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Policy Brief

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What New Era for China? The Challenges of Domestic Prosperity and International Assertiveness

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Summary

China's 14th five-year plan introduced "dual circulation", a structural shift from intensive capital accumulation (China as the world's factory) to innovation-led development.

The domestic part of the strategy consists of developing the internal market, taking into account the issue of demographic transition. This offers new opportunities, with the creation of a huge consumer market. But it also calls for a thorough overhaul of safety nets, which is slow to materialize. Increasing the technological intensity of production tools, a key element of China's domestic strategy, faces a new challenge. The United States is using the semiconductor industry as a tool in its strategy to contain China, with both civilian and military implications. Finally, the road to carbon neutrality by 2060 will be very steep, and the political commitment to achieve this goal seems too weak at this stage. China, which has become a leader in the energy transition sector, could nevertheless turn part of this challenge into an opportunity, as a new engine of growth.

The international aspect of the transformation of the growth regime consists in proposing an alternative to the system built around the Bretton Woods institutions, with China as the leader of the emerging countries. It reflects the fact that antagonism between China and the United States has hardened considerably and seems irreconcilable. This vision has been welcomed by emerging countries as a means of weakening their dependence on the United States and the dollar system, notably at the latest annual BRICS summit. But this proposal for an alternative system is hampered by tensions within the group, and more generally the absence of a common political project.

China has an ambitious roadmap. It faces major demographic, climatic and geopolitical challenges that could slow the transformation of its growth model and limit its sphere of influence on the world stage.

Introduction

The 14th five-year plan, drawn up in 2020, aims to initiate a transition from a society of moderate prosperity to the pursuit of a fully developed socialist market economy in 2049, the centenary of the People's Republic of China. This plan is a milestone in Chinese reform because it ushers in a new era: moving from capital-intensive growth to innovation-led development, to make total factor productivity the main source of growth. The desired trajectory is based on the principle of "dual circulation", within China on the one hand and with the rest of the world on the other.

moving from capital-intensive growth to innovation-led development, to make total factor productivity the main source of growth

Domestic circulation is based on the expansion of a consumer market for an enlarged middle class. Stronger social protection and high-tech production, supported by a massive research and development (R&D) effort, should form the basis of moderate growth for an ageing population. The restrictions imposed by the United States on exports to China in the semiconductor industry, which are part of the US strategy to contain China, could thwart the upmarket development of China's production base. They illustrate the country's continuing strong dependence on international value chains in sophisticated and strategic sectors.

As for the vision of an ecological civilization, it is a call for a major energy transition, with the official goal of carbon neutrality by 2060. This will require far-reaching changes to the country's industrial base and the allocation of capital.

External circulation is part of a strategy of international influence, illustrated by the "Belt and Road Initiative" launched in 2013, which has seen China assert itself on the world stage as a major investor, lender and trading partner, particularly with emerging countries. The aim is to propose an alternative system to the one organized around the Bretton Woods institutions, towards a more multipolar international system in which China would play a key role.

1. Reforming domestic balances to strengthen strategic autonomy

In his report to the National People's Congress, outgoing Premier Li Keqiang set a cautious target of 5% growth in 2023, compared to 3% in 2022. An upturn in household consumption was expected to boost aggregate demand, so that employment, especially among young workers, could be restored. But the recovery in domestic demand has not fully materialized. The confidence shock associated with the zero-Covid policy, and then the property crisis, appears to be lasting. Some of what appears to be excess household savings is in fact a conversion into bank deposits of investments in financial products and property, and is not being translated into an increased capacity to consume.

Developing the internal market in the long term, with a view to a model of self-sufficiency for an enlarged middle class, will involve considerable and interdependent social transformations.

As a prerequisite for the other stages of the transformation, the government will have to restore confidence and reduce the need to save. Strengthening safety nets is the key to achieving this. This means reducing social and territorial inequalities and taking account of the ageing of the population. But this objective has been identified as a strategic priority since the 12th five-year plan announced in 2010, without any radical progress since then, and seems to remain a challenge in the absence of any significant political change in this area. The fragmentation of worker status and social protection mechanisms is hampering the establishment of a unified system. The rapid ageing of the population also increases the financial burden of such a project. In addition, the pandemic crisis has revealed the strong bias of the authorities towards the forces of supply rather than demand, revealing a relative inconsistency between the rhetoric focused on rebalancing the growth model towards more consumption, and the actual economic policies constrained by shorter-term growth objectives.

Another key factor in the longer-term projection of the "dual circulation" is China's technological ascent. But it would be difficult to achieve self-sufficiency in technology-intensive sectors, given China's current heavy dependence on international value chains, particularly for the most sophisticated technologies. It would require a gigantic R&D effort, in particular, for the semi-conductor value chain; China is still lagging far behind, although progress is promising, as the Chinese company Semiconductor Manufacturing International Corporation (SMIC) has supposedly succeeded in producing 7nm (nanometer) chips.

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For long-term sustainability, the government will also have to clean up the financial system. Extensive capital controls enable the authorities to control domestic financial conditions, but internal vulnerabilities remain high. China will also have to steer the energy transition: the objective of net zero by 2060 will require reorganization of the production system. This seems very ambitious given the current trajectory of CO_2 emissions, which are still accelerating sharply.

