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Destructive Decoupling

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MILAN – Over the last year, the trajectory of Sino-American relations has become indisputable: the United States and China are headed toward a substantial, though not complete, decoupling. Far from resisting this outcome, both sides now seem to have accepted that this will play out as a largely non-cooperative game, to the point that they are embedding it in their policy frameworks. But what exactly will decoupling entail, and what will its consequences be?

On the American side, national-security concerns have led to the creation of a lengthy – and still growing – list of restrictions on technology exports to and investments in China, as well as on other channels whereby technology moves around the world. To enhance the strategy's impact, the US is trying to make sure – including through the threat of sanctions – that other countries join its efforts.

This approach might have met resistance, including in Europe, were it not for the war in Ukraine. The conflict seems to have re-solidified transatlantic relations, after a few fractious years. And while China has remained officially neutral in the war, it has remained committed to its “no-limits partnership” with Russia, which Chinese President Xi Jinping reaffirmed on his recent three-day visit to Moscow.

At the heart of Xi's partnership with Russian President Vladimir Putin is the shared belief that the US-led West is determined to keep their countries down – to impede their development, thwart their territorial ambitions, and constrain their international influence. This conviction – seemingly vindicated by recent US policy – is also central to the latest iteration of China's domestic economic agenda.

The beginning of Xi's unprecedented third term in power brought a flurry of documents illuminating China's economic plans, not least its strategy to restore rapid GDP growth. Having concluded that the world economy will be less open and more hostile, and thus a less reliable growth engine, China's leaders are seeking to reduce their dependence on export demand. So, despite continuing to tout multilateralism and economic openness, Chinese leaders' highest priority is now stability and self-reliance in trade, investment, and technology.

The economic logic is sound. With an economy roughly 80% the size of the US, China has a huge internal market for goods and services, and for factors of production. By improving the integration of its domestic market, China may be able to take fuller advantage of its growth-enhancing potential, thereby insulating itself to some extent from foreign pressures, including challenges to its centrality in global supply chains.

In fact, diversification of supply chains – such as through so-called friend-shoring – is already well underway, and not only because of the US-China competition. Frequent shocks – from climate-related extreme weather to pandemic and war – and the growing use of economic sanctions as a foreign-policy tool have also given businesses and governments incentive to strengthen resilience.

For many countries, greater resilience would ideally include less dependence on the US dollar. While the greenback's global dominance is not in immediate danger, given the absence of a viable alternative, several Asian countries are trying to create mechanisms for settling trade that avoid reliance on the dollar. Tactically, this would make it harder for the US to track transactions and identify sanctions violations.

Make no mistake: the economic consequences of this lurch toward confrontation are as far-reaching as they are severe. As global supply chains become less elastic, less efficient, and more costly, their ability to counteract inflationary pressures will decline. Central banks will thus be left to manage price growth alone, by suppressing excess demand.

All of this generates powerful growth headwinds. Moreover, as we have recently seen, rapid monetary-policy tightening, after years of ultra-low or negative (in real terms) interest rates, produces financial stress and bouts of instability, especially when debt levels are substantial.

The combination of higher interest rates and heavy sovereign-debt burdens will compound fiscal pressures. Though lower inflation could ease those pressures, interest rates are likely to remain elevated for a while, especially if suboptimal global economic trends and secular forces like population aging cause supply-side conditions to deteriorate. Nor is the downward trend in productivity growth – which has become particularly pronounced in the last decade – likely to be reversed in a fragmented global economy with barriers to technology development and diffusion.

These barriers will also jeopardize progress on the sustainability agenda, which requires free and frictionless flows of existing and emerging technologies. Likewise, the green-energy transition will require capital to flow to where it will have the most impact, including to lower-income countries. The incremental capital investment needed for the global energy transition – estimated at about \$3-3.5 trillion – simply will not be mobilized without international coordination. To crowd in private investment, the international financial institutions need increased capitalization and support from all the major shareholders, which is not likely in the current environment.

Many people on both sides of what might be called the “mutual distrust equation” know that decoupling is a distinctly suboptimal and perilous course. But in both the US and China, dissenting voices are either ignored or stifled, whether through political pressure or outright repression.

Many emerging and developing economies recognize that a fragmented global economy – let alone one where they must choose between two competing blocs – is not in their interest. But they currently lack the power to change the major players' incentives. India may be able to play such a role someday, but not yet. And while Europe is big enough to resist the decoupling pressure, it is not fully integrated, and is hamstrung by its energy dependence. As for multilateral institutions, they are too beholden to their major shareholders in the developed world to advocate strongly for cooperation, openness, and an adaptive rules-based system that promotes efficiency, growth, and inclusiveness.

That leaves no obvious off-ramps from the current trajectory. The future is partial decoupling and fragmentation.

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