

Success in the Struggle against the People's Republic of China

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AT MACQUARIE UNIVERSITY, SYDNEY



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Cover: The Guard of Honor of the Chinese People's Liberation Army escorts the national flag during a flag-raising ceremony at the Tiananmen Square to celebrate New Year's Day on January 1, 2023, in Beijing, China. (Photo by VCG/VCG via Getty Images)

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Lavina Lee

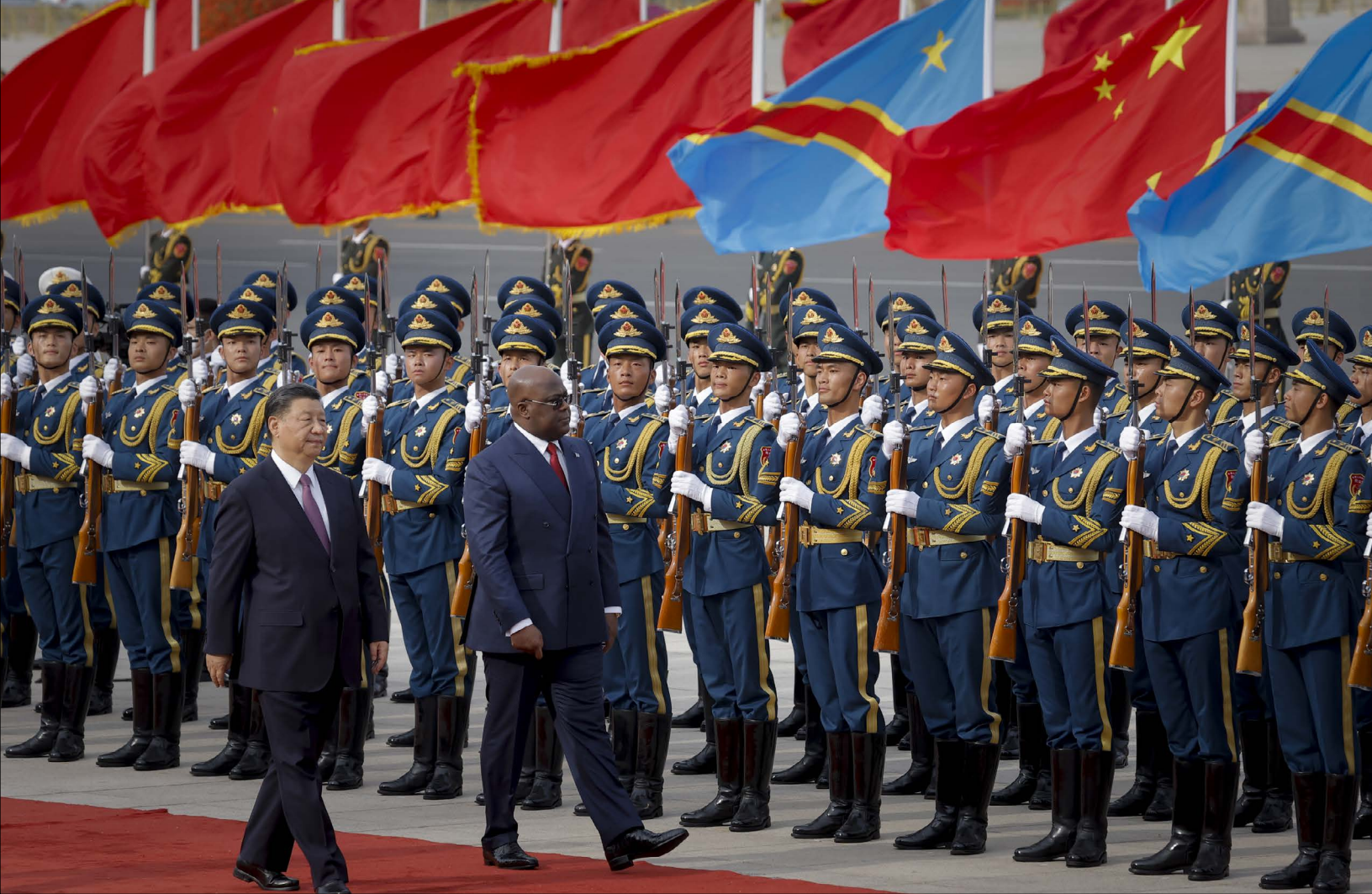
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INTRODUCTION

In April 2023, the Australian government released the officially commissioned but independently produced Defence Strategic Review. Intended to assist the government of Australia with its strategic and defense policies over the next decade and beyond, the report offered the fundamental assessment that the Indo-Pacific region “faces increasing competition that operates on multiple levels—economic, military, strategic and diplomatic—all interwoven and all framed by an intense contest of values and narratives.”¹ The Biden administration’s National Security Strategy, which had been released several months earlier (October 2022), stated the challenge in even starker terms: “The People’s Republic of China harbors the intention and, increasingly, the capacity to reshape the international order in favor of one that tilts the global playing field to its benefit.”²

At the heart of these statements is the perception that China poses a systemic and comprehensive challenge, not just to

the vital interests and values of the United States and Australia, but to the entire system and order that was cobbled together after the Second World War. These postwar rules, norms, institutions, conventions, practices, alliances, and security relationships have been underwritten by US material power. They constitute a liberal order that is under intense challenge from China.³

This report explores what *success* in relation to China looks like for the US, Australia, and allies such as Japan. Several substantial and thoughtful pieces have described what *victory* would look like for China,⁴ and there have also been many good efforts

Photo: Democratic Republic of Congo’s President Felix Tshisekedi and Chinese President Xi Jinping attend a welcoming ceremony at the Great Hall of the People on May 26, 2023, in Beijing, China. (Photo by Thomas Peter-Pool/Getty Images)

to describe what victory would look like for the US and its allies, given China's goals and objectives.

The current report focuses on a US and Australian vision of success in which the geopolitical contest and struggle are enduring and do not end with a victory for any side. Victory generally means defeating an enemy or opponent in a specific context or activity. Unsurprisingly, the term is commonly associated with defeating an enemy during a battle or compelling the unconditional surrender of the enemy when engaging in war. In victory, there is a clear winner and loser.

By way of contrast, success or *successful struggle* means the accomplishment of an aim or purpose in general or specific contexts. It might include subduing an opponent and attaining victory over that opponent. But success can also be achieved without the strict formal requirement of victory, depending on one's objective.

The term *success* is used here because the scope of this report is broader than victory in a traditional war context (even if the use of force is always an option to achieve success or deny it to the opponent). It will be apparent that the Chinese notion of war is far broader than the Western notion. The West holds that war is fought within and across identified air, sea, land, space, and cyber domains, and that war has a discernible beginning and end. In the Chinese conception, war has no boundaries or restrictive form and does not necessarily involve the kinetic use of force. It is material, but also ideational, psychological, and structural.⁵ Indeed, for the Chinese, the apogee of conflict is to win without fighting, even if the Chinese Communist Party (CCP) sees the environment as one of perpetual struggle. Hence, war may have no formal beginning or end.

For this reason, a US and Australian vision of success cannot simply be about achieving specific key objectives, like maintaining Taiwanese de facto independence or preventing further Chinese militarization of the South China Sea. To be sure, a vision

of success is based on certain fundamental end states (such as preventing Chinese material and normative dominance in East Asia). However, it also accepts the likelihood of a constant struggle against a formidable China, just as China assumes the long-term existence of a formidable US with significant allies in the region.

In other words, *the authors work on the prudent assumption that China will be neither defeated nor terminally weakened, and that its expansionist ambitions and substantial capabilities will remain*. Rather than focusing on a final victory or endpoint, a vision of success conceptualizes an advantageous and enduring state of affairs or system of arrangements in the region that supports the fundamental objectives of the US and its allies in the Indo-Pacific.

This report is about successful struggle, but not in the context of a major war where one side wins decisively and the next step is to establish a sensible peace. This is not to discount the possibility that the use of force could be decisive in shaping the region. But the report focuses on scenarios of an increasingly tense competition and rivalry occurring over the next decade and explores what success looks like in that context. It does not discount the possibility or necessity of limited military action, but does not assume that any such action would be decisive in producing a permanent winner and loser.

Finally, this report focuses on two different but related questions:

- How can the US and Australia counter, constrain, or circumvent the aspects of China's vision of success that the allies most wish to avoid?
- What does a US and Australian vision of success entail, and why?

The vision of success for the US and Australia elaborated in this report will hold to the following conditions:

- The vision of success is within the capability and prowess of the US and Australia to achieve. It cannot simply assume and flow from US and allied dominance and preeminence. Neither can it rely on an unrealistic prescription for how the US and Australia achieve dominance and preeminence—one that depends on some unexpected collapse in Chinese power and influence.
- The vision needs to be relatively stable and enduring, even as it evolves, and needs to be based on an appropriate degree of institutionalization and socialization.
- The vision can offer an alternative arrangement with China that is plausible and desirable for the US, Australia, and the region.



HOW CHINA VIEWS SUCCESS

Since the end of the Second World War, only the US possessed the capabilities and relationships to dominate or intervene decisively in the key maritime areas of East Asia. China's approach from the 1990s onward has been about acquiring capabilities to dissuade the US and its allies from intervening decisively, specifically by being able to inflict (or threatening to inflict) prohibitive costs.

Over the past decade and more, Beijing has increasingly focused on acquiring the geographical presence and capability to project dominant power beyond its periphery, which largely accounts for its recent actions in contested regions such as the East and South China Seas. Although Japan is reemerging as a great regional power, China still realizes that it is largely dealing with an assorted collection of small states. While some small states such as Vietnam and Indonesia may yet become formidable strategic actors in their immediate localities, their pri-

mary strategic value is to render assistance to great powers as enablers or blockers.

The region's obsession with US-China relations and comparisons is understandable, given the preponderance of small states with no ability to individually affect the balance. *Small state* is obviously a relative concept, but any definition reflects the reality that East Asia is a lopsided geostrategic and geopolitical construct. Geographically, China is the enormous continental heart of East Asia and is surrounded by several states that are significantly smaller in terms of land mass. Consider the four largest states by land mass after China: China is about 6.5 times larger than Indonesia, over 14 times larger than

Photo: Employees work on the assembly line of electric vehicles at a factory of Dayun Automobile Co. Ltd. on March 28, 2023, in Yuncheng, China. (Photo by VCG/VCG via Getty Images)

Myanmar, almost 19 times larger than Thailand, and 25.5 times larger than Japan.