1.1. The status and challenges of social protection: current reforms

Social protection in China is under the responsibility of the Ministry of Human Resources and Social Security. A uniform social security system covering the entire population would

require the rural/urban divide to disappear. This separation is linked to the *hukou* system, introduced in 1958 to register the population and control internal migration. Its advantages became more important with the rapid urbanization that started with the economic reform initiated in 1978 by Deng Xiaoping. It denies rural residents the same rights and benefits as urban residents, in terms of pension, health and other types of insurance (unemployment, industrial accidents, maternity). This complicates the Chinese social insurance system.

China has initiated a gradual, decentralized reform of the *hukou* system, with urban *hukou* becoming accessible to migrants who have a fixed address and stable employment. Pension insurance in rural areas has also been greatly improved, but remains fragmented between provinces. A law on social insurance is planned to enable unification at national level. To this end, the government has established a social security identification for each citizen.

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However, the fragmentation of social security systems is a major source of social and territorial inequalities, and prevents the establishment of a unified, inclusive and transparent social protection system. More than half of China's population now lives in cities, but only 35% of them have an urban hukou. Around 250 million migrant workers have no access to social benefits, from child education to medical assistance. Many employers do not pay contributions for these workers either, because they have temporary, often informal, contracts. This fragmentation also relates to institutions, as social insurance policies are determined by different types of agencies in different regions, without coordination according to *hukou* status and the nature of the jobs.

The challenges of social protection are all the more urgent because the population is ageing rapidly and most retired people are not covered by pension insurance. The ratio of the working-age population to the population aged 65 or over was 9.8 in 2000, and could fall to 2.3 by 2050. Even though the government has extended pension insurance cover for urban workers, it is still too low, as their numbers have risen sharply with migration. The situation is even more acute in rural areas, where most elderly people are not covered by pension insurance, even though the rate of ageing is much higher in rural areas. The challenge is primarily financial. The Chinese Academy of Social Sciences (Zhen *et al.*, 2019) estimates that the pension system will run out of money by 2035. China's retirement age is another major issue and could be used as a lever to alleviate costs. At 60 for men, 55 for women and 50 for women working in factories, it is one of the lowest in the world. Yet life expectancy in China has risen from around 44 years in 1960 to 78 years in 2021, higher than in the United States, and is expected to exceed 80 years by 2050.

1.2. China's declining and ageing population: challenge or opportunity?

The year 2022 marked the first decline in China's population for six decades, since the famine of the Great Leap Forward. This is the result of an insufficient birth rate and rapid ageing. The first reason is linked to the one-child-per-couple policy introduced in 1979 and continued until 2015. The decline in the number of births has been accompanied by a gender imbalance that is further reducing the number of women. Overall, between 1950 and 2020, the fertility rate fell from 6.1 to 1.3 births per woman. The United Nations expects the population to decline from 1.4 billion in 2023 to 1.2 billion in 2060, then 800 million in 2100 (*UN World Population Prospects*).

In an attempt to stem the decline, the government has recently reversed birth-control policies and introduced support measures such as tax deductions and maternity leave. Despite these pro-natalist policies, the desired effects have not yet been achieved; societal and financial factors (schools, housing) have led to strong inertia in family composition.

In social terms, this puts pressure on the working-age population to finance the rest of the population. Politically, a higher proportion of older people puts pressure on the government to make social protection more accessible. This has a knock-on effect on the economy because the government, in order to limit the budgetary impact, wants services for the elderly to be provided in part by businesses and non-governmental organizations. All in all, there is a risk that ageing will create social problems and put too much of a brake on economic growth. It could also slow down the process of increasing consumption in favor of savings. This could hamper the objectives of rebalancing China's economic model.

The question is, therefore, whether demographic change can transform the growth regime by creating new opportunities. Companies will have to adapt to these social transformations. In healthcare, public services showed their limits during the pandemic. Working-age adults may turn to private services for pharmaceuticals, medical devices and support for their parents and grandparents, as the value of care for the elderly could more than triple by 2030 to $3 trillion (Ping An, 2023).

ageing hamper the objectives of rebalancing China's economic model

Demographic decline and an ageing population pose a related challenge: the loss of human capital. Fewer entrepreneurs, fewer innovations and fewer skills, particularly in new technologies, will exacerbate the shortage of highly skilled workers in cutting-edge technology and engineering sectors, and weigh on China's ability to move upmarket. China has stepped up its efforts to attract foreign talent, notably through the "Thousand Talents Plan". But the relatively closed nature of the country, international competition and the tightening of regulations, illustrated by the zero-Covid policy, are eroding China's attractiveness to foreign workers.

Faced with the challenges of ageing, boosting productivity is a key issue. It is possible to identify five priority areas that can create opportunities for the private sector, in the fields of education, health, innovation and technology:

- invest in technology and automation, and therefore in R&D and technical training for the workforce, to cushion the impact of new technologies and help them evolve;
- invest in training and skills development for employees to ensure a skilled workforce adaptable to market conditions;
- diversify products and services to attract a wider range of consumers, in tune with changes in market demand;
- offer flexible working conditions through work from home, flexible working hours and employee involvement in work organization;
- develop local partnerships with foreign companies to attract them to China by giving them access to local resources.

However, improvements in total factor productivity in China will continue to be hampered by the predominance of state-owned enterprises (SOEs), which contribute to sub-optimal allocation of capital, the continuing importance of investment in GDP, and China's low attractiveness to foreign talent and capital (Brandt *et al.*, 2020).

