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How President Xi's tightening grip on China and the superpower rivalry are reshaping the geopolitical landscape

By Angelo Katsoras

Table of contents

Introduction

Since taking office in 2012, President Xi has tightened the Communist Party's grip on Chinese society by expanding state control over the economy and strengthening the security apparatus. This two-pronged campaign has contributed to worsening relations with the United States and the West, as each side accuses the other of creating an uneven playing field for foreign companies in their markets.

As a result, both the West (led by the United States) and China have accelerated efforts to partially decouple their supply chains in key areas.

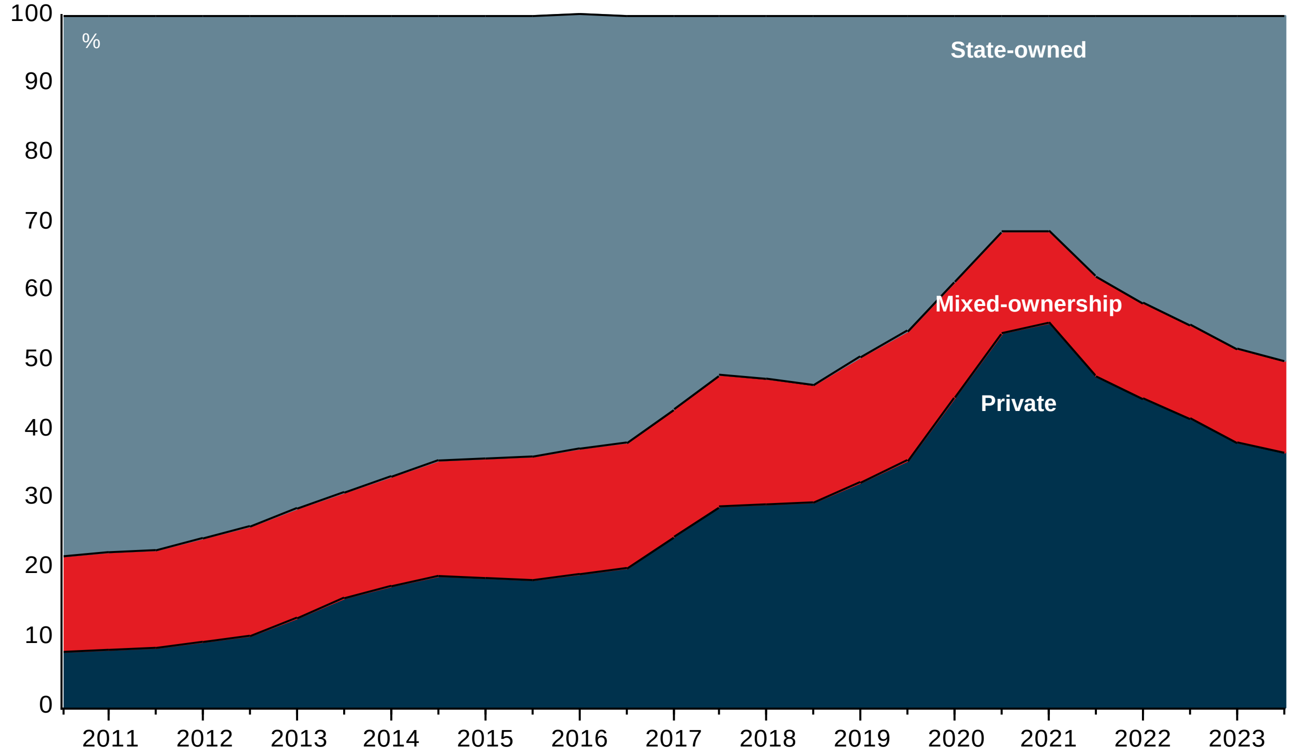
The decline of the private sector in China

One of President Xi's main goals is to limit the influence of the private sector. He has pursued it in part by mandating an increasing number of mergers between public and private companies. According to Fitch Ratings, from 2019 to 2021, an average of 50 state-owned enterprises per year acquired a controlling share of listed private companies, up from less than 10 in 2017.[1]

Consequently, the total market capitalization share of private firms among China's 100 largest listed companies fell from a mid-2021 peak of 55% down to 37% by the end of 2023.[2] Private firms are defined as those with less than 10% state ownership, while those with 10% to 50% government control fall under the category of mixed ownership.

[1] "China's State-Owned Entities Boost Investments in Private Companies," Fitch Ratings, July 3, 2022
[2] "Share of China's top companies in the private sector continued to steadily decline in 2023," Peterson Institute for International Economics, January 18, 2024

Private ownership is declining among the top 100 listed Chinese companies (% of market capitalization as of Dec. 31/23)



NBF Economics and Strategy (data via Peterson Institute for International Economics)

Why did China crackdown on certain parts of the IT sector?