Small states are also markedly small when it comes to their military capabilities and potential. According to 2021 figures on military expenditure, China spends more than the rest of Northeast Asia and Southeast Asia combined, and its military spending equates to almost two-thirds of all East Asian military spending. Its military budget is currently more than 6.5 times the combined military budgets of Southeast Asian nations. China's military budget is more than five times that of its nearest East Asian rival, Japan, and the gap is growing.⁶ See table 1.

These regional disparities highlight that China would dominate East Asia but for the presence of the United States. It is for this reason that China has long been obsessed with identifying America's strategic, military, and nonmaterial weaknesses.⁷ Beijing has also recognized that the much greater distance of the US from maritime East Asia can be both a structural advantage and disadvantage. It is an advantage for the US because the prospect of an Asian hegemon creates more apprehension for resident smaller states than the prospect of a distant one. The distant US power requires greater acquiescence from regional states to retain its presence and relevance in the region. Hence, the US is more structurally bound to provide public security goods than would be the case for an Asian hegemon. That partly explains why most states in the region still largely welcome the US as a superpower.

The structural disadvantage for the US is that the strategic neutrality of these small states can be crippling, while it is only inconvenient for an Asian hegemon such as China. Hence, Beijing does not have the same strategic or military need for cooperation from local allies and partners as the US. Beijing has the easier task of seeking to merely neutralize US allies and partners rather than the more difficult task of acquiring them for itself. If China can change the cost-benefit calculations of these allies and partners in its favor, then the US is immensely exposed as

Table 1: Major Military Spenders in Asia, 2021

RANK 2021	COUNTRY	SPENDING
1	China	\$293.0B
2	India	\$76.6B
3	Japan	\$54.1B
4	South Korea	\$50.2B
5	Australia	\$31.8B
6	Taiwan	\$13.0B
7	Pakistan	\$11.3B
8	Singapore	\$11.1B
9	Indonesia	\$8.3B
10	Thailand	\$6.6B

Source: Diego Lopes da Silva, Nan Tian, Lucie Béraud-Sudreau, Alexandra Marksteiner and Xiao Liang, "Trends in World Military Expenditure, 2021," Stockholm International Peace Research Institute, April 25, 2022, https://www.sipri.org/sites/default/files/2022-04/fs_2204_milex_2021_0.pdf.

a geographically distant power. In other words, simply minimizing the strategic and military relevance and agency of Southeast Asian states works in China's favor, given it is the People's Liberation Army (PLA) that is strengthening its presence in the region and not the US and its allies. Neutralizing US allies was always a central pillar of China's strategy of seeking to ease the US out of Asia and thereby win without fighting.

To be sure, recent Chinese behavior has caused Japanese and Australian allies to reaffirm and enhance their alliances with the US and their security relationship with each other. But if Japan and Australia serve as the northern and southern anchors of the US-led security system, the soft heart or underbelly of maritime Asia remains Southeast Asia.

Xi Jinping has put noticeably more strategic and diplomatic emphasis on small states than his predecessors,⁸ frequently under the banner of "all-dimensional diplomacy."⁹ Doing so

makes sense from the Chinese perspective. Small states are less powerful and usually less important to other great powers. This means they are more likely to hedge or remain neutral rather than balance, even if there is an aggressive power such as China in their neighborhood. At the same time, Beijing does not need the consent of other states to maintain or extend its presence and influence. There is therefore more scope for China to coerce and intimidate neighboring small states than there is for a country such as the US.

Winning over small states in Southeast Asia, or else buying their silence or neutrality, is also comparatively cheap, especially if they are low-income authoritarian political economies where elite capture is feasible. From a Chinese point of view, relatively insignificant increases in state-directed investment, infrastructure building, and tourism create a disproportionately large benefit for these struggling smaller economies. This has been amply demonstrated by successful Chinese efforts to ensure that ASEAN (Association of Southeast Asian Nations) members are incapable of arriving at a consensus that would be detrimental to Chinese interests. Bear in mind that all states carry the same voting rights in various institutions (even if their influence might be disparate).

This perspective on small states is reaffirmed by a growing discourse among Chinese strategists about cultivating “strategic support states.” In 2015, 50 Chinese scholars of China’s periphery diplomacy in the Xi Jinping era concluded that China could acquire “strategic support states” through regional cooperation and provision of economic and public goods as China expands. According to one extensive analysis, one of the principles of cultivating strategic support states is ensuring that “China has the ability and resources to guide the actions of the country so that they fit into [China’s] strategic needs.”¹⁰

China and Smaller States: Authority, Legitimacy, and Leadership

If China relied only on coercion and insidious forms of “sharp power,” Southeast Asian nations’ fear of an Asian hegemon in

their midst would prompt them to take on greater risks to prevent the emergence of that hegemon.¹¹ They would be more likely to embrace Donald Trump’s “free and open Indo-Pacific” or Joe Biden’s “safe and prosperous Indo-Pacific,” and to countenance more active balancing measures against the prospect of Chinese dominance. However, China has been proactive and creative in persuading Southeast Asian states to hedge in different ways rather than balance against Beijing.

China is thinking deeply and creatively about enduring and effective foundations for the accumulation and exercise of power and influence over Southeast Asian states. Beijing is cognizant that the significant powers in the region are unlikely to become Chinese allies in the manner of Japan and Australia in relation to the US. Indeed, the PRC’s 2019 Defense White Paper reaffirms that Beijing will not seek alliances with any country.¹² For that reason, dominance based on overwhelming material superiority is probably not possible, or at least will not be enduring even if achieved. Constant coercion of other states might eventually convince these states to balance against Beijing. But coercion alone cannot be a sound future basis for Chinese power and influence.

As its power grows, Beijing is therefore attempting to enhance its “authority” and “legitimacy” in relative terms, being aware that its increase in relative power will likely not last indefinitely. Whereas coercion relies on threats or actual punishments to shape or change the behavior of others, the notion of authority is based on the legitimate exercise of power. Such authority is a more efficient and enduring way to exercise power because it induces compliance from smaller powers that recognize or accept the right of China to impose obligations on them.

The recognition of such a supposed right might be based on moral, normative, or long-term material considerations. Whichever it is, the point is that smaller countries come to accept that the rules for the great Chinese power are different from the rules for smaller powers. Unlike the American rules-based framework, the Chinese proposition is inherently hierarchical. If

accepted, that hierarchy reduces the need for China to rely on mere threats or punishments.¹³

Consider the primary forms of diplomatic messaging China uses for Southeast Asia and the Pacific Island countries compared to messaging reserved for Western liberal democracies such as Australia, the US, and the European Union states. With respect to the latter groups, China promotes the notion of mutual benefit and win-win. With Southeast Asian countries, the emphasis is on the permanence and greatness of Chinese civilization as the enduring basis for hierarchical but stable and benevolent relationships with smaller states in Asia. Importantly, according to Beijing, the permanence and greatness of Chinese civilization guarantee the success of China's reemergence (as that reemergence is natural) and support Beijing's claims that the Chinese overlord will be just and fair (as it has been for millennia, according to the Communist Party's view of history).

China has attached these narratives to actual policies directed toward Southeast Asian states. For example, the Belt and Road Initiative (BRI) is designed to spur "common development" through the strengthening of infrastructure, networks, connectivity, and enhanced people-to-people interactions and exchanges. In its dealings with Southeast Asians, Beijing is not apologetic that the BRI is Sinocentric or even that Chinese entities are the primary beneficiaries. Countries are often flattered by being told that they form essential nodes for a vast Sinocentric network. But the overriding message is that benefits can flow to the entire region only if the great Chinese civilizational state is at the center of economic, political, and diplomatic life in the region. According to this message, impersonal and ruthless market-based principles that measure only profitability will create short-term winners and losers, whereas the Chinese system will give participants guaranteed and enduring benefits even if these are unevenly distributed.

Southeast Asian countries are aware that some of China's actions—its financing and building of infrastructure and other capital expenditures, its direction of development assistance and

grants, and even its granting of Approved Destination Status to boost Chinese tourism numbers—are partly based on Chinese largesse rather than impersonal market forces, which seem to drive Japanese, American, and Australian economic activity in Asia. These actions are part of China's moral, normative, and material case for its unique hierarchical authority.

Because the primary target for China is elites, the moral, normative, and material case is largely designed to achieve elite capture or co-optation throughout the region. Domestically, elite capture is how the modern CCP has remained in power and what it has learned to do best.¹⁴ In Southeast Asia, Beijing has discovered that the most efficient way to gain consent for its strategic and security policies (or at least stifle opposition) is to win over elites or else silence them. One report, which is consistent with the authors' observations, finds that elite-to-elite diplomatic outreach accounts for about 90 percent of China's outreach in these countries.¹⁵

It is also worth noting that the external purpose of China's United Front Work Department is to complement all the above objectives, specifically by promoting a series of narratives and beliefs:

- The narrative of inevitable Chinese dominance and the greatness of the Chinese civilizational state
- The belief that the CCP-led Chinese state is fundamentally undeterrable and is willing and able to absorb any cost in achieving its objectives, while the US is undependable and always at risk of abandoning Southeast Asia
- The view of China's hierarchical order as superior to the US-backed rules-based order, and the belief that the former offers guaranteed benefits while the benefits offered by the latter are uncertain
- The belief that Chinese strategic and security policies (including in the South China Sea) are a necessary component of establishing this more virtuous and beneficial order

- The belief the Communist Party has been entrusted with the great rejuvenation of the Chinese civilization and state and is the only legitimate authority over the Chinese peoples (including those in other countries), and the attendant belief that opposing the policies and principles of the CCP is tantamount to defying the will of the 1.4 billion people who are part of the enduring Chinese civilization

Analyzing various mechanisms of influence—such as the upgrading of the ASEAN–China Free Trade Area to a special ASEAN–China Defense Ministers Meeting and promotion of ASEAN–China cultural cooperation—shows that the fundamental approach is to advance Sinocentric economic opportunities in underpinning political, security, and cultural advancement and cooperation. A smooth, peaceful, and prosperous transition to an inevitable Sinocentric region is possible, according to Beijing, only when there is little or no resistance from Southeast Asian states—that is, when these states accept the “natural propensity of things”—the notion of “shi” and “harmony”—and seek to work with rather than against it.¹⁶ As Xi Jinping puts it, “When the big river is full of water, the smaller ones never run dry.”¹⁷

Consider the powerful bind and pull for these smaller states: resistance appears to be pointless, but giving in to the “propensity of things” and embracing that as “natural” will “condition” these states to act in accordance with China’s wishes.¹⁸

China’s Economic Strategy

In July 2020, Chairman Xi Jinping articulated a new dual circulation strategy to supposedly unleash the full potential of China’s domestic demand, build technological and other forms of self-reliance as quickly as possible, and position China to engage with international markets more resiliently and on superior terms. This strategy includes creating self-sufficient cycles of production, distribution, and consumption for domestic economic development.