1.3. The property boom, its crisis and the difficulties of resolving it

During the global financial crisis in autumn 2008, the Chinese government launched a huge stimulus package to maintain the high growth seen since the early 2000s. A feature of this growth has been the urbanization of the provinces through the migration of workers from countryside to cities. Local governments have seized on the importance of this development by selling land to property developers, who have leveraged massive amounts of yuan and dollar debt. Households, partly as a result of the lack of investment alternatives, bought homes under construction over a decade to reach more than two-thirds of their total assets.

As long as prices were rising, fueled by local government land sales, a property bubble developed. It became all the more dangerous that the central government, worried about over-indebtedness, discouraged banks from lending, so developers turned to unregulated shadow banking. The sector expanded massively, accounting for around a third of the country's GDP. Property speculation continued until the world's largest property development group, Evergrande, became over-indebted.

Faced with this unsustainable situation, the authorities decided to tighten regulations on the levels of debt leverage authorized for property developers, causing a sharp fall in the property market. The economic impact was direct. Evergrande defaulted on some of its yuan and dollar debts, dragging other developers down with it, as well as a large number of unpaid suppliers and subcontractors. The difficulties experienced by the Country Garden property group, initially renowned for its relatively solid situation, demonstrate the opacity of the exposures and liquidity risks of property developers in the country, and the extent of the contagion of fragilities in the sector.

The crisis has had other indirect effects. The halt in construction has caused concern among buyers of homes under construction, who have stopped making monthly payments on their mortgages. The collapse in property transactions has put a strain on local governments, for which land sales were the main source of revenue, accounting for a third. As a result, China's provinces were running budget deficits in the third quarter of 2022 and had to be supported by central government to complete unfinished property projects and avoid large defaults.

1.4. Over-indebtedness as a risk to financial stability

The doubling of the level of debt in fifteen years (2007–2022) reflects a development model based on a high level of investment financed by debt. The level of debt of the entire non-financial sector in China (almost 300% of GDP in Q3 2022) is already the 10th highest in the world as a percentage of GDP and by far the highest of all emerging countries. The slowdown in Chinese growth, due to the disruption caused by the pandemic crisis, and the structural problems that are lowering potential growth, will make this debt burden even harder to absorb.

The crisis in the property sector is emblematic of the impact that over-indebtedness can have on other sectors of the economy. The regulatory takeover that triggered the property crisis is having a strong impact on short-term growth, but it is also triggering a process of deleveraging in the sector, which is necessary after decades of laissez-faire. The first signs of stabilization in the property sector were seen in the first quarter of 2023 in terms of sales and prices, but normalization will take time.

The property crisis has highlighted the risks of corporate over-indebtedness, as corporate debt in China is one of the highest in the world relative to the size of the economy (nearly 160% of GDP). In addition to targeted reforms, like in the property sector, corporate balance sheets also need to be cleaned up by reforming state-owned enterprises (SOEs). In 2019, SOE debt accounted for more than half of the debt of non-financial companies, even though their return on assets is almost half that of private companies. Their debt-to-asset ratio has fallen sharply in recent years, reaching a level similar to that of private companies. Yet, genuine reform to improve their profitability (competition, transparency) does not seem to be on the political agenda.

Government debt is also a risk factor. Official statistics put it at 51% of GDP in 2022, but the IMF estimates it to be more than double that (110% of GDP; IMF, 2023). In particular, local government debt is unsustainable. Faced with a chronic deficit since the 1994 tax reform, local governments have developed lines of financing via ad hoc private funds, the Local Government Financing Vehicles (LGFVs). Now equivalent to almost 50% of GDP, LGFV debt carries an average interest

rate of 4.3%, while the profitability of their assets, half of which are physical, continues to fall, to 0.4% in H1 2022 (0.75% in 2021) (Zhang, 2023). While no LGFV has yet defaulted on a bond, cases of bank debt restructuring (60% of LGFVs' outstanding debt) have multiplied in recent years. Tax reform, which is expected to rebalance public finances between central and local authorities, has not yet been implemented and will take time. One of the pillars envisaged is a property tax that is difficult to implement in the current context for the property sector. However, the provinces most at risk have relatively small amounts of debt in absolute terms.

The banking sector is largely absorbing the risks and costs of debt reduction. Lending to developers and LGFVs has fallen, but will still account for 17% of total bank lending in 2022. The further decline is likely to be gradual and driven by the authorities, forcing banks to carry the risks and costs of corporate and local government defaults on their balance sheets for a long time to come. Banks are also being penalized by the fact that they are partly financing the monetary stimulus, which is moderate but costly for them, with their margins being squeezed by the reduction in interest rates on bank loans decided by the People's Bank of China (PBoC). Bank capital ratios are high, with a Core Tier 1 ratio of 10.5% in Q1 2023. However, the smallest banks are at greater risk.

The stock of non-bank financing is another risk factor that is always difficult to estimate. Officially, non-bank and market financing accounts for 8% of total outstanding financing, equivalent to 12% of bank loans. This amount has stopped shrinking, but seems to be under control by the authorities. Yet, it remains high, and its links with the banking sector are opaque (Sun, 2019).

Nevertheless, the banking sector benefits from a strong implicit guarantee from the state, as seen in the case of Baoshang Bank's bankruptcy in 2020 (Liu, 2020). The government will therefore continue to guarantee the solvency of the banking sector, which in turn will ensure continuity of funding to avoid a widespread debt crisis.

