POLITICO

Thomas Peter - Pool/Getty Images

LETTER FROM ASIA

How Trump's Trade War Is Driving China Nuts

Chinese leader Xi Jinping has reacted to American pressure with a level of desperation that is good for neither Washington nor Beijing.

By WILLIAM PESEK | October 16, 2018

TOKYO — Five years ago, China's Xi Jinping rocked the Communist Party establishment by pledging to let markets play a "decisive role" in decision-making. Reformists rejoiced as President Xi signaled a revival of Deng Xiaoping's pro-capitalism revolution.

Things haven't gone as planned. First, Xi slow-walked steps to reduce China's reliance on runaway credit, debt and an antiquated state sector. He prioritized short-term growth over long-term upgrades. And then Donald Trump came along to imperil both objectives.

Initially, Xi's government figured the president was bluffing. Beijing's calculation was that, sure, Trump might slap some tariffs on Chinese goods, but it's a mere negotiating tactic—his "*Art of the Deal*" writ large. After all, past American presidents had often attacked China on the campaign trail—only to make nice while in office. Xi's men held it together as Trump slapped taxes of 25 percent on steel and 10 percent on aluminum. They figured Trump's initial attack on $50 billion of Chinese imports in June would satisfy Peter Navarro and other protectionist voices in the White House.

Hardly, as Xi's team is realizing. If the extra $200 billion of levies Trump tossed Beijing's way in September weren't reality-check enough, Mike Pence's Oct. 4 "we-will-not-stand-down" speech suggests 2019 could get even worse for Beijing.

Pence accused Beijing of trying to "malign" Trump's credibility, of "reckless harassment" and of working to engineer "a different American president." On both economic and military issues, Pence declared: "We will not be intimidated; we will not stand down."

The vice president seemed to confirm that Trump's trade war is more about tackling China than creating U.S. jobs. Worse, perhaps, taxing Beijing is shaping up to be a 2020 reelection strategy. Forget Russia, Pence suggested: China is the real election meddler. It "clearly laid down an official marker for a much more competitive and contentious new era of U.S.-China relations," says China analyst Bill Bishop.

All this is throwing Xi's domestic strategies into disarray—perhaps permanently.

Six months ago, Beijing was throttling ahead with "Made in China 2025," a multitrillion-dollar effort to dominate the future of self-driving vehicles, renewable energy, robots and artificial intelligence. Party bigwigs were also planning festivities to commemorate the 40th anniversary of Deng's reforms—and Xi's steps to accelerate them.

Now, Xi's undivided attention is on making this year's growth numbers. Trump's trade-policy grenades are sending a few too many market forces Beijing's way for comfort. China's currency is down 6.4 percent this year. Shanghai stocks are down 22.3 percent this year as JPMorgan Chase and other investment banks turn cautious despite China's 6.7 percent growth.

The headwinds heading China's way are unmistakable, particularly with Trump threatening to up the tariff ante to $505 billion. In August, export growth weakened to just under 10 percent from the previous month—crisis levels for a trade-reliant developing nation. Fixed-asset investment has

stalled, falling to a record low in August. And the latest purchasing managers' data from the government and Caixin at right at the 50-point mark—just a small step from contraction.

That's unleashed a frantic push to keep China's growth engine from crawling to a stop. Almost daily, Xi's team rolls out new plans to cut taxes, boost business lending and ramp up infrastructure spending. Regulators are easing up on credit curbs and limits on property speculation. On Oct. 7, the central bank slashed the amount of cash lenders must set aside as reserves for the fourth time this year. It is as clear an admission as any that China's 6.5 percent growth target is in trouble.

So are Xi's designs of raising Deng's upgrades to 11. In 1978, Deng set the most populous nation on a journey from impoverished backwater to surpassing Japan's gross domestic product on the way to America's. Deng replaced Maoist egalitarianism with meritocratic forces. He loosened price controls, decollectivized agriculture, allowed entrepreneurs to start businesses, welcomed foreign investment and morphed China into a global manufacturing juggernaut.

Xi's Made in China 2025 gambit aimed to push the economy upmarket—making it more about tech companies like Alibaba and Tencent than sweatshops. Yet now Xi is engaged in all-hands-on-deck battle against Trump's ploy to turn back the clock on China's rising influence.