Starting in 2020, Chinese authorities imposed large fines and stringent regulations on e-commerce tech giants like Alibaba and Tencent. While the government has cited data security and anti-competitive practices as reasons for its regulatory crackdown, we believe that another crucial motive was to prevent the rise of power centres that could one day challenge the Communist Party's absolute control. Simply put, Chinese authorities do not wish to see domestic companies gain anywhere near the level of influence that their Western counterparts wield. The Communist Party is also very much opposed to these companies having access to more data on Chinese citizens than the government actually has.

Greater control via the compulsory study of President Xi's thoughts

President Xi's views and reflections on political, social, and economic-related matters as expressed in his writings and speeches have come to be known as Xi Jinping Thought. In 2018, his views were officially inserted into the country's constitution.

Until recently, only Communist Party members and government officials were required to study Xi Jinping Thought. It is now mandatory also for staff in both state-owned and private-sector companies. This includes senior executives being sent to off-site learning centres.[3]

Xi Jinping Thought has also been part of the curriculum of the education system (from primary school to university) since 2021.

State-owned companies are increasingly establishing militias

Another indication of Beijing's heightened focus on national security is that state-owned enterprises have been instructed to form reserve military units comprised of their workforce. A Financial Times review revealed that dozens of these enterprises established such militias in the second half of 2023.[4] These units serve as reserve forces for China's military, ready to be deployed for tasks ranging from natural disasters to civil unrest.

The Industrial and Commercial Bank of China, the country's largest lender, was the first major financial institution to establish a militia. The photo below shows a ceremony held at one of its branches to inaugurate the new reserve army unit.[5]

[3] "China state companies step up study of 'Xi Thought' in hard times," Nikkei Asia Review, September 3, 2023
[4] "Chinese companies revive Mao Zedong-era militias," Financial Times, February 19, 2024
[5] "ICBC Qinghai Sets up People's Armed Forces Department," Caixan Global, April 26, 2024

Source: "ICBC Qinghai Sets up People's Armed Forces Department," Caixan Global, April 26, 2024

Foreign spies everywhere

In another security-related measure, the government is using billboards on city streets and social media to warn people to watch out for foreign spies. The Ministry of State Security also recently launched an online comic strip called "Shenyin Special Investigation Squad". In its first installment published January 7 of this year, it depicts the arrest and interrogation of a blond man suspected of violating the country's anti-spying law.[6]

Source: "A comical effort by China's intelligence agency," The Economist, January 11, 2024

In 2023, the Chinese government broadened its counterintelligence legislation to include "work secrets", a term used to refer to non-state secret information that could have negative consequences if leaked.[7] This law, like other security statutes, is vague enough to apply to anything the government deems a threat to national security.

Moreover, it comes at a time when the foreign business community is already on edge following a series of police raids last year on due diligence and consulting firms, including the Mintz Group, Bain & Company, and Capvision. Many foreign investors believe that the mere act of gathering market intelligence has been criminalized.

This fear has been underscored by recent reports that quality inspectors working in the pharmaceutical sector have refused to visit China for fear of being arrested for espionage. "A large number" of inspectors from Germany are refusing to visit China for fear of arrest, according to the German Medicines Manufacturers' Association.[8]

[6] "A comical effort by China's intelligence agency," The Economist, January 11, 2024
[7] "China expands scope of "State Secrets" law in security push," February 28, 2024
[8] "Pharma groups warn of supply crunch over China spying law," Financial Times, April 21, 2024

National security extends to criticizing the Chinese economy

Below are several examples of this:

- In August 2023, the Chinese property trading platform Beike issued an apology after releasing a report indicating that 12% of completed residential apartments in China's 28 major cities were unoccupied. As punishment for this "indiscretion", Beike was banned from publishing historical transaction prices.[9]
- Last December, Liu Jipeng, a dean at China University of Political Science and Law in Beijing, discussed the challenges faced by investors owing to the prevalence of unethical institutions. His social media account, which had over 700,000 followers, was subsequently banned.[10]
- Weibo, China's leading microblogging platform, recently warned its users against posting negative content about the economy.[11]

In fact, even before this crackdown on bad economic news, China had been publishing less and less economic-related data.