The CCP has long aimed for economic autarchy and self-reliance in many areas. More recently (since before the advent of

the Trump administration), Beijing has sought to limit its economic exposure and dependency on the US and craft strategies to advance a Sinocentric economic order that excludes the US in important areas and limits US involvement in others.¹⁹

Some recent history is required. The CCP’s economic mindset stems from an enduring sense of economic insecurity despite decades of economic expansion. At the end of the first decade of this century, despite three decades of double-digit economic growth, China’s economy remained far less resilient than was widely assumed, and Beijing still needed Western markets and consumers to fuel the country’s export-driven growth. Net exports were the primary driver of gross domestic product (GDP) growth up to the 2007 global financial crisis. To achieve constant economic upgrading and drive the increase in its export-oriented and domestic manufacturing capabilities, the country predominantly depended on foreign (especially US) technology, innovation, expertise, and commercial know-how.

This is the context for blueprints such as the BRI. There are understandable economic benefits for China in advancing the initiative, not least in creating external capital investment opportunities and external markets for its large, lumbering, and capital-intensive infrastructure and construction firms. But consider what else it is designed to achieve. Its other objectives include the building of Sinocentric regional infrastructure, platforms, and institutions to facilitate trade, investment, and other beneficial economic exchanges between China and countries along the BRI. All six main economic corridors are designed to connect to China so that the latter emerges as the central hub. So while the immediate goal might have been to create external capital investment opportunities for Chinese firms, the greater and grander purpose is to ensure that roads, rail, ports, cables, digital networks, and infrastructure begin and end in Chinese provinces—and operate on terms favorable to Chinese interests.

Because China has used state resources to build the vast Sinocentric economic system within which Chinese firms and enti-

ties dominate, these firms are able to negotiate the terms and conditions of any deal—with an American or other foreign firm or other entity. Disputes and disagreements are not resolved by preexisting laws and rules, but through negotiations where Chinese political and economic leverage is brought to bear, or according to BRI rules and processes drafted by Beijing.

Additionally, with a greatly reduced US commercial presence in East Asia and Eurasia, the capacity for American firms and authorities to set or revise commercial and quality standards is greatly diminished in all sectors. Once such standards are set, it is expensive—usually prohibitively so—for firms and economies to operate in a different economic ecosystem. When BRI economies are combined with Sinocentric infrastructure, institutions, logistical networks, and the like, they become captive to China. At the same time, outsiders such as the US are in a much weaker position to enter what Beijing hopes will be the most important economic zone in the world, stretching from East Asia to South Asia, from Central Asia to Western Europe, and from the Middle East to Africa.

Further complementary plans, such as Made in China 2025 (MIC 2025), show how China sees economic competition on its own terms. This plan envisages Chinese control over, and dominance of, entire manufacturing processes, supply chains, and associated services supporting the dozen advanced sectors identified. It should be noted that Beijing is in violation of World Trade Organization rules by specifying domestic-content targets for core components and materials of 40 percent by 2020 and 70 percent by 2025.

The explicit objective is not simply to ensure China becomes an advanced and innovative economy, but to control the global supply chains, innovation, and know-how required to ensure Chinese firms dominate the identified sectors in global markets. In looking to decouple from or lock out America and other major economies, or else keep them from being able to compete successfully, Beijing is hoping the economic contest

will be over before Americans truly realize it has begun. This is the context within which to understand Xi's dual circulation strategy, which is largely a reiteration or extension of the MIC 2025 approach of decreasing reliance on technology imports through self-sufficiency.

A recent addition and update to further the Chinese vision of success is the introduction of frameworks and concepts linked to the Global South. In a virtual address to the United Nations General Assembly in September 2021, Xi introduced China's Global Development Initiative (GDI). Ostensibly, the GDI is not revolutionary in that it exists to support and fast-track the UN 2030 Agenda for Sustainable Development by "[steering] global development toward a new stage of balanced, coordinated and inclusive growth."²⁰ Priority areas for the GDI would include poverty alleviation, food security, COVID-19 response (including vaccines), development financing, climate change and green development, industrialization, digital economy, and connectivity.

While the US and Australia paid relatively little attention to the GDI, the initiative is clearly poorly aligned with and inconsistent with important US and allied interests, values, and principles. For example, the GDI identifies economic development as the "master key" to "all problems" and as the prerequisite for citizens to enjoy human rights.²¹ The implication is that governments should feel legally and morally entitled to prioritize economic development over human rights and that Western notions of human rights are less relevant or irrelevant to developing nations. The Chinese approach also criticizes key liberal virtues such as transparency, accountability, and contestability. Finally, the GDI elevates the collective or greater good over universal and individual rights—implying that it is the prerogative of the ruling regime to define the collective or greater good.

The relatively low levels of Western interest in the GDI, and the little attention given to it by many academic and policy experts, is even more remarkable considering that more than 100 countries and international organizations have since expressed inter-

est in (but not necessarily offered support for) the initiative, while 50 countries—nearly all of them developing economies—have joined the UN Group of Friends of the Global Development Initiative established by Beijing in early 2022.²² UN General Secretary Antonio Guterres and numerous UN agencies have also supported the GDI.

Moreover, Beijing is increasingly linking the GDI with its Global Security Initiative (GSI) announced in mid-2022—and both the GDI and GSI are linked to the so-called Global South.²³ Prima facie, the GSI is more concerned with security than development. Talking about the GSI at the 2022 Boao Forum, Xi focused on “indivisible security” and a “balanced and sustainable security architecture,” as opposed to “exclusive” arrangements such as the Quadrilateral Security Dialogue (or Quad, which includes the US, Japan, India, and Australia) and AUKUS (the US, United Kingdom, and Australia).²⁴

However, the GSI is largely being packaged as the geopolitical complement to the GDI and BRI within a Global South effort. For example, when addressing developing nations, China frames the GSI as a broad geopolitical approach to enhance and accelerate rapid economic development and material advancement. As Ved Shinde notes, the claim is that the GSI advances the approach of “respecting the independent choices of development paths and social systems made by people in different countries.”²⁵ The more “inclusive” GSI is contrasted with US-led security architecture that imposes Western institutions and systems on developing nations as a precondition for material assistance from the West. As has been observed, the GSI (along with the GDI and BRI) comprises a “non-Western alternative and mechanism by the global south for the global south.”²⁶ David Arase points out that China’s GSI is being explicitly contrasted with the material and ideological “hegemonism” of the US and the West.²⁷ The GSI is also being linked with Chinese notions of “Asian” approaches and Asian unity—the implication being that US initiatives are divisive and unsuited to the developing needs of much of the Global South.

The Global South concept offers attractive and fertile ground for China, which has the advantage of being a Global South nation that is highly industrialized and innovative but also a developing and middle-income economy. As scholars such as Kenton Thibaut observe, China “sees the Global South as an important vector for enhancing discourse power.”²⁸ In Thibaut’s view, such discourse power emphasizes narratives and promotes institutions that support an authoritarian view of state sovereignty, human rights, and economic development. The Global South concept is also useful for China because, beyond its connection to the assessments and grievances explained above, *it is an amorphous concept connected with the narrative and psychology of subjugation (by the Global North) and victimhood—which can be weaponized against the West.*

China is positioning itself not just as a member and leader of the Global South, but as the only member with solutions and options that allow other Global South economies to avoid further submission to and capture by the Global North nations, which continue to dominate international institutions.²⁹ China thus appears not merely the leader of a resistance but the first among equals of a fledging but rising Global South order (or at least a hybrid international order that is more empowering for and better reflects the priorities of the Global South).

Beijing treats the notion of Global South more as a concept to weaponize against the US than as a comprehensive organizing principle for its relations with the world. China is still heavily dependent on the US and other Western countries for technology, innovation, capital, and know-how, and requires access to their markets. Unlike some of the regimes and elites in poorer and smaller nations, Beijing may not genuinely see itself as being subjugated or structurally disadvantaged by the West. In fact, China has spent the last three decades devising ways to exploit and gain disproportionately from its relationships and agreements with the Global North. In some sense, Beijing’s desire to be seen as the leader of the Global South is an attempt to benefit from interactions with richer Western

nations while exploiting the Global South concept for its own purposes.

At the same time, the focus on South-South relations is more than just propaganda to be used against the US and other fully developed democracies. China casts itself as the champion of developing countries. The South-South cooperation approach entails more than just aid or overseas development assistance, as it includes investments, diplomacy (and advocacy for “South” issues), and other frameworks such as those implemented through the BRI.

Moreover, GDI is a significant development because it seeks to introduce a normative framework for China’s South-South activities. For example, GDI was introduced because the UN’s 2030 Agenda for Sustainable Development was supposedly failing under the leadership of the US and Western powers. China promotes its approach—based on state-led outcomes rather than allegedly self-serving Western principles, such as Organization for Economic Co-operation and Development (OECD) principles championed by the West—as the better way ahead for developing nations.³⁰ The Chinese framework includes Chinese alternatives to Western approaches to governance and transparency, aid, digital standards, finance of infrastructure and other projects, trade agreements, and international institutions.

Indeed, China ties the GDI with existing blueprints such as the BRI to offer what it promotes as a more comprehensive approach to development success. While China is not seeking in every case to export its model of authoritarian development to other countries, it is looking to legitimize its political-economic model, elevate it above that of the democracies, and present it to developing nations as morally and practically superior to the Western model. Indeed, with Global South economies in mind, China will likely use the GDI as a counterpoint to US initiatives such as the G7’s Partnership for Global Infrastructure and Investment, the US-Pacific Economic Framework, and the Quad’s sustainability and development agenda.

The combination of all this is fertile ground for China, including in East Asia, for several reasons:

- China can succeed at elite capture or co-optation by offering immediate and guaranteed economic and commercial gains to elites and their countries. Elites in many developing economies will accept Chinese material offerings even if China is the primary beneficiary of the arrangement. The intended consequence is that these countries find themselves more reliant on Chinese acquiescence and largesse, but also in a weaker position relative to China.
- These Global South regional economies are often not attractive places for multinational firms to invest and operate in. This means elites in these countries are even more desperate for any guaranteed Chinese offering and are willing to do political or strategic favors in return.
- Elites in many Global South regional economies fall foul of Western democratic norms and practices. The partnership with China gives them protection and the promise of material benefits without any pressure to change or reform.³¹
- Countries and elites who come to rely on Chinese capital or largesse are vulnerable to its withdrawal. In essence, they become locked into the Chinese system, and leaving that system carries high exit costs and risks.

China’s Global South strategy can be seen as an increasingly important part of Beijing’s Indo-Pacific or regional strategy to ease the US out of its periphery and advance the creeping Sinocentric order. The GDI and GSI provide a defense against the alleged “bullying of the weak states by the West” and a pathway to transcend Western geopolitical constraints and norms.³² The focus on winning over the developing nations is becoming ever more important in the Xi Jinping era. In reference to China’s relationship with regional developing nations, China is using its successful development record, size, and

market power to act as the shaper of economic and regional governance. While the US continues to enjoy strong discursive and institutional power over Western democracies, developing nations' appetite for China-led frameworks and mechanisms is growing. This is evident in the contrast between the responses of developed versus undeveloped economies to Chinese initiatives such as the BRI. There is an alignment between the goal of legitimizing China's domestic political economic system and efforts to promote its authoritarian approach to neighboring developing countries.

Moreover, there is a strong alignment between efforts to increase the spread of China's approach to development and the CCP's broader geostrategic goals.³³ The adoption of Chinese approaches and frameworks by developing economies in the Indo-Pacific will not change the US and Western determination to counter and constrain China. But it will make it far more difficult to do so.³⁴

Finally, Xi continually speaks about the "great changes unseen for a century" as one underpinning for Xi Jinping Thought.³⁵ In the current global system, the post-World War II institutions underwritten by the US have not kept pace with the great shifts in global power that Xi is referring to. But merely criticizing allegedly outdated institutions is insufficient. In this sense, China's focus on winning over the Global South—beginning with its immediate region and shaping new and dominant institutions and norms to favor Chinese interests—is consistent with the perceived structural trends in power now occurring. It creates a stable Sinocentric hegemonic order around China's periphery by allowing developing economies a greater material stake in the emerging Chinese order, and puts the CCP "on the right side of history."³⁶

Summary of Key Aspects of China's Strategy

The Chinese strategy is a nuanced and gradual one that is built on two pillars:

- Maintain the viability and robustness of the current CCP-led political economy and expand this approach (and related principles and processes) throughout the region.
- Continually shrink the strategic, military, economic, political, and normative ground in the region on which the US can sustain, build, and demonstrate its power and influence.

This strategy applies to China's decades-old military modernization approach, as it does to the Belt and Road Initiative, the Global South effort (which excludes or else locks out the US), China's "Asia for Asians" messaging, and the relentless promotion of a Sinocentric system—presented as the natural and permanent state of affairs in the region—at the expense of the US-led liberal regional order. To isolate stubborn US allies such as Australia and Japan, China is changing, manipulating, or denying the capacity or resolve of regional states to assist the US in maintaining or extending its role and presence in Asia.

In summary, Beijing's material and nonmaterial approaches to achieving success are based on the following key priorities:

- **Simplify and reduce the complexity of the strategic map.** For China, the fewer active strategic players, the better. The Chinese ideal is that other regional states remain on the sidelines so the strategic competition/rivalry is only between the US (and a small band of stubborn allies) and itself.
- **Use gray-zone tactics to present an actual or perceived fait accompli** (e.g., actions in Taiwan and the South China Sea, or domination of supply chains from which other states cannot extract themselves).
- **Manipulate, persuade, or compel smaller regional states to focus on absolute rather than relative gains** (*win-win Chinese style*). As China is invariably the larger and more powerful party, Chinese entities are generally better able to negotiate an advantageous outcome for themselves

in any arrangement or agreement. However, Beijing will often present guaranteed (absolute) gains to the weaker side to entice them to agree to the arrangement. In the medium to longer term, these countries then find themselves more reliant on Chinese acquiescence or largesse, as well as in a weaker position relative to China.

- **Manipulate, persuade, or compel smaller regional states to separate geostrategic or geopolitical issues from economic issues and persuade them to focus only on pursuing short-term economic gains.** This approach allows China to be the only state genuinely enhancing its comprehensive national power, putting it in a better position to deploy all tools of national power to achieve the CCP's objectives. This approach is supported by Beijing's increased capacity and willingness to consider and use all Chinese public and private sector entities as tools of the party and state. Moreover, by getting other states to focus on economic growth (i.e., absolute economic gains) rather than other forms of power, China increases its relative dominance in these other forms, and thereby its overall leverage in the longer term.
- **In every context (military, economic, diplomatic, etc.), ensure that China appears more willing and able to**

escalate than either the US or another regional state.

This approach reduces the resolve of the other state. China will link this approach to its capability or authoritarian socialist system, which purportedly allows it to mobilize and respond more quickly and decisively than other states. At the same time, Beijing will emphasize limitations around the specific issues on which it chooses to escalate; the aim is to suggest that achieving one goal (e.g., in Taiwan) is not a precursor to another one (e.g., in the South China Sea). This approach increases the incentives for the US and others to concede each time Chinese escalation occurs.

- **Normalize forms of Chinese behavior such as coercion.** This approach not only offers Beijing a broader tool kit for statecraft, but it also eventually leads other states to accept and internalize such Chinese behavior. As a result, attempts by the US or others to resist or counter such Chinese behaviors are perceived as provocative, escalatory, or futile.

Note that these strategies all reinforce the Chinese grand narratives mentioned above about the inevitability of Chinese dominance and the futility of resistance. If countries accept Beijing's narratives, then success is assured.



CHINA'S WORSENING DILEMMA: GUNS VERSUS BUTTER

To enhance their agency and options in the comprehensive competition and rivalry with China, it is important for the US, Australia, and their allies to understand Chinese vulnerabilities and weaknesses in the context of the struggle. Chinese growth in hard power has been accompanied by immense domestic weaknesses and fragility. Indeed, the increase in hard power is in important respects driving worsening domestic weaknesses and fragility. The key for the United States and its allies is to find ways to exploit these to their advantage.

Chinese Overspending on Domestic and External Security

China achieved its impressive military modernization by allocating enormous resources to this end. From 2001 to 2011, military spending increased by about 189 percent. From 2011

to 2019, military spending increased by about 190 percent. From 2019 to 2022, military spending increased by about 12 percent.³⁷ These calculations use official Chinese numbers from the Ministry of Finance, which consistently understates what Beijing is truly spending on the military.³⁸ They also do not include national resources as part of the country's military-civil fusion policies.

China also spends heavily on the People's Armed Police (PAP), which is a military-trained but domestically focused entity con-

Photo: J-10 fighter jets of the Bayi Aerobatics Team of the People's Liberation Army Air Force perform in the sky ahead of Changchun Air Show on August 23, 2022, in Changchun, China. (Photo by Zhang Hui/VCG via Getty Images)

centrating on managing and suppressing domestic unrest and threats. From 2001 to 2010, China allocated to the PAP the equivalent of around 90–100 percent of what was allocated to the PLA (on top of resources put toward normal policing). However, since 2010, the PAP’s budget has been larger than the PLA’s. By some estimates, the PAP budget was around 103.5 percent of the PLA’s budget in 2010, and it had risen to around 119 percent of the PLA’s budget by 2017.³⁹

Compare these expenditures with government fiscal revenues, which grew 80 percent during 2001–11 and 90 percent during 2011–19.⁴⁰ Since the early 1990s, growth in the annual budgets of the PLA and PAP has been double the growth in both GDP and fiscal income. Currently, almost half of central government expenditure (after transfers to local governments, which are primarily responsible for the provision of social and public goods) goes to the PLA and PAP. And beyond this, local governments are obligated to spend up to 10 percent of their central government receipts on the PAP. The bottom line is that total Chinese government spending (central and local) is at least 12 percent of the entire fiscal budget. If the calculation assumes, as the Stockholm International Peace Research Institute does, that the true PLA budget is over 55 percent higher than the official one, then more than 60 percent of central government expenditure (not including transfers to local governments) is for the PLA and PAP, which equates to around 15 percent of total Chinese government spending.

Central versus Local Government Priorities

These expenditures and expenditure arrangements exacerbate another serious problem for the CCP. Prior to 1994, approximately 78 percent of fiscal revenues went to provincial/local governments (referred to as “local governments” in this report), which are responsible for approximately 72 percent of government expenditure. After the 1994 fiscal reforms, an increasing amount of fiscal revenue was collected by the central government. In 1995, local government revenues dropped to 44 percent of all government revenue. By the middle of the last de-

cade, local governments received about half of all fiscal revenue (most coming from central government transfers), even though local governments were responsible for about 85 percent of all government expenditure.

Since 2007, the funding gap between fiscal transfers received by local government and expenditure commitments has been increasing; it now represents about 10 percent of GDP (approximately US\$1 trillion to US\$1.35 trillion) and continues to increase. So far, Beijing has resisted significant fiscal reform. The central control over fiscal finances has allowed Beijing to direct enormous and growing shares to national domestic and external security (e.g., the PLA and PAP). To alleviate the plight of local governments, Beijing has chosen to implement some band-aid solutions.

One such solution is forcing lenders (to local government financial entities) to roll over maturing loans. Another involves allowing local governments to issue bonds to fund capital projects, and to manage or pay off existing debts.⁴¹ Even then, there has been adequate demand for such bonds only because they are implicitly guaranteed by the central government, meaning a large proportion of them will become a central government liability upon maturity given the indebtedness of local governments. Moreover, the problem is exacerbated because a growing percentage of new borrowings by local government entities is being used to manage existing loans. For example, in 2015, it was estimated that local governments were using up to one-third of all new borrowings just to keep existing loans from defaulting.⁴² The worsening of dangerous corporate debt levels and the exponential rise of off-the-books lending (widely referred to as the shadow banking system) are largely being driven by local government state-owned enterprises (SOEs) and so-called local government financing vehicles (LGFVs) seeking to meet their economic commitments and obligations, including the need to increase their revenue base to fund the provision of social and public goods.⁴³

The problem for the central government is that the local government shortfalls cannot be quarantined or ignored. While

the central government has assumed primary responsibility for national defense (external as well as internal), external diplomacy, and national infrastructure projects, local governments continue to take the lead in local construction and infrastructure, education, health care, and most other social and public goods. The central government's establishment of new social schemes without consideration for their funding makes this situation worse. For example, the Chinese government announced recently that it will extend minimal public health insurance to almost 95 percent of the population, with local governments expected to pick up much of the expense.

Public Chinese demands on local governments will grow exponentially up to 2030 and beyond. Demographics are a compelling indicator for this. China's population is aging; by 2040, the segment of the population 65 and older will increase by 150 percent from 2015 levels (i.e., from 135 million people to 340 million people, almost a quarter of China's population)⁴⁴—but only around one-third of all urban residents and less than 10 percent of rural residents currently have some form of central, provincial, or local pension fund. For China's spending on social and public goods as a percentage of GDP to reach a level similar to that of other lower-middle-income countries, the government will need to find an additional US\$1 trillion per year. If calculations include liabilities from existing but unfunded pension schemes in an aging society, the result could be fiscal pressures unprecedented for any recent major economy.

More generally, China spends just over 25 percent of its total governmental expenditure on social goods such as welfare safety nets, health care, and education, with local governments responsible for about 95 percent of spending in these areas.⁴⁵ Among lower-middle-income countries, the average share of budget spent on these public and social goods is around 36 percent. The figure is 33 percent for upper-middle-income countries and 42 percent for OECD countries.⁴⁶

The following conclusions can be drawn from the above analysis:

- In keeping with the current trend, Beijing's sense of both domestic and external insecurity is likely to increase even as it spends more on national (domestic and external) security in an absolute and relative sense.
- The central government is allocating a growing share of national resources and fiscal receipts to domestic and external security and to power projection. Simultaneously, it is taking an ever more dominant role in collecting and allocating fiscal revenues to ensure that it can control and allocate national resources for state and party purposes.
- The central and local governments systematically under-spend on social and public goods, largely a result of the focus on national (domestic and external) security.
- Requirements for public spending not related to security will increase dramatically in 2030 and beyond due to systematic underspending in these areas, changes in demographics, and changes in citizens' expectations.
- The focus on national (domestic and external) security is creating serious problems for local governments, which are resorting to ever riskier and more leveraged approaches to increasing revenue and managing existing debt.

The CCP is aware of these fiscal and broader economic/social issues. In 2017, the Nineteenth Party Congress declared China's most pressing challenge to be the contradiction "between unbalanced and inadequate development and the people's ever-growing needs for a better life."⁴⁷ The theme has been reiterated periodically since and refers specifically to the fact that growing national wealth is not leading to proportionate gains in public and social goods for citizens.

Over the next 10–20 years, the CCP is seeking to dramatically raise public/social spending without reducing the growth in spending on the PLA and PAP. The CCP is also seeking to

avoid any fiscal reforms that would substantially increase local governments' fiscal collection powers and responsibilities, as Beijing aims to further centralize policies, actions, and spending to enhance national power.

To avoid a direct trade-off between spending on national security and spending on public/social goods, Beijing is looking to dramatically increase its fiscal revenues. The problem is the country's limited and unbalanced tax base. For example, in 2019 (a typical year), about 45 percent of fiscal revenue came from a domestic value-added tax (in which producers pay at every stage of production) and 21 percent from corporate income taxes. Only 6 percent came from personal income taxes.⁴⁸ This figure is not surprising, as only about 30 million people, or about 2 percent of the population, pay income taxes.

Hence, China's tax receipts are tied heavily to the performance and profits of corporations rather than to household or personal income. In turn, corporate performance is disproportionately reliant on fixed or capital investment to generate growth: a dramatic slowdown in fixed investment growth will disproportionately impact corporate performance, and therefore tax revenues. This problem is inextricably linked to the country's SOE-dominated political economy, in which SOEs have been the primary commercial beneficiaries of growth and opportunity.

This is the context for a serious Chinese problem. Around a dozen large SOEs (and their subsidiaries) account for about 70 percent of all profits made by central SOEs, while up to half of the more than 150,000 other central and local government SOEs do not make any profits.⁴⁹ By any commercial measurement (such as return on investment, return on assets, or total factor productivity), SOEs tend to be 30–50 percent less efficient than China's private sector firms—even with the capital, land, regulatory, and taxation advantages SOEs enjoy. Indeed, a large part of the motivation behind the BRI and MIC 2025 is to create a permanent structural economic environment beyond China that will provide the next great boost in profits for Chinese SOEs

and national champions. Beijing's plans to increase spending on both national security and public/social goods depend on it.

The Problem of an Aging Population

The aging of China's population will lead to problems that are not well appreciated. Minimizing the negative economic and national power impacts of the aging population depends on Chinese domestic policy settings. When China began its market reforms in 1979, there were about seven working-age persons to every person of retirement age. Today, the ratio is about 5 to 1. Current projections suggest that by 2035 there will be fewer than 2.5 working persons for every retiree. The age profile of the working population also matters. Studies show clearly that most workers are at their most productive and innovative from their late 20s to their 50s. These workers were the basis for China's "demographic dividend" from the 1980s to the 2000s; the combination of declining fertility levels and a mass of young workers entering the workforce with relatively few familial responsibilities generated enormous productivity.⁵⁰

By 2040, China's population over the age of 50 will include 250 million more people than in 2015, while the population under the age of 50 will include 250 million less. By 2040, the median age in China will be 47—higher than was the case for any country in 2015.⁵¹ Economies can only grow in one of three ways: more labor inputs, more capital inputs, or more productive use of labor or capital inputs (known as total factor productivity). From 2030 to 2040, China's capacity to significantly increase labor and capital inputs will be constrained for the reasons given earlier. So China will have to make difficult decisions about fixing the domestic structural inefficiencies related to its political economy. It also means that Chinese firms will have to create and capture disproportionate value and profit from economic and commercial interactions with the region.

Shrinking China's External Commercial Opportunities

This situation offers an additional powerful incentive for the US and Australia to prevent Chinese firms from dominating the

maritime economies in East Asia (by forcing those businesses to compete on commercial grounds against much more efficient advanced economy firms) and to drive Chinese fixed investment (including BRI projects) to the less profitable and less palatable economic regions in continental Eurasia.

The current financial dynamics for Chinese funding of the BRI could become a millstone on China's back over the next two decades. Presently, around 87 percent of this funding comes from the country's already over-leveraged state-owned policy and commercial banks. Of the remainder, about 9 percent comes from Chinese commercial firms, 2 percent from multinational financial institutions such as the Asian Infrastructure Investment Bank, and 2 percent from the Silk Road Fund.⁵² In other words, 98 percent of the funding comes from China's already over-leveraged domestic financial and commercial entities, while the Silk Road Fund draws most of its financing from the country's foreign currency reserves, which will decrease if trade with the US stagnates or declines.

These dynamics offer a powerful incentive for the US and others to counter, contain, and negate Beijing's MIC 2025 plans as much as possible in the time before 2025 and beyond.

Summary: Exploiting Chinese Political-Economic Weaknesses

Unable to establish a Sinocentric maritime East Asian economic zone where Chinese entities benefit from entrenched privileges and exclusive opportunities, Beijing faces a difficult choice regarding domestic political-economic reform: either allow the private sector to become genuinely private and operate on a level playing field with SOEs (which will significantly raise household incomes and therefore broaden the tax base) or suffer a chronic and serious decline in growth of corporate profits and fiscal revenues. The CCP's domination of SOEs, and the SOEs' domination of the economy, help entrench the CCP's role and relevance in the Chinese political economy and help it to remain in power. But a largely unreformed Chinese political economy

(i.e., one where SOEs and national champions continue to receive the lion's share of privileges and opportunity, and where the CCP continues to control and supervise all firms) must force Beijing to make another difficult choice: continue to prioritize domestic and external national security at the risk of greater national fragility, or agree to significant increases in the funding for public/social goods to meet rapidly rising domestic needs.

Even if Beijing refuses to reform its political economy and chooses to prioritize national security, it is in the interest of the US and its allies that Beijing directs an increasing share of funding to domestic/internal rather than external security. Just as core interests expand and military doctrines become more elaborate when the military budget is rapidly expanding, they tend to be dialed back as priorities if military budgets stagnate. Beijing has a number of separate missions that require their own investments and resources: "containing separatist forces," "resisting aggression" from land-border neighbors (such as India), and carrying out "core missions" like "safeguarding border, coastal, and territorial air security" and "winning local and regional wars [against the US and its allies] under informatized conditions." So far, Beijing has not had to make zero-sum funding decisions. The US and others can bring forward the time it must do so. An unreformed Beijing needs to be forced to make such difficult choices.

Bear in mind that in a time of generous budgets, the CCP suppresses underlying rivalries between the PAP and PLA, as well as interservice rivalries within the PLA. As budgetary belts tighten, these rivalries will emerge and intensify. This could help retard improvements—such as in human capital, training, and logistical and integrative (or jointness) capabilities—that the PLA needs across all services.⁵³

The CCP's ability to remain in power depends on its capacity to co-opt economic and social elites by providing the best economic, career, and social opportunities. The ideal would be to increasingly see more genuine separation—in agency, oversight, corporate activity, and institutional connection—between

the CCP on the one hand and Chinese economic actors on the other. That greater separation between party, state, and corporate entities offers a number of benefits:

- It reduces the presence of and role for the CCP in almost every aspect of Chinese civil society.
- It reduces the potency and effectiveness of military-civil fusion policies and outcomes.
- It reduces Beijing's capacity to compel Chinese firms to economically coerce other nations and foreign firms.
- It decreases Beijing's capacity to use Chinese firms to pursue foreign and strategic objectives in the region.
- It decreases the commercial, security, and political risk of US and other firms doing business with Chinese firms.

It reduces the CCP's capacity to compel Chinese firms to help Beijing advance supervision and surveillance over its own citizens (and implement related policies such as the social credit system). In addition to its impact on human rights, this change helps to expand private space for citizens, enable the development of an

independent civil society in China, and reduce the CCP's capacity to control information coming into and out of China.

Beijing is likely to come up with some proactive tactical responses to many of the problems noted in this chapter that will fall short of reform. These include deepening local and central government and corporate bond markets to fund shortages; widening the tax base to help government become more immune to the corporate performance of its firms; and implementing measures that reduce overt or serious corruption within SOEs. Regardless, none of these measures solves the problem of the country's highly inefficient and somewhat dysfunctional political economy, which encourages the massive and systemic misallocation of economic resources and opportunity. A closed Chinese capital account prevents mass capital flight and gives the CCP a guaranteed capital base to draw from. But such economic policies will continue to dampen international appetite to purchase Chinese equities and bonds.

None of these tactical fixes can alter the conclusion: *Chinese efforts to enhance national power and security cannot continue in the same uninhibited way as in the previous two decades.* This problem for China creates strategic opportunities for the US and its allies that should be exploited.



TOWARD A SUCCESSFUL COUNTERSTRATEGY

There is growing recognition that the US and Australia need to prepare to compete in systemic terms rather than simply prepare to prevail in the event of contingencies in specific theaters (e.g., the Taiwan Strait) or over specific issues (e.g., global leadership in key technologies such as 5G and artificial intelligence). According to an analysis published by the RAND Corporation, “The United States [and its allies] should seek to maintain predominant influence over the international system—its institutions, rules, norms, processes, networks, and values.”⁵⁴ This analysis argues that the US and its allies need “to think and act *in systemic terms*” rather than focus on “individual disputes. That means moving away from linear, problem- and issue-specific strategies and working to generate broader and more indirect effects.”⁵⁵

The requirement to compete at a more comprehensive or systemic level is recognized throughout key documents such as the US National Security Strategy and Australian Defence Strategic Review. However, much of the policy literature on

comprehensive competition is based on one system seeking dominance or preeminence over the rivalrous one. The more likely scenario, and one that this report deals with, is competition in an Asian environment where contrasting and hybrid parallel orders are present. Just as neither the US nor China is likely to comprehensively dominate Asia in material, institutional, or normative terms, the emerging and evolving order will have a mixture of liberal and authoritarian elements underwritten by the US (and its allies) and China respectively. Most if not all nations will have substantial interactions with both great powers and will therefore participate in both the US-led and China-led orders. It is within this hybrid and contested meta-system that a US and Australian vision of success is conceived.

Photo: Australian Prime Minister Anthony Albanese, US President Joe Biden, and British Prime Minister Rishi Sunak hold a press conference after a trilateral meeting during the AUKUS summit on March 13, 2023, in San Diego, California. (Photo by Leon Neal/Getty Images)

China is engaged in an ongoing effort to shrink the strategic, military, economic, political, and normative ground in the region on which the US and Australia can sustain, build, and demonstrate their power and influence. The US and Australia must clearly counter this effort. However, the countries' countermove is not as straightforward as increasing their ground and shrinking China's in an absolute sense. This is because China has the advantage of operating in its own region. Therefore, the US and its allies likely cannot significantly shrink China's strategic, military, economic, political, and normative ground (in absolute terms and relative to the US and its allies), even if they might manage to do so in some contexts. Hence, simply outspending or outmuscling China is not a feasible strategy. However, it is critical for our interests that China punches beneath its material weight while the US and Australia punch above theirs.

Taking Advantage of Strategic Disorder and Regional Insecurity

When AUKUS was announced in September 2021, American and Australian diplomats assured East Asian countries that the pact would not trigger a new regional arms race, and that Australia's plans to enhance its military capacity and reach would be a force for stability and a continuation of business as usual. The eagerness to calm and placate raised eyebrows in the region, where for decades the US had been militarily and economically dominant and where it had fostered a system of hub-and-spoke alliances. This liberal order dampened security competition and rivalry between states, as none were powerful enough to challenge the US-enforced status quo. This allowed developing states to pursue the so-called peace dividend of economic development while they outsourced strategic and security matters to the US-led system. As G. John Ikenberry puts it:

Over the decades, the United States found itself playing a hegemonic role in the region—providing security, underwriting stability, promoting open markets, and fostering alliance and political partnerships. It was an order organized around “hard” bilat-

eral security ties and “soft” multilateral groupings. It was built around security, economic, and political bargains. The United States exported security and imported goods. Across the region, countries expanded trade, pursued democratic transitions, and maintained a more or less stable peace.⁵⁶

Within the safety of this US-led order, most maritime Asian states grew accustomed to pursuing absolute rather than relative material gains, as rivalries were suppressed and rapid economic development trumped other objectives and achievements. They also came to place the highest premium on stability and gradualism, treating unpredictability and disruption as inherently undesirable and seeing cooperation and (economic) integration as absolute goods. Finally, countries became less interested in enhancing their strategic agency and relevance in the affairs and maneuverings of regional and global great powers, and they elevated the principle of formal sovereignty and noninterference in another's internal affairs over other norms.

The contemporary problem is that a regional order consisting of largely compliant or insipid states (in strategic terms) works to China's advantage. Such an order is well aligned with Chinese efforts to create a modern tributary system in Asia, where subservient states offer modern forms of tribute as well as compliance and silence in return for largesse, opportunity, and hierarchical stability. Even structural trade elements such as the integration of supply chains are being reengineered to advance Chinese order and authority. And rather than appealing to rules or laws as the final arbiter, China maintains and enforces that order through the threat of coercion—a threat that smaller states have gradually normalized and internalized.

This is an immense challenge for the US and Australia because it requires them to reverse an approach that goes back decades. For the second half of the twentieth century, the US encouraged the withering of strategic muscle memory among regional states, and the outcome was peace, stability, and ris-

ing prosperity. But in the second quarter of this century, the absence of strategic muscle memory could render the region incapable of opposing Chinese dominance.

Hence *the return of competitive nationalisms and even of rivalrous mindsets over the next two decades would be a net strategic benefit for the US and Australia*. This is not to suggest that such nationalisms and mindsets will necessarily be directed against China or always be aligned with US and allied interests. They may even be damaging to the latter. But their return will indicate that countries are beginning to devote material resources, including military resources, to advancing and defending their interests against external (and not just internal) threats. Countries should be encouraged to pursue relative and not just absolute gains. Importantly, they need to discover (or rediscover) martial attitudes and the resolve to use blood and treasure to defend their core interests, as countries such as Japan and Taiwan are beginning to do. This shift complicates the strategic environment for China much more than it does for the US and its allies, since it is China that seeks to decrease the number of significant strategic actors in the region.

The withering of Southeast Asian strategic memory and muscle over decades is reflected in the defense expenditure of the maritime states. Singapore and Vietnam have respectively spent around 3–5 percent and 2–2.5 percent of GDP a year over the past few decades, but they are the exceptions. Malaysia, the Philippines, and Thailand have had an average defense spending of around 1–1.5 percent of GDP over the last 10 years. In 2022, the respective figures for these three countries were 0.96 percent, 1 percent, and 1.16 percent. In Indonesia the figure is even lower: it has spent less than 1 percent of GDP each year on defense since 1998, and in 2022 spent 0.7 percent of GDP.⁵⁷

To be sure, some states, such as Malaysia, Indonesia, and the Philippines, are putting greater doctrinal and policy emphasis on the maritime domain rather than traditional land-based capabilities, which are much more inward-focused (against do-

mestic insurgencies and terrorism). There are also numerous policy documents promising to enhance asymmetrical denial capabilities over an advanced adversary (i.e., China) in the maritime domain. But despite a high number of potential military suppliers (including Russia, the US, European nations, Japan, South Korea, and China), only Singapore has managed to build up an inventory of modern weapons.⁵⁸

From a strategic perspective, the continued withering of Southeast Asian strategic muscle memory and military ambition eliminates what ought to be a significant roadblock for a China seeking hegemony in East Asia. It also reduces strategic opportunities for the US, Australia, and other allies to work with these smaller nations so as to complicate matters for China. Over the next 10 to 20 years, demographics and economic expansion will likely allow some minor players—countries like Vietnam and Indonesia—to become far more formidable (if they can get their domestic and military policy settings right).⁵⁹ None of these rising powers will be large enough to contemplate a post-American regional order, and the region will still need the weight of the US and its allies to provide some balance. The latter will still have sufficient power to regulate competition and rivalry between many states. But these rising powers could be formidable enough to create strategic problems for China in their immediate periphery. At the least, Beijing would be forced to recalculate the costs and benefits of its expansionary actions.

It is important to recognize that as the PLA becomes more informatized, networked, and advanced overall, the opportunities for smaller powers to asymmetrically impose expensive and considerable costs grow. The feasibility of smaller states acquiring cheaper weapons and capabilities, and with them causing damage to the advanced and expensive military assets of China or any other country, is increasing. This so-called asymmetrical approach is reflected in Australian documents like the 2020 Defence Strategic Update and the aforementioned 2023 Defence Strategic Review.⁶⁰ These approaches offer new strategic and tactical options for states so long as they acquire a martial and

proactive risk-taking-for-reward mindset vis-à-vis hostile external powers.

As China will continue to militarize its real and artificial territories in the South China Sea, the absence of non-Chinese militarization in the region is detrimental to the US and Australian military, which need to project power over great distances and operate from bases, ports, and airfields that are vulnerable to attack and disruption. Given current trends of an under-militarized Southeast Asia, it will become progressively easier for China to present a fait accompli to the US and the region following the PLA's use of force. Hence, the deeper and broader the level of militarization in Southeast Asia, the better (even if some states are not aligned with the US). Militarization in the region complicates both China's strategic risk calculations and its assessments about capacity to control escalation should it choose to provoke or use force. Regarding deterrence, the US may not need to demonstrate that it can control escalation (which is difficult to do). The US and others may merely need to thrust China's risk and escalation calculations into disarray.

An Institutional Strategy for Cautious States

Smaller states largely understand hedging to entail maximizing strategic options and maintaining diplomatic relevance vis-à-vis larger powers. They are cautious about overtly and irreversibly choosing sides—and will remain that way even if they become more strategically active in the ways described above.

The mindset of a hedging country is to focus on defense rather than attack. To put it another way, the mindset is more about minimizing change (and the risks that come with that) than it is about proactively transforming the environment. When the country does make decisions, it prefers predictable processes that are somewhat sanitized or removed from overt strategic competition and great power politics.

This is where existing and new institutions come into play. China seeks to control prices, policy, and discourse through material

power and influence over institutions. Regarding the latter, Beijing has emphasized the link between setting the agenda, changing norms and standards, and exercising control within and over even ostensibly nonpolitical regional and international institutions with the objective of maximizing comprehensive national power.

The US and its allies cannot always dominate the growing number of regional and international institutions. Success requires activating Asian maritime states, almost all of which support resistance against Chinese hegemony so long as there are no overt costs for them. A recent example was the election of Singapore's Daren Tang as the next director general of the World Intellectual Property Organization (WIPO); he prevailed over a Chinese candidate in the final round by 55 votes to 28. Singaporean agencies and officials were deeply involved in lobbying for Tang, as were counterparts from the US, other advanced economies, and nations in East Asia. Because competition was regulated by an administrative process and ostensibly unrelated to strategic issues, and because the voting was by secret ballot and therefore lower profile, Singapore and those nations supporting Tang were prepared to risk Chinese castigation. The happy outcome is that it is less likely that WIPO will be used to change rules and norms regarding intellectual property.

This example suggests some steps for achieving a proactive institutional strategy:

- Regarding institutions that ostensibly do not deal with security or strategic issues, the US and Australia should encourage as many status quo states (almost all the maritime East Asian states) to be as active as possible in securing leadership or influence within these institutions. These states need not be acting in unison with the US, and many will shy away from being seen as doing so. But they should be made aware of when China is seeking to change the existing rules, norms, and standards pertaining to a given institution so as to promote its own interests, and then should be encouraged to block or resist such changes.

- Unwieldy or ineffective institutions (e.g., institutions with a large membership, consensus-based decision-making processes, or no enforcement power) should be allowed to take the lead on an issue only when the issue has little or no strategic significance. Alternately, unwieldy or ineffective institutions should be given the lead when a delayed decision or nondecision favors US rather than Chinese interests.
- Asian states should be encouraged to take a global rather than a regional view of the role, standing, and purpose of local institutions. In other words, the notion that East Asia is its own unique subregion with its own rules and traditions is dangerous and plays into Chinese hands.

China's ability to dominate regional institutions for its own purposes is greatly enhanced when Beijing convinces neighboring states that regional institutions ought to have their own rules, standards, and even norms. For example, China's success in deflecting criticism of its activities in the South China Sea is in part due to Beijing's success in getting ASEAN to use a regional framework (a code of conduct based on China-ASEAN negotiation) rather than an international framework (the UN Convention on the Law of the Sea and international law).

Over the past five decades, Asian maritime states have become accustomed to emphasizing regional institutions to pay lip service to the virtues of cooperation and neutrality, while at the same time unilaterally maintaining the freedom to make their own strategic arrangements—and also insisting that status quo great powers such as the US demonstrate their allegiance to these facile institutions. Beijing, which is playing the same game but thinking several steps ahead, has cleverly exploited that somewhat cynical but understandable mindset.

The other Asian powers realize this and conclude that relations with China (vis-à-vis the US but also regional states) will become more contested in all areas over the next decade and beyond. Crafting an approach that gives these Asian states room to ma-

neuver through institutions will allow smaller Asian status quo powers more strategic options, and enable them to hedge in a manner more aligned with American rather than Chinese interests.

An Effective US and Australian Geoeconomic Strategy

A successful economic strategy is the most complex task for the US and Australia given China's enormous and indispensable role in the regional and global economy. In the future, success will be based on effective defense and offense.

In the economic context, the US and Australia have three key strategic priorities:

- Counter China's objective of acquiring strategic support states.
- Counter elements of China's technological upgrade strategy that are designed to help it surpass the advanced democracies.
- Counter Chinese plans to dominate high-tech and high-value global export markets in high-tech and high-value sectors.

These priorities are related because Chinese success in one area leads to success in others. For example, the emergence of China as a dominant technological power will deepen regional dependency on Chinese technology and supply chains. This will in turn strengthen Beijing's leverage over regional capitals. At the same time, China will be in a better position to dominate global exports while shutting imports out of the Chinese economy.

The remainder of this section discusses several principles for competing successfully.

Prioritize Commercially Profitable Economic Zones

The US and Australia will have limited capacity to compete in landlocked economic zones like Central Asia and parts of continental Southeast Asia. But they are well placed to work with

economic partners to prevent the emergence of a Sinocentric economic order in maritime Southeast and South Asia, the South Pacific, and Europe. These maritime economies and regions will be the primary determinants of how power and prosperity are distributed throughout Asia. Part of the US and allied approach over the next decade and beyond should encourage these economies to take the following steps:

- Disentangle or diversify their supply chains in critical and strategic sectors away from China; this is especially important for advanced economies on China's periphery, such as Japan, Taiwan, and South Korea.
- Agree on common industry rules, standards, and export controls for high-value and high-tech sectors.
- Link common market access to adherence to legal, regulatory, and human rights rules and standards.
- Seek sources of external (non-Chinese) financing that do not impose oppressive debt burdens or unreasonable restraints on a country's sovereignty or domestic decision-making.
- Work with economies in these areas to reform or build institutions that can resist illegitimate or predatory Chinese economic practices and even punish China for them.

In most economic interactions, the objective is to prevent these economies from becoming too dependent on the Chinese economy for supply chains, production processes, or access to finance. Such overdependence comes from pursuing the guaranteed absolute economic gains from China while ignoring both the leverage China gains and the strategic consequences of that leverage. Preventing overdependence on China is particularly important with respect to high-value and high-tech sectors, or sectors of critical or strategic value. Maritime Asian states cannot be allowed to become trapped in the Chinese ecosystem. Once they are in any high-tech or high-value ecosystem,

leaving becomes difficult or prohibitively costly.⁶¹ For this reason, the US needs to work with other advanced economies to create and promote high-tech and high-value ecosystems that are far more appealing than China's.

ASEAN economies are already deeply integrated into US and global production networks. Foreign direct investment (FDI) from Japan, the US, the EU, South Korea, Australia, and Singapore far exceeds that from China. That trend needs to continue into the next decade and beyond, forcing China's less efficient and less productive firms to allocate capital to landlocked BRI corridor economies that are less attractive and less important—and that are also less strategically important to the US. This step will help ensure that Asian supply chains and production processes are not overly dependent on China.

The easiest and most direct way to achieve many of these objectives is for the US to join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP)—a possibility that is too easily dismissed as politically infeasible even though administrations have never properly pushed the issue with Congress or the public.⁶² Some important aspects of the Biden administration's Indo-Pacific Economic Framework for Prosperity (IPEF) are well aligned with CPTPP principles. IPEF presents a principled approach to economic interaction between members, who are free to join in and work with the US on any or all four of the pillars: connectedness, resilience, clean environment, and fairness.⁶³ However, the most laudable frameworks—including the broad framework of a free and open Indo-Pacific—do not provide countries with guaranteed and immediate gains. This is especially true for low- and middle-income economies.

Pursue an Achievable Supply Chain Strategy

Supply and value chains for traditional and current-generation merchandise goods will continue to become more regionally based, especially in East Asia. The rapid pace of technological progress in manufacturing-related technologies—such as

robotics, automation, artificial intelligence, and 3D printing—will help this trend. These technologies will interact with each other in ever more sophisticated ways,⁶⁴ and they will encourage businesses to locate the production and assembly of merchandise goods closer to the end consumer.

While it does not make sense for the US and Australia to compete for low-paying global manufacturing jobs (and they will fail if they try to do so), they should encourage advanced manufacturing plants serving American and Australian consumers to base themselves in friendly countries if not in the US or Australia. The US government should also offer incentives to American firms—and to those from advanced like-minded economies such as Japan, South Korea, the EU, and Australia—to invest in advanced technologies and capabilities within the US when serving North American markets—or at least to relocate these away from China.

The objective should be to nurture a booming North American production and assembly zone for an increasing number of merchandise goods designed to serve North American consumer markets while also lowering advantages for and reliance on China-based firms, whether these firms have headquarters in China or elsewhere. One cannot prevent China-based manufacturing firms from increasing their share in the Chinese consumer market, as Beijing will offer these firms substantial assistance. But this is different from allowing entrenched advantages for Chinese firms serving large external consumer markets in North America and Europe.

Adopt Good Defense

The most consequential contest will be in the high-tech and high-value sectors. Without Chinese dominance of these sectors, Beijing cannot dominate Asia or decouple from the US on its preferred terms. The US and Australia will want to ensure that China is not in a position to dominate supply and value chains for these emerging and enabling technologies and sectors, or to set standards for them.

Leadership and dominance in these technologies and sectors are generally predicated on four conditions:

1. Investment at scale
2. Access to large and advanced markets
3. An effective system to drive innovation and competition
4. Channels to develop or acquire technology and know-how

China's state-led approach and economic size allow it to fulfill the first condition, albeit in an extremely inefficient manner. However, the US and its allies have considerable agency in ensuring the other three conditions become far more problematic for China. China needs to have access to large and advanced markets, develop an effective system to drive innovation and competition, and find channels to develop or acquire technology and know-how.

Supply chains in high-tech sectors are becoming more global and centered around advanced economies even as supply chains in traditional merchandise goods are becoming more regional. Most of these advanced economies are liberal democracies and US allies, while China is the outlier. "Globalization as usual" suits China since it benefits disproportionately from strategic competitors and rivals (i.e., the US and its allies). In the current and emerging period in which Chinese notions of decoupling have raised the stakes, China cannot be allowed to benefit at the expense of the US and its allies.

The US needs to oversee an increasingly difficult decoupling from China in the high-tech and high-value sectors—but on US terms when it comes to content and timing. Just as China does not draw a distinction between military and civil use in its military-civil fusion framework, the US should not limit the identification of problematic Chinese entities and technologies to those primarily working with or related to the military. All technologies identified by the MIC 2025 plan and in the dual circulation framework should be considered appropriate and legitimate battlegrounds.

US demands for reciprocity should be used as both a sword and shield in diplomatic and tactical terms. The Chinese lack of reciprocity is so stark and is such an entrenched feature of the Chinese political economy that the demand for genuine reciprocity will most likely never be met. But demanding reciprocity will put China on its back foot and help the US and its allies dictate the pace and nature of bilateral or multilateral negotiations, given long-standing failures by the World Trade Organization to resolve many of these issues.⁶⁵

The demand for reciprocity is not simply a negotiating tool. In sectors and areas that are purely economic rather than genuinely strategic, American and Australian companies should be able to sell as freely in China as the Chinese can in American and Australian markets. Likewise, in nonsensitive areas, American and Australian firms should be able to invest in China as freely as China can invest in the US and Australia, and with the same protections.

However, in strategic sectors such as enabling technology, reciprocal treatment and protection of rights include measures that would entail deep reforms of China's economic and legal institutions and practices; without these, reciprocity would be impossible. As Beijing will likely not yield in this area, or not yield promptly, US and Australian authorities will need to justify to China (and to domestic stakeholders) the decision to block many Chinese purchases of US and Australian technology companies, and to do so in a way that goes beyond generalized explanations of strategic and technological competition or rivalry.

Demanding reciprocity will also give the US and Australia time to organize their legal and regulatory responses. Moreover, it will likely take some time for the US (and other key allies and partners) to coordinate legislative and policy responses that involve scrutinizing and potentially blocking Chinese purchases of technology assets.

The principle of reciprocity should also be used to prevent or limit unintended or illegitimate technological leakage from the US or Australia to China. For example, the legislative and regu-

latory frameworks for FDI should increasingly consider allowing Chinese investment in sensitive sectors only if those sectors are open to foreign investors in China. Since virtually all these sensitive sectors in China are closed or restricted, this gives the US and Australia a strong reason to knock back any Chinese investment that might prove problematic. Science and technology cooperation with China should be reciprocal. A tit-for-tat restriction by one against the other is in keeping with US and Australian interests because cooperation has become far more beneficial to Beijing than to the US or Australia.

Pursue a Focused Denial Strategy

Denial strategies need to be targeted to minimize unintended costs and disruptions. The US and Australia need to forensically identify key technological chokepoints and vulnerabilities when thinking about how best to prevent China from acquiring, transferring, or stealing key capabilities and know-how.

The US CHIPS and Science Act of 2022 is an important piece of legislation in this regard. Yet there is less reason to prohibit or restrict Chinese access to technologies and processes at which China is already proficient. The highest priority of the denial strategy is to prevent China from becoming self-sufficient or emerging as a leading player, able either to host or to access a complete supply chain for the technologies that will shape national power in the years ahead.

A denial strategy should consider not just US and allied thinking about which sectors are important but also which sectors are being prioritized by China. For example, those in the US advocating only a moderate response by focusing on a relatively small number of key technologies argue that "many in Beijing believe that the United States is intent on destroying the Chinese technology system, and Chinese domestic narratives about tech competition have become increasingly nationalistic. A particularly harsh U.S. restriction, or the overall accumulation of controls, may cause China to step up its responses or broaden into new areas. Alternatively, Beijing

might overreact due to misperceived U.S. intentions.”⁶⁶ But this perspective inaccurately depicts China as the passive bystander or responder to current and future US and allied actions. As previous sections argue, China seeks technological decoupling on its own terms and timeline. Beijing has long planned to permanently eclipse and sideline the US and other advanced economies in technological prowess and associated economic benefits. China is already engaged in a technological war with advanced economies, and the primary risk for the US is not overreach but doing too little to prevent the Chinese plan from eventuating.

The US and Australia should allow research or technological cooperation only to procure a relative advantage or a net benefit—or to avoid isolating or harming the US, Australian, or other friendly economies.

Restrict and Regulate US and Australian Research and Development (R&D) in China

Chinese innovation and know-how depend heavily on joint ventures with foreign firms. For US-headquartered firms, China is the fourth most important international destination for R&D by expenditure after the UK, India, and Germany (table 2).

About three-quarters of US R&D in China goes into manufacturing, traditionally for export but increasingly to the Chinese consumer market. Most of the R&D in China is not relevant to high-tech competition, and thus not relevant for this report. However, the US and its allies should better examine some aspects of foreign R&D related to manufacturing (e.g., advanced materials, robotics, machine learning, and artificial intelligence) that feed directly into China’s MIC 2025 and dual circulation policy framework. Some discrete categories—such as computer system design, biotechnology, and life sciences—also need to come under much greater scrutiny, including possible regulation or prohibition. In general, there is a need for much stronger guidance on and regulation of US-headquartered firms’ R&D activities inside China, including guidelines on acceptable joint-venture R&D partners.

Table 2: US Foreign R&D by Location, 2018–19

COUNTRY	2018	2019	2018-19 % CHANGE
Total	\$100,376M	\$104,464M	4%
UK	\$11,278M	\$11,797M	5%
India	\$9,521M	\$9,846M	3%
Germany	\$8,391M	\$8,879M	6%
China	\$7,867M	\$8,195M	4%
Canada	\$6,140M	\$6,862M	12%
Israel	\$5,099M	\$5,974M	17%
Switzerland	\$4,434M	\$4,536M	2%
Ireland	\$4,034M	\$4,207M	4%
Japan	\$3,986M	\$4,090M	3%
France	\$3,332M	\$3,313M	-1%

Source: Francisco Moris, “Foreign R&D Reported by IT-Related Industries Account for About Half or More of US-Owned R&D Performed in India, China, Canada, and Israel,” NSF 22-328, National Center for Science and Engineering Statistics, National Science Foundation, April 28, 2022, <https://ncses.nsf.gov/pubs/nsf22328>.

Regulate and Restrict Portfolio Investment in China

Until recently, US and Australian portfolio investment in China (investment in Chinese securities and debt) was low compared with FDI in China. For example, in 2017 US entities had significant holdings in equities listed in advanced-economy stock markets around the world, but American holdings of Chinese equities amounted to less than 3 percent of Chinese listed securities. However, in recent years, US portfolio holdings have increased significantly, even as US FDI in China is generally declining from the peaks of 2018. From 2011 to 2019, the value of US foreign portfolio investment in China increased 5.5 times, compared to 1.7 times for the value of FDI.⁶⁷

Beijing will increasingly rely on portfolio investment to obtain capital through foreigners’ purchases of Chinese equities and central and local government bonds. That this is a deliberate strategy is affirmed by significant changes over the past few

years that smooth the way for foreign portfolio investment in China at a time when the CCP is putting more emphasis on accelerating its industrial and technological ambitions. For example, the Shenzhen–Hong Kong Stock Connect was launched in 2016 and provides foreign investors with access to many of the high-growth technology firms listed in Shenzhen. Authorities have also removed quotas for both the Shanghai and Shenzhen Stock Connect programs. In April 2018, this step quadrupled the daily quota amount for the stock connects.⁶⁸ Beijing implemented similar changes for Chinese bond markets to enable foreign entities to buy Chinese bonds more easily.⁶⁹

Moreover, there are now hundreds of billions of “passive” portfolio investments in China following changes by major indexes such as the MSCI All Country World Ex-US Investable Market Index, FTSE Russell, and S&P Dow Jones, as well as pension funds such as the Thrift Savings Plan’s International Stock Fund, to give a heavier weighting to Chinese firms. By including and more heavily weighting Chinese equities, these indexes provide these firms with flow-on advantages such as access to cheaper capital and “captured” institutional investors, given the need for benchmark or passive funds to own these stocks.⁷⁰ In 2019, an estimated US\$400 billion of new investment in Chinese equities was driven by changes in these benchmark indexes alone, and the figure was likely to be around a trillion dollars in 2020.⁷¹ The inclusion and greater weight given to Chinese bonds in relevant indexes has resulted in an additional US\$100 billion invested according to some estimations.⁷²

This is a problem because the Chinese firms included are largely SOEs and national champions that are central to Beijing’s MIC 2025 and dual circulation policy plans. Similarly, an increasing share of Chinese government bonds (including local bonds) is being used to fund Beijing’s broader industrial and technological plans. In this context, portfolio investment by foreigners offers a loophole through which Chinese entities can gain access to much-needed foreign capital despite US actions to restrict such access. This situation means that

American entities are sleepwalking their way toward holding more and more Chinese assets—assets that carry sovereign and political risk that neither indexes nor passive investors are sufficiently pricing in.

Conclusion

As America, Australia, and other allies engage in their enduring and comprehensive geopolitical struggle with China, they are placing increased emphasis on concepts such as “stabilization” and arguing that “guardrails” are needed to manage the competition.⁷³ These instinctively attractive notions nevertheless need to be understood in an appropriate and updated context.

Stabilization in relations with China cannot mean a truce or pause in rivalry, or even a temporary putting aside of differences. That is not how Beijing understands stability in the relationship and not how the US and Australia should understand it, either. Instead, stability should mean competing relentlessly and effectively without allowing unintended escalation into conflict. Indeed, China rejects the argument that guardrails are needed;⁷⁴ it sees them as a device to inhibit its ability to compete without restriction. Hence, any cooperation with China or temporary cessation in a disagreement will occur only for tactical reasons for one or both sides. The US objective is not primarily to get along but to compete successfully while being able to control the pace and nature of escalation. Similarly, pursuing relative rather than absolute gains vis-à-vis China, or else engaging Beijing in a zero-sum competition, needs to be accepted as a necessary part of any successful struggle.

It is also necessary to abandon older taboos that treat all escalation as ill-advised or as a failure. Escalation in some contexts is as important and useful as de-escalation, and may sometimes be unavoidable. Whether the US escalates or de-escalates over a disagreement ought to be a tactical decision. Escalation will reveal much more about China’s risk tolerances and vulnerabilities than de-escalation. Only escalation leading to an unintended conflict ought to be avoided. Short of

this, permanent tension is an inevitable feature of the enduring struggle with China.

Finally, many of the assessments and recommendations in this report will be unsettling because they reject the comforting notion that China will become a satisfied, peaceful, and constructive global power within a liberal rules-based order characterized by openness and democratic accountability. Some discomfort may also arise with the realization that America's preferred liberal rules-based order did not achieve the comprehensive victory over authoritarian alternatives that seemed so certain only three

decades ago. There might also be angst with the assessment that there will be no truce or pause in the competition and rivalry with China, regardless of whether tensions are overt or simmering beneath the surface at any given time.

For these reasons, and while engaging with China is unavoidable, interactions will increasingly be framed by the enduring and comprehensive struggle. One cannot wish away what China under the Chinese Communist Party has become. The choice is whether to struggle effectively or poorly against a determined rival.

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