A key element of moving China beyond boom-and-bust cycles and making growth more productive is tackling dueling bubbles in credit, debt and property prices. That means increasing transparency, policing an out-of-control $20 trillion shadow-banking sector and dropping support for state-owned enterprises to create a vibrant private sector. Such upgrades will necessitate slower growth—5 percent or below.

Yet they are now largely on hold. Xi reverting to the stimulus-at-all-costs playbook that got China into financial hot water is a worrisome bookend for the Deng revolution. Xi is ensuring that when China's debt-excess reckoning comes, what economists call a "Minsky moment," it will be bigger, more spectacular and more globally impactful. If you thought the "Lehman shock" of 2008 was scary, wait until the No. 2 economy with $14 trillion of annual output goes off the rails.

Beijing is well aware of its plight—and the air of panic and paranoia is manifesting itself in bizarre ways.

The disappearance of a beloved actress, the detention of an Interpol bigwig and the visa troubles of a Western journalist wouldn't normally be big concerns for economists. But there's nothing typical about the lengths to which China is going to fend off Trump's escalating trade war.

The first narrative involves "X-Men" star Fan BingBing, who resurfaced last week after vanishing from public view. She was detained for alleged tax evasion and ordered to cough up $129 million.

Yet her case was a stark reminder about something else: Xi's paranoia about capital outflows as wealthy mainlanders spirit their fortunes abroad.

The second concerns Meng Hongwei, the Chinese head of Interpol who went missing last month. Meng is being investigated for bribery. Yet Xi's heavy-handed tactics highlight the lengths to which the Communist Party will go to maintain absolute control over its subjects, even those on the world stage. Couldn't Interpol deal with any credible allegations in-house? It hardly helps that Xi's anti-graft drive often seems more about sidelining rivals than cleansing the system.

The third narrative relates to Hong Kong-based Financial Times Editor Victor Mallet, whose visa renewal was just rejected. Mallet is vice president of the Foreign Correspondents' Club, which in August enraged Xi by hosting a pro-Hong Kong independence speaker. It may be the latest sign of Chinafication in a city that once stood as a financial green zone for investors tapping the mainland market.

Taken together, these plotlines make a mockery of Xi's market-forces pledge. Rather than creating a predictable rule of law on which trusted economies thrive, Xi's China is regressing in ways sure to chill foreign investment. This imperils his efforts in the Trump era to portray China as a credible power ready to fill the global leadership void. Xi is engaged in his own Trumpian battle against the media—even outside the mainland—and going after high-profile rivals.

Trump doesn't get all the blame. If Xi had worked with Deng-like determination to recalibrate growth engines and wean China off exports, the economy would be less vulnerable to Trump's attacks. By certain metrics, meantime, Xi, is dragging China backward. Its press-freedom ranking from Reporters Without Borders worsened to 176th, three notches below 2013.

Irony abounds, of course. Earlier this year, Xi persuaded the party to effectively make him president for life rather than the traditional 10 years. Past U.S. presidents would've condemned the power grab; Trump was all compliments. Yet the stronger Xi becomes, the more he clamps down on the media and dissenting voices needed to police the government and corporate titans.

Nor has Xi addressed a central paradox: how China increases innovation while walling off innovators from Google, Facebook and the big debates of the day. Those market forces Xi pledged to heed are coming from Silicon Valley, too. While Trump complains about fake news, Xi's China has a "fake reform" problem, says Wang Yiming, deputy director of the State Council Development Research Center.

A propensity for own-goals, too. Case in point: allegations that China's government inserted tiny spying chips into smartphones and other devices. Might that troll Trump to retaliate further? "Conflict with China over trade, investment, technology and geopolitical dominance will only

escalate," says analyst Arthur Kroeber of Gavekal Research in Beijing.

That's likely to further reduce China's appetite for risk. Since Xi's legitimacy is predicated on rapid growth, he's likely to punt Deng 2.0 forward. It follows that the faster China grows over the next 12 months, the less reforming Xi's men are doing behind the scenes.

Trump's reign, unfortunately, may just enable Xi's impulses. For decades, America's grand strategy once was to usher China gently into the community of developed nations. That seems to be gone now, trumped by a U.S. leader for whom "trade" is a four-letter word.