Source: "China's GDP blackout isn't fooling anyone," October 21, 2022

Western firms are often competing against the Chinese state

Greater government intervention has also meant that more state money has been funneled into key sectors like electric vehicles (EVs) and solar panels. This has exacerbated the country's production overcapacity. A late-2023 article in the New York Times highlighted the magnitude of the problem: "China has already built enough solar panel factories to supply the entire world's needs. It has built enough auto factories to make every car sold in China, Europe and the United States."[12]

When President XI was asked about the overcapacity problem on his trip to Europe in early May, he replied: "The so-called problem of China's overcapacity does not exist."

Significant financial backing from the government for enterprises in the aforementioned industries often places foreign companies in direct competition not just with Chinese businesses, but essentially with the Communist Party itself. In 2023, it was reported that 22% of industrial firms in China were operating at a loss.[13] Without the critical lifeline of government aid, many would have been forced to close their doors already.

In 2019, the Center for Strategic and International Studies reported that China's subsidies to various sectors amounted to $250 billion, almost three times as much as the $84 billion in subsidies doled out in the United States. As a percentage of GDP, China's subsidies were more than four times those in the United States (1.73% vs. 0.39%).[14]

The United States, aiming to avoid a repeat of the early 2000s when an influx of cheap goods forced many factories to close, initially responded by pouring massive subsidies into key sectors. More recently, it raised tariffs significantly, as shown below.

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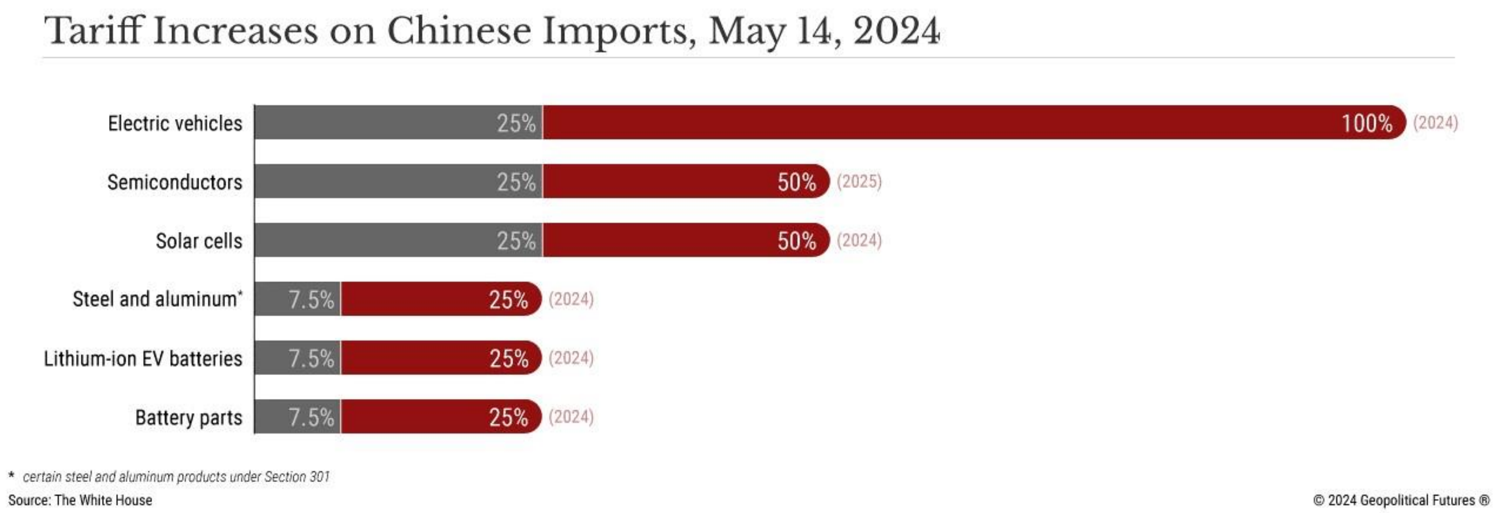
[9] "Sliding Beijing home prices spur alarm in China's property sector," Financial Times, December 20, 2023
[10] "China's Censorship Dragnet Targets Critics of the Economy," New York Times, January 31, 2024
[11] "China asks bloggers to stop badmouthing the economy," Financial Review, December 15, 2023
[12] "More Semiconductors, Less Housing: China's New Economic Plan," New York Times, November 6, 2023
[13] "The mind-bending new rules for doing business in China," The Economist, April 3, 2024
[14] "Finding a way to manage China's protectionism in procurement," Japan Times, March 16, 2023



While these tariffs will eliminate any last hope Chinese EV manufacturers had of breaking into the U.S. market, they will also raise costs for American automakers that rely on Chinese parts. For example, Tesla's cheapest model, the standard Model 3 is manufactured in California with Chinese-made batteries. This is does not take in account the financial impact of any retaliation from China.

This leaves the United States and much of the West between a rock and a hard place. On one hand, reducing reliance on China's green-energy supply chains will make achieving green-energy goals more expensive and time-consuming. On the other, moving to meet these targets quickly means becoming overly dependent on a key geopolitical rival.

In an effort to avoid American tariffs, China is rerouting goods through intermediary countries

The United States will be forced to impose new tariffs to block indirect entry of Chinese products via other countries. This issue was highlighted in a recent letter to the U.S. Trade Commissioner from the House Select Committee on the Chinese Communist Party: "The US must also be prepared to address the coming wave of [Chinese] vehicles that will be exported from our other trading partners, such as Mexico, as [Chinese] automakers look to strategically establish operations outside of [China]."[15]

This situation creates a cat-and-mouse dynamic. China seeks to circumvent export restrictions by redirecting goods through intermediary countries (where it often undertakes some minor final assembly production), while the United States and some other Western countries respond with new tariffs to stop these rerouted exports from entering their markets. Ultimately, this adds more steps and complexity to supply chains without necessarily improving their resilience.

Canada and EU likely to increase tariffs as well

Because Canada has extremely low import tariffs on Chinese EVs (about 6%), it could see more of these vehicles diverted its way.[16] This could reduce the return that the various levels of government expect on the tens of billions of dollars that they have promised to foreign car and battery manufacturers to set up operations in Canada. Consequently, Canada will likely be forced to raise tariffs on these EVs. Similarly, the EU is likely to increase its 10% tariff on Chinese-made EVs, which already account for one-quarter of the EV market there (includes Western brands made in China).[17]

Some analysts have suggested that China could ease trade tensions by emulating Japan's factory opening strategy of the1980s. It is important to note, however, that unlike Japan, China is viewed as a geopolitical rival. This creates a more hostile environment for Chinese companies in the United States.

Where non-Western countries are concerned, the outlook for China is mixed. While it may succeed in building more factories in these regions, moving production abroad means higher operating costs relative to domestic production. Additionally, other countries are adopting Western practices by restricting certain imports from China. For example, India recently banned the use of Chinese-made solar panels in government-subsidized projects.

[15] U.S. House Select Committee on the Chinese Communist Party, November 7, 2023
[16] "Joe Biden's new China tariffs put Canada in a bind on electric vehicles," Globe & Mail, May 16, 2024
[17] "Biden outdoes Trump with ultra-high China tariffs," The Economist, May 14, 2204

Conclusion

China's move toward greater state control of its economy and its heightened emphasis on national security, along with deteriorating relations with the United States and Western countries, has intensified efforts by all parties to restructure global supply chains.

However, the reconfiguration of these supply chains for geopolitical reasons, rather than efficiency, means that smaller supply chains will be created in higher cost regions. Consequently, what is gained in terms of national security will be lost in terms of efficiency and economies of scale.

It is also important to note that supply chains in China have taken decades to perfect. Moving them to other regions means having to train workers, rebuild local supply chains, and overcome quality-related difficulties. These are some of the challenges that U.S. efforts face in bringing solar panel manufacturing back from China, which controls over 80% of the global production process at every step. This challenge extends to the lithium refining sector, where China controls over 70% of the world's refining capacity. According to the Oxford Institute for Energy Studies, it costs three to four times more to build a lithium refinery outside of China.[18]

This makes it imperative for investors to assess the ability of the companies in question to raise prices enough to offset higher operating costs. If these companies do not have the necessary pricing power, then the focus should shift to their ability to lobby for government support in the form of tariffs or subsidies.

The more tensions rise between the United States and China, the harder it will be for companies in key sectors to navigate this political divide, where complying with U.S. regulations could mean violating Chinese law, and vice versa.

Consequently, despite efforts by companies to create separate supply chains to avoid sanctions, many U.S. and Chinese companies heavily dependent on the other country’s market in sectors deemed strategic will inevitably lose market share over the long term. Semiconductors are case in point: China is building up capacity in the sector while America restricts sales of advanced semiconductor-related technology to China.

Finally, China’s moves to assert greater control over the economy and society in general can also be seen as a challenge to the long-held Western orthodoxy that a country cannot become rich without first becoming democratic and loosening state control over education and the economy. One side sees democracy and freer markets as essential to prosperity, while the other views one-party rule and state control as the key to delivering economic growth.

[18] “Lithium price volatility: where next for the Market?,” The Oxford Institute for Energy Studies, February 2024

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