1.5. Capital controls and excess savings give authorities control over financial conditions

China's financial system remains very closed to the rest of the world and dominated by state-owned players, allowing the authorities to steer market conditions. Domestic investors hold nearly 95% of the debt of central and local public authorities (and 96% of the debt of property developers), the majority of which are state-controlled commercial banks. Financial conditions have remained very stable on average in the country in recent years, despite the major disruptions in the technology sector, the property crisis and the pandemic. Excess savings, accumulated as a result of strong financial repression and weak safety nets, are very high in China, at 46% of GDP in 2021 compared with a world average of 28% of GDP. This partly hampers investment capacity, but also acts as a counterweight to financial risks for economic agents. At a national level, China also maintains a net external position in surplus ($2,500 billion in 2022), the third largest in the world after Japan and Germany. However, the rebalancing of the economic model in favor of consumption, if it materializes, together with demographic ageing, could eventually lead to a reduction in this external surplus, which is why reforms aimed at strengthening the resilience of the financial sector are still necessary.

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Despite the sluggish recovery from the pandemic crisis, the authorities are likely to put a debt reduction target back on the agenda, which will weigh on growth. Their continued restrictive stance towards property developers, with only adjustments at the margins, signals their will to pursue structural reforms even to the detriment of short-term growth.

1.6. Financial stability remains a strategic objective for Beijing

Before the outbreak of the pandemic crisis, the country's leaders pledged to step up the fight against financial risks and better control asset bubbles. In 2017, President Xi Jinping stated that financial stability was a key element for "national security". This statement kicked off a series of measures to regulate the banking and insurance sector more closely and curb the expansion of shadow banking. In fact, non-bank and market financing has stopped growing since then. At the same time, the government had authorized an increasing number of bankruptcies to break down the idea of a systematic implicit guarantee. However, practices remain far from pure market mechanisms, particularly for state-owned enterprises, slowing down reforms in the country.

One aspect of these efforts is the rationalization of the financial regulatory system, which has historically been highly fragmented. This will involve the centralization announced at the March 2023 session of the National People's Congress. The aim is to unify the regulation of the financial system in order to completely control over-indebtedness. The banking and insurance regulatory bodies will be replaced by a new institution that will be responsible for supervising the entire financial system, with the exception of the Securities Regulatory Commission. The latter will have greater power over local government bond issues.

The new regulatory and supervisory body will encompass all sectors of the financial industry. This entity will also take on supervisory functions currently carried out by the central bank,

such as the supervision of public conglomerates and companies in the digital sector integrating financial services.

This high-level agency will have a concentration of regulatory and supervisory powers, and will report directly to the State Council chaired by Xi Jinping himself. This will facilitate the coordination and speed of intervention against systemic risk, and make it easier to restructure a financial institution with a solvency problem.

1.7. The race to catch up, then to technological self-sufficiency

In China, the state is both a direct entrepreneur and involved in guiding targeted industries. The West relies more on diffuse networks of universities, non-governmental agencies and companies pursuing Schumpeter-style innovations. The Chinese method, in which the state invests alongside the private sector, may prove effective in venture capital for catching up with the leader. But will this method be sufficient for technological breakthroughs in strategic industries such as artificial intelligence, semiconductors, quantum computing and biotechnology?

Growth in these directed investments has risen from 15% in 2019 to 35% in 2020. But there are allocation flaws in the guiding funds (Wei *et al.*, 2017). The increased centralization of power around Xi Jinping, which has become more pronounced in recent years, may be a factor holding back innovation and entrepreneurship, although the impact is still difficult to assess as China's start-up ecosystem is one of the most vibrant in the world. This is the duality between top-down and bottom-up approaches. Today, basic research is not yet at the level of the United States.

building "Fortress China" is a slogan that Xi Jinping uses to describe the urgent need for technological breakthroughs to compete with the West and become a self-sufficient technological power

One example that has made Chinese technicians wonder about their lag in cutting-edge technologies is the launch of ChatGPT, produced by the Californian start-up OpenAI, which is capable of answering questions and carrying on almost human conversation. This announcement has sparked a race to imitate it in China by search engine Baidu and Tencent. More generally, the challenge is to achieve technological breakthroughs in semiconductors and artificial intelligence in order to become a technological superpower known as "Fortress China".

China's political decision-makers are fully aware of their country's limits in terms of semi-conductor production. Building "Fortress China" is a slogan that Xi Jinping uses to describe the urgent need for technological breakthroughs to compete with the West and become a self-sufficient technological power.

In particular, semi-conductors are China's main import in terms of value, ahead of oil. China's technological focus on semiconductors stems from the fact that they are the raw material for a new industrial technological revolution encompassing Big Data, artificial intelligence, the Internet of Things, robotics, the Cloud and clean energy. China's comprehensive industrial policy strategy, "Made in China 2025", published in 2015, includes semiconductors as one of the main areas on which China wishes to focus its industrial policy. China is still lagging far behind. The Chinese company SMIC has managed to produce 7nm chips, a significant advance even if this production is not yet commercially viable, but is still a long way from the technological frontier (3nm).

In addition to civil issues, the race for the latest generation of semiconductors has major implications for the military sector, as cutting-edge microprocessors are essential in the production of weapons, which require supercomputers to guide missile trajectories. This is why China is focusing on quantum computing, to outdo the United States. Leading the competition in quantum technologies would offer gigantic computing potential, sophisticated communication and, above all, high-precision radar and image sensor detection. This is why the central government is mobilizing science and technology universities. It is also requiring digital companies to set up joint laboratories with defense-sector research units.

The Chinese government's desire to achieve self-sufficiency in semiconductors has led it to allocate more than $150 billion to new industrial projects. But the challenge of localizing the production of the highest-performance semiconductors is extremely difficult. Some steps of the value chain are highly concentrated in the hands of a few firms, or just a single firm. In particular, the Dutch company ASML produces the essential EUV (extreme ultraviolet) lithographic equipment needed to manufacture the highest-performance chips, while the Taiwanese company TSMC (Taiwan Semiconductor Manufacturing Company), produces the highest-performance 3nm chips and is experimenting with the production of 2nm chips. Other segments of the value chain are highly concentrated, for example around Nvidia for graphics processing units (GPUs) used for the Cloud and artificial intelligence. The other two leading companies in the semiconductor value chain are Samsung in South Korea and Intel in Arizona. This concentration has become an instrument of power for the United States in its strategy to contain China, as we shall see in Part 2.

1.8. The steep road to carbon neutrality

Since the beginning of the economic reforms launched in 1978, China has undergone a phase of development and strong growth. Between 2001 and 2021, its population increased by around 200 million people, and its GDP multiplied by almost 15, with a strong preponderance of industry. Against this backdrop, China's energy consumption has risen considerably over the last two decades. Yet its energy mix has been, and remains, heavily dependent on coal (55% of the total in 2021, compared with 11% in the United States, for example). As a result of this

highly carbon-intensive mix, combined with the high energy intensity of growth, China emits three times more CO_2 for each unit of GDP produced than the United States (and over six times more than France). With a GDP equivalent to 18% of world GDP, China was responsible for 31% of global CO_2 emissions in 2021, according to the Global Carbon Budget database.

China has a strong commitment to a major energy transition towards peak emissions by 2030 and carbon neutrality by 2060. In the National Determined Contribution (NDC) pledges made at the United Nations General Assembly in 2020, China announced its intention to reduce its carbon intensity (CO_2 emissions/GDP) by more than 65% by 2030 compared with 2005 levels. It has also pledged to increase the share of non-fossil fuels in primary energy consumption to around 25% by 2030 (from 16% in 2021) and its total installed wind and solar power capacity to more than 1,200 GW by 2030 (almost double the capacity in 2021). The 14th five-year plan calls for an 18% reduction in the carbon intensity of growth between 2020 and 2025.

China's commitments are encouraging, but will have to be followed by much more ambitious efforts to make the path to net zero credible (Hepburn *et al.*, 2021; Cabrillac and Macaire, 2023). The target of reducing the carbon intensity of growth by 18% between 2020 and 2025 is commendable, but, as GDP growth continues in absolute terms, it effectively authorizes an increase in emissions of close to 25% over the life of the plan. What's more, this target looks increasingly difficult to achieve. According to figures published by China's National Bureau of Statistics, the carbon intensity of growth fell by 3.8% in 2021, and by just 0.8% in 2022. To meet the target of the five-year plan, it would have to fall by an average of 5.1% each year over the next three years, which seems ambitious.

At the same time, the greening of China's energy mix should not mask the fact that, with GDP growth still high despite a recent slowdown, China's share of global fossil-fuel consumption continues to rise. Faced with energy supply risks, particularly in the face of droughts that have affected hydroelectric power generation, China has approved the construction of coal-fired power stations with a total capacity of 106 GW by 2022, representing a 10% increase on its current fleet (and 5% of the world total). Under these conditions, the road ahead to peak carbon emissions in 2030 and then carbon neutrality in 2060 will be particularly difficult. What's more, given the structural difficulties and economic slowdown facing China, greening objectives are becoming increasingly rare in official discourse.

What solutions are open to China? To achieve its targets, the authorities will have to reduce the carbon intensity of growth by modernizing and rebalancing the economy towards less energy-intensive sectors, and transforming the energy mix in favor of low-carbon sources (IMF, 2022b). This commitment requires a very ambitious investment trajectory in renewable energy production, electricity distribution, less-polluting transport, building renovation, bio-agriculture and the restoration of natural habitats. The World Bank estimates that between $14,000 and $17,000 billion (0.97% of GDP per year) will be needed in investment in the transport and energy sectors to achieve net zero by 2060 (World Bank, 2022), with a more sustained effort over the next decade to kick-start the transition (an additional 0.13 points of GDP per year).

In terms of financing green projects, the PBoC has encouraged the emergence of green bank loans. Outstanding amounts of green loans amounted to $3,600 billion in March 2023, or 10.7% of all loans (PBoC data). In particular, the PBoC has set up a low-cost refinancing facility dedicated to green projects, the Carbon Emission Reduction Facility (CERF), through which it had distributed almost $60 billion by March 2023.

Beijing has also taken initiatives to develop green financial assets. In 2015, the PBoC defined the types of projects eligible for the issue of green bonds in its Green Bond Endorsed Projects Catalogue. This initiative has contributed to the rapid emergence of this market segment. In the first quarter of 2022, China was the second largest country in terms of outstanding green bonds issued (with $250 billion, or 13% of the world total). A total of 42% of green bonds issued in China in 2021 were not aligned with international standards, according to data from the Climate Bonds Initiative. However, the taxonomy was revised in 2021 to exclude all projects associated with fossil fuels.

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Beijing's commitment to green multilateral initiatives is also visible. In particular, the PBoC participated with seven other central banks (including the Banque de France) in the 2017 launch of the Network for Greening the Financial System (NGFS), which now has 125 members. Within this framework, China has emphasized the importance of preserving the environment, in addition to climate change. China (the PBoC) co-chairs the G20 Sustainable Finance Working Group with the United States, and is an active member. China is also working on the Common Ground Taxonomy, an analytical tool for mapping and comparing EU and Chinese green finance taxonomies, which aims to promote harmonization.

