to hide

³⁵ Mark Wu. “The ‘China, Inc.’ Challenge to Global Trade Governance.” *Harvard International Law Journal*. Vol. 57, 1000-1063 (2016).

their ultimate owners (e.g. in the case of Lattice semiconductor and Canyon Bridge, a California-based venture firm that was revealed to have sole funding from the Chinese State Council), these efforts were rebuffed by precisely the institutions designed to protect national security interests in the context for foreign investment. Scholars of regulation, especially in financial sectors, have written about “institutional” or “regulatory amnesia,” by which regulation solves a problem just for policymakers to later forget that the problem existed and deregulate. The opposite would be a sort of regulatory “autoimmune” disease, or overreaction whereby an institution deals effectively with a new challenge but nonetheless policymakers create even more regulation in the face of that challenge.

This nearly happened in 2018. The original FIRRMA legislation proposed in 2018 in reaction to increased Chinese technology acquisitions in the U.S. and growing concerns about forced technology transfer on the part of global firms seeking access to Chinese markets, including provisions that would have required CFIUS oversight of any outbound direct investment on the part of a firm with substantial American business. The consequences of such legislation would have been profound, requiring government review of almost every business decision of global firms. This is, in fact, how the Chinese Ministry of Commerce deals with outward investment from China, and so, in our efforts to combat the “threat” of Chinese economic competition, the U.S. Department of Commerce would look like its counterpart. Thanks to bipartisan efforts and cooperation between legislators and the executive branch, a combination of modernized export controls (ECRA) and expanded CFIUS powers prevailed. It would be a shame to jettison these institutions in favor of much harsher restrictions just when they proved flexible enough to adapt to a new source of stress and potential threat.

Second, contesting China's global influence by trying to shut all Chinese firms out of global markets or forcing allies and partners to choose between China or the U.S. is likely to backfire for a few reasons. First, if Chinese firms who are operating on commercial motives and playing by global rules find themselves constrained unfairly, the U.S. risks alienating potential partners and allies and convincing them instead that global rules and institutions were never designed to permit them to succeed. Second, it is a basic reality that, for a variety of reasons, Chinese firms are willing and eager to do business and make investments in places that American and other western firms do not show interest. When countries like Sri Lanka, who have not seen meaningful investment from American or European firms for decades, are made to feel that they have to "choose" between accepting Chinese investment or financing or doing business with America, the choice feels like one between something and nothing.

Moreover, U.S. firms and policymakers can easily convince third party countries of the benefits of having both Chinese and U.S. firms involved in their markets and efforts to grow. In BRI countries, for example, U.S. firms may not be building infrastructure, but U.S. firms can participate in different parts of the value chain for infrastructure, for example consulting on financing, long-term plans, and so forth. French firms, for example, are already doing this in Africa, and Indian firms have been involved in planning in other parts of South Asia despite the Indian government's deep concerns about Chinese investment in the region.³⁶

Instead, and third, the U.S. should work with partners and allies to reinforce institutional frameworks, such as export controls and investment review mechanisms, that permit openness and mitigate risk. It was clear in 2014-2018 during the high tide of Chinese semiconductor acquisitions that European trade partners did not have the institutional mechanisms to review

³⁶ On this, see Deborah Brautigam and Meg Rithmire. "The Chinese Debt Trap is a Myth." *The Atlantic*. February 6, 2021. <https://www.theatlantic.com/international/archive/2021/02/china-debt-trap-diplomacy/617953/>.

investments for national security risk and therefore “borrowed” American institutions. For example, President Obama invoked CFIUS power to block the acquisition of a German company (Aixtron) by a Chinese consortium that it believed posed a national security threat. At the end of the Obama administration, American officials were working with counterparts in Europe and elsewhere to settle on common investment review and export control procedures and norms—arrangements that would enlarge the “garden” and create common “fences” so that economic engagement among likeminded countries could proceed without constant controversy about openness to China and Chinese firms. By committing to our own institutional rules and working with allies and partners to secure their own, the U.S. can depoliticize choices to “work with China or not” and demonstrate the benefits of rule of law and institutional investments.

One example of a Trump era policy that did involve multilateral cooperation and international alliances (such as NATO) was the State Department’s Clean Network Initiative to coordinate on 5G and garner commitments from governments and telecommunications firms in Europe and Latin America to exclude “untrusted vendors” from networks. In combination with entity listings and export restrictions, this initiative was “successful” in that over 60 countries and dozens of telecom firms were folded into the Clean Network through various means of excluding Huawei and ZTE. But that success came with costs. First, the commitments to the network are “thin,” in that they do not require institutional changes, adoption of technical standards, or otherwise “sticky” forms of rule adoptions that provide policy sustainability. Put simply, the goal was to quickly sign countries and firms onto the initiative, and that speed and ease of coming on board trade off with ensuring that the commitments last beyond administrative turnovers in the U.S. or elsewhere. Second, the messaging of the Clean Network initiative from the Pompeo-led State Department focused heavily on an ideological battle between “democracy

and authoritarianism,” heightening the sense of some ideological confrontation between the U.S. and China and, more importantly, making it more difficult to recruit non-democracies to the initiative.³⁷ Even more importantly, excluding vendors based on the regime type of their home countries disincentivizes adjustments that China could make, such as softening its legal regime governing the state’s ability to intervene in firm affairs or commandeer firm assets. As many have pointed out, these changes appear unlikely at the current moment, but framing competition as zero-sum and based on regime type eliminates any “carrots” the U.S. and allies could offer and ensures a longer term and higher stakes form of rivalry.³⁸

Various voices in the Trump administration presented mixed messaging on what aspects of the U.S.-China economic competition were important for what reasons. As has been widely discussed, Trump himself seemed fixated on a trade deficit and some advisors on China’s business practices, while other voices were more squarely focused on the security implications of economic engagement with China, for example the implications of Chinese dominance in 5G. A lack of coordination and focus on these security issues, perhaps, left policymakers with a time-sensitive problem of Huawei’s global dominance and few tools of addressing it. In such a context, the rapid execution of the Clean Network was a way of addressing the 5G issue quickly; in the years ahead, the U.S. and allies should focus on adopting standards and institutions that manage the technology and security issues sustainably and transparently.

Fourth, U.S. policymakers should clarify what U.S. interests are in economic engagement and competition with China and carefully consider the costs and benefits of policies. This sounds like a vague or obvious recommendation, but two trends in particular make ascertaining and

³⁷ Though Vietnam did formally join, efforts to recruit Egypt, the UAE, and other Middle Eastern countries seemed to stall.

³⁸ This section draws heavily on Meg Rithmire and Courtney Han. “The Clean Network and the Future of Global Technology Competition.” HBS Case 721-045. April 10, 2021.

pursuing U.S. interests especially complex. First, U.S. economic interests are incredibly diverse when it comes to China. Consumer goods companies and agricultural producers have done very well selling products in China; financial firms desire more market access but are overall also enthusiastic about engagement with China. Many technology firms benefit tremendously from engagement with Chinese supply chains and customers (e.g. Apple), but others (e.g. Google, Facebook) have been precluded from competing for Chinese customers. Still others, such as U.S. semiconductor firms, worry about unfair competition and even illegal practices on the part of Chinese firms.³⁹ What is good for one set of interests may be disastrous for others. For example, pushing exhaustively for reciprocal market access for some sectors in the U.S. economy, especially technology and finance, could be extremely costly while also yielding few if any benefits for most Americans.

Second, the impulse to think of all economic interactions in terms of national security often obscures cost-benefit considerations. The threat of commercial or scientific espionage is real, but actions that would threaten educational exchanges between the U.S. and China to address a handful of actions would not eliminate espionage, but it would instead have tremendous material and other costs for U.S. universities and educational institutions. Similarly, coerced technology transfer or weak intellectual property enforcement can harm U.S. firms and could conceivably have national security implications, but discontinuing or chilling all economic interactions in China would, again, deeply disadvantage American firms vis-à-vis Chinese and international competitors and also fail to eliminate IP theft.

³⁹ For an incredibly knowledgeable take on the diversity of interests, see Craig Allen. “US-China Trade Negotiations,” Talk at the Harvard Fairbank Center for Chinese Studies. <https://fairbank.fas.harvard.edu/wp-content/uploads/2019/08/Craig-Allen-US-China-Trade-Negotiations-No-Perpetual-Friends-or-Enemies-Only-Perpetual-Interests.pdf>.

Many U.S. and global firms have benefitted enormously from competing in China, and not just because of its large market or because cheap labor has led to efficiency gains. The size of China's market and the presence of foreign direct investment (FDI) and domestic firms has made competition fierce. To be sure, non-tariff barriers of many kinds, including forced technology transfer, subsidies, and local content requirements have made for a harsh competitive landscape for foreign firms. Nonetheless, foreign firms of all kinds have been pushed to become more efficient or more innovative to compete in China's middle market in particular.⁴⁰ To be excluded from China's market would mean leaving the world's largest domestic market as the exclusive playground of non-U.S. firms, and U.S. firms would inevitably lose more than just Chinese customers.

Concerns about trade deficits and unfair business practices of Chinese firms are to be taken seriously, but they are qualitatively different than concerns about the security implications of doing business with Chinese firms, especially in high-tech and potentially dual-use sectors. A risk of lumping all of these concerns together is that allies and others cannot discern when the U.S. is adopting protectionist policies for its own firms and when it is addressing more urgent and fundamental security firms. The Biden administration has an opportunity to clarify what aspects of China's economic practices and international behaviors require a coordinated response by security agencies and allies and which are in the realm of economic competition. For example, state influence in tech firms and China's suite of laws extending state authority over firms present security challenges and justify rule-based actions by institutions such as the Bureau of Industry and Security or CFIUS. By contrast, the mere presence of industrial policy in China,

⁴⁰ Loren Brandt and Eric Thun, "The Fight for the Middle: Upgrading, Competition, and Industrial Development in China," *World Development* 38, no. 11 (2010): 1555-1574; Jonas Nahm and Edward Steinfeld, "Scale-Up Nation: China's Specialization in Innovative Manufacturing," *World Development* 54 (February 2014): 288-300.

however, is an issue of economic competition that should be addressed by better economic competitiveness at home. In its early months, the Biden administration has clearly embraced the idea that to compete with China requires strengthening the domestic economy, research and development, and infrastructure, broadly defined to include the social and technological scaffolding of American society. This approach could mark the beginning of a virtuous cycle by which competition with China generates domestic investments and interest alignment for the longer term.