However, low-carbon initiatives are still fragmented due to the lack of a policy framework for effective synergy. Restrictive measures against energy-intensive and pollution-intensive companies do exist, but incentives for clean energy and low-carbon infrastructure projects are still lacking, due to the absence of strong price signals for carbon valuation. In addition, large subsidies to fossil fuels persist, against a backdrop of administered fuel prices in China.

It is important both to reduce the return on polluting investments and to increase the prospective return on green investment projects. On the one hand, establishing a value for carbon, rising steadily until carbon neutrality is achieved, will change

the structure of consumption in favor of less carbon-intensive products. On the other hand, encouraging companies to make innovative low-carbon investments requires the introduction of an instrumental value (shadow price) to ensure that companies' anticipated prospective return is high enough to combat the uncertainty that accompanies extreme climatic events.

China launched the new Shanghai National Carbon Market (ETS) in July 2021. This market unifies the activities of eight local emission allowance markets that have been in operation since 2014. It covers emissions, linked to electricity production in the initial phase, which are responsible for more than 40% of China's CO_2 emissions. It is due to be extended to seven energy-intensive sectors (petrochemicals, chemicals, construction materials, steel, non-ferrous metals, paper and civil aviation) according to a timetable that is still uncertain. Even in its initial phase, it is the largest carbon market in the world, covering almost three times the amount of emissions covered by the European carbon market. This new market cannot break new ground quickly. The current price of carbon allowances is one of the lowest in the world (58 yuan per ton on average in 2022, or 8.2 euros, compared with more than 80 euros per ton on the European market), there is no absolute emissions cap, and allowances are being offered free of charge. However, it is an important tool available to the authorities, which could activate it in the medium term.

in 2022, China was home to 34% of the world's renewable energy production capacity

Alongside the transformation of the energy mix, one of the levers is to rebalance the growth model in favor of less energy-intensive sectors (IMF, 2022a; Zhao *et al.*, 2022). This is also one of the strategic objectives of the Chinese authorities. In 2018, the industrial and energy production sectors accounted for 78% of total emissions, including 33% for the industrial sector (Crippa *et al.*, 2021), which reflects (a) a very high share of the manufacturing sector in GDP, (b) a still large share of heavy industry and (c) still limited energy efficiency in the industrial sector. The evolution of these three factors is moving in the direction of a reduction in energy consumption, but the difficulties associated with rebalancing the growth model that we have seen above will continue to weigh on this trend.

1.9. Establishing a world leader in the energy transition industry

In addition to its efforts to strengthen the resilience of its growth model towards a more self-sufficient ecological civilization, China is positioning itself as a world leader in the renewable energy sector. The country has become the world's biggest investor in renewable energy capacity ($83 billion in 2019, compared with $55 billion in the United States, the second biggest investor).

In 2022, China was home to 34% of the world's renewable energy production capacity and 48% of solar energy capacity, as well as almost half the world's renewable energy jobs, according to data from the International Renewable Energy Agency (IRENA). The country is developing its capacity to produce the ores and strategic metals needed to develop the renewable energy industry (60% of global production in 2021 according to the US Geological Survey), and is stepping up investments abroad to strengthen its position (Bonnet *et al.*, 2022). China is also the world leader in the refining of these products, taking responsibility for their environmental cost. It will be responsible for manufacturing almost 80% of lithium-ion batteries and 80% of solar panels by 2021 (IEA, 2023).

This quasi-monopolistic position on supplies that will become increasingly strategic could give China a major diplomatic tool that it could use to strengthen its international position. Because of its dominant position in this field, China could, however, suffer from shortages of critical metals of which it produces little or not at all, from increasing difficulties in accessing Western technologies, and also from protective measures taken by other trading powers, as shown by the measures recently taken by the United States under the Inflation Reduction Act. The opportunities for China are therefore real, as demonstrated by the very rapid development of electric vehicle production, but they remain uncertain because of the scale of the efforts required.

2. China as an alternative to the Western model on the world stage

The Chinese government has an ambitious plan for China's place on the world stage, which includes three priorities: controlling new technologies, defining a more multipolar world order, and reunifying Taiwan.

The first objective is to achieve self-sufficiency in cutting-edge technologies, leading to a technological superpower that depends as little as possible on Western countries. This is the "Fortress China" ideology described in Part 1. This central issue is at the heart of Sino-American tensions, via the "technology war" initiated in 2018 and targeting Chinese technology companies. The measures decided by the United States in 2022 to restrict exports to China of semi-conductors and the tools needed for this industry represent an unprecedented challenge for Chinese industry. They highlight the weaponization of new technologies in the context of intensifying geopolitical fragmentation.

three priorities: controlling new technologies, defining a more multipolar world order, and reunifying Taiwann

The second objective is to strengthen China's international position by offering emerging countries an alternative to the system dominated by the Bretton Woods institutions. It is finding support in emerging countries that denounce the unilateralism

and influence of the United States in international relations. The annual BRICS summit held in August was an emblematic event, confirming the institutionalization of an alternative forum for international dialogue that will soon include half of humanity. China's stance on the war in Ukraine, through its growing political support for Russia, also reflects this positioning. The low-level use of the renminbi (RMB) internationally masks China's growing influence in the international monetary system through investments, bilateral and multilateral loans, and financial infrastructures that link China to a growing number of countries, outside any multilateral cooperation framework. This movement is part of the Belt and Road Initiative (BRI), which needs to be redefined because it is burdened by the excessive debt of countries benefiting from China's financing, particularly in Asia and Africa.

The third objective is the most uncertain but could have the most destabilizing implications, since the political authorities of the Communist Party of China (CCP) consider Taiwan to be an integral part of China, while the United States has been giving political signs of its willingness to support Taiwan. The risk of an armed conflict in the Strait is therefore not negligible, while its economic, financial and diplomatic consequences are impossible to anticipate.

2.1. Technological innovation at the heart of Sino-American rivalry

The technological conflict between China and the United States saw a new pivot in October 2022, with the US administration's hardening of its use of the semiconductor industry as an economic weapon (Bown, 2020): the publication by the US Department of Commerce of new sanctions on the export to China of semiconductors and the tools needed for this industry. In January 2023, Japan and the Netherlands joined forces with the United States to collectively limit sales of advanced semiconductor production equipment to China. This is also the first multilateral agreement to restrict the flow of chip production tools to China, demonstrating international support for the strategy launched by the United States to contain China, despite the significant financial impact on the companies concerned, which are now deprived of the Chinese market.

The agreement is a commitment in principle to restrict sales to China of lithography equipment, a segment dominated by two non-US companies: ASML (Netherlands), which holds around 90% of the market, and Nikon (Japan), which holds most of the rest. The restrictions are likely to affect two types of deep ultraviolet (DUV) lithography machines sold by ASML and comparable equipment from Nikon. In addition, ASML has a monopoly on extreme ultraviolet (EUV) lithography machines.

If fully implemented, these measures could hamper China's ability to design and manufacture the most advanced electronic chips (3nm) needed in particular to develop algorithms for artificial intelligence. The resulting long-term clash with the United States would probably be the most serious external challenge for China since the start of the reform era.

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Most of the sales of SMIC, China's leading chipmaker, come from the production of simpler 28nm chips, which are used in cars and household appliances. SMIC has also managed to produce 14nm chips (widely used in consumer electronics), and announced in 2022 that it had started producing more advanced 7nm chips, which TSMC and Samsung made from 2016 and 2018, respectively. However, SMIC's 7nm chips do not yet have a commercial yield, and if it is denied access to high-end DUV machines, it will be almost impossible for it to produce these chips on a large scale. Furthermore, denying EUV technology to Chinese chipmakers, particularly SMIC, prevents them from progressing up the technological ladder and manufacturing even more advanced chips.

This is because technological catch-up by Chinese players in this ultra-sophisticated industry can only be very slow and very costly, if not impossible given China's entry costs (Miller, 2022). The delay caused by sanctions will hamper China's ability to move closer to the technological frontier. As the country gradually loses ground in the technological race, it will become increasingly difficult to catch up. This will not only have an impact on civilian applications, but also have major implications for the military technology race.

China could limit the impact of these measures to the most mature segments. In the medium term, Beijing's efforts to support industry could lead to the emergence of industrial processes that could partly offset external supplies. On the other hand, the impact of export controls will depend on the severity of restrictions, which could be weakened by strong commercial interests in the Chinese market. China is also the main supplier of many raw materials needed by industry. It could take advantage of this position to implement retaliatory measures, as it did with the germanium and gallium export restrictions imposed in July 2023. But it remains difficult at this stage to estimate the risks associated with the application of these measures, and their impact in the international showdown.

2.2. The renminbi's difficult breakthrough as a reserve currency

The quest for influence on the world stage also involves financial flows and the balance of currencies in the International Monetary System (IMS). The decline of the US dollar in foreign reserves of central banks, which began in the mid-2010s, has accelerated since the start of 2020. At the same time, China is stepping up initiatives to strengthen the international role of the RMB, and many emerging countries are demonstrating their political will to reduce their dependence on the dollar. These initiatives, carried out outside any framework of

international cooperation, are reviving the debate on the risk of fragmentation of the IMS, leading to confrontation between groups of countries.

However, the weakening of the dollar seems at this stage to reflect more a strategy of diversifying reserves, with a view to mitigating the risks associated with the financial volatility and geopolitical tensions that have increased. Since 2016, the RMB is the currency that has gained the largest share of total reserves (+1.6 pp, to reach 2.8% of reserves), according to IMF COFER data. But other currencies are also benefiting from the fall in the dollar (JPY, EUR, GBP, CAD, AUD). The RMB accounts for only 25% of reserves in non-traditional currencies (other than USD, EUR, GBP and JPY). CAD (23%) and AUD (20%) also play an important role. At the same time, gold also seems to be gaining in appeal as a reserve asset.

the emergence of an “RMB bloc”, in which the Chinese currency would have a dominant place, does not seem possible in the medium term

While a change in the dominant currency is unlikely in the medium term due to the inability of competing currencies to provide assets that are as safe, liquid and, above all, in similar quantities to those denominated in USD, the transition to a more multipolar monetary system is underway.

As far as the RMB is concerned, there are still major obstacles to the acquisition of assets denominated in this currency by institutional investors: capital controls and political risk, financial risks and opacity, lack of risk hedging tools, and the narrowness of the addressable market (Aglietta and Macaire, 2019). These obstacles underlie the RMB’s still very small share of global foreign exchange reserves. Given China’s current policy stance, they are unlikely to weaken in the short to medium term, and will remain obstacles to the RMB becoming a leading reserve currency. The Bank of Russia, which has significantly increased the share of the RMB in its reserves, highlighted in a recent financial stability report the operational difficulties associated with holding illiquid currencies, including the RMB (Bank of Russia, 2023). This is why the emergence of an “RMB bloc”, in which the Chinese currency would have a dominant place, does not seem possible in the medium term. Instead, the desire for diversification seems to point towards an international monetary system still dominated by the dollar and the euro, but more multipolar, unless we envisage the promotion of special drawing rights (SDRs) as the ultimate reserve asset, making the IMF the international lender of last resort.

However, the RMB has a number of advantages that will continue to support its gradual internationalization, particularly as an invoicing currency for international trade, for which China is multiplying its initiatives. First, there is the size of the Chinese economy, combined with the political will of the authorities to internationalize their currency. This is particularly the case through the proliferation of international financial infrastructures (swap agreements, clearing banks abroad) and the strengthening of economic and financial links with emerging countries (trade, investment, bilateral loans). Geopolitical tensions are also a factor, with Russia the main example, having increased the proportion of its reserves in RMB and turning more to China for its trade. The increasing number of announcements of trade settlements in RMB (recently by Brazil), although without any real commitment in terms of amounts and which will probably remain a minority in the short term, also reflects growing political will among emerging countries to reduce their dependence on the dollar.

In the longer term, other potential levers are emerging. Through trade, China could push for a greater proportion of its energy commodity imports to be denominated in RMB. China is in discussions with Saudi Arabia, its biggest source of crude oil imports, on this subject. It could also take advantage of its key role in renewable-energy value chains, in particular its leading position as a processor of critical raw materials. Ultimately, a greater role for the RMB in world trade would support the internationalization of the RMB as a reserve currency (Eichengreen, Macaire, Mehl, Monnet and Naef, 2022).

2.3. China wants to offer an alternative to the “dollar system” for global finance

Over and above the currency balance, China continues to increase its influence on the international financial scene, particularly with emerging countries, although this is not fully reflected in the use of the RMB. The US dollar continues to dominate China’s financial links with the rest of the world, and should continue to play a major role here too, for the structural reasons outlined above.

China feels excluded from negotiations on the architecture of international safety nets. The governance rules of the Bretton Woods institutions give the G7 countries the upper hand (41% of votes against 14.5% for the five BRICS) and the leadership to the USA and Europe. Hence, China has gradually developed an alternative financing network, outside any multilateral cooperation framework. It has become the leading international lender, with outstanding bilateral loans estimated to exceed those of the World Bank. China has also positioned itself in emergency financing, with outstanding amounts equivalent to around 20% of those of the IMF in the last decade, notably via its swap agreements (Horn *et al.*, 2023). It is also extending its influence in world trade, becoming the leading trading partner of a majority of the world’s countries.

China has also contributed to the creation of the New Development Bank (NDB) and the Asian Infrastructure Investment Bank (AIIB), international financing institutions designed as an alternative to the existing multilateral development banks, to carry the voice of emerging countries. The NDB brings together the BRICS, and the AIIB has over 100 members; both are headquartered in China. With 27%

of the vote, China is the most influential member of the AIIB. These two institutions are now among the five most important multilateral financing institutions in the world.

Cooperation with China on the issue of international financing is made difficult by the differences in underlying standards (governance, sustainability, etc), the lack of transparency in Chinese institutions, and the preponderance of China's political objectives in the strategy for allocating funds (Belt and Road projects). On the American side, the lack of progress on the issue of IMF governance is also a major stumbling block. In this respect, the quota review, which should be finalized before the end of 2023, will be a key point of negotiation.

China deployed a central bank digital currency (CBDC), the e-CNY. It is the first operational CBDC and now has over 100 million active accounts. It participates in a cross-border exchange platform for CBDCs ("mBridge"), currently involving China and Hong Kong, Thailand and the United Arab Emirates, as well as 15 observer members, including the Euro system and the Fed, enabling payments in real time and in a multi-jurisdictional context). Those breakthroughs could also be a major lever for China, enabling it to strengthen its ability to impose its technological standards in the field of payment systems (Kshetri, 2023).

China is therefore taking initiatives in building a new international financing network based on institutions, infrastructures and even technologies that are alternatives to the system organized around the Bretton Woods institutions. The risk of fragmentation into antagonistic blocs is therefore more likely to affect the rules underlying the international monetary system (in particular, international safety nets and financial standards) than the use of currencies.

2.4. A new vision of multilateralism, with China as leader of the emerging countries

The financial aspect is one facet of a broader project to reorganize the world order, as desired by China, supported by the Belt and Road Initiative (Aglietta *et al.*, 2021). To legitimize this initiative, China is highlighting the success of its economic development since the start of economic reforms in 1978, which has transformed the country, shaped part of world trade and led to a historic and unprecedented fall in poverty.

The BRI is promoting long-term development strategies (energy transition, digital innovations, infrastructure) that require an overhaul of the financial framework in order to break the dominant logic of short-term profit. The American Enterprise Institute estimates that almost half of Chinese investment abroad between 2005 and 2019 was in the energy, transport and infrastructure sectors (Scissors, 2019). Admittedly, Beijing's more stringent requirements on project profitability levels, together with the international community's growing awareness of the risks associated with emerging countries' indebtedness to China, slowed investment in Belt and Road countries in 2019. The slowdown has continued since then, with the disruptions associated with the pandemic crisis. But commitments total almost a trillion dollars since 2013 (Nedopil, 2023).

China is also seeking to reinforce political and economic integration with emerging countries, through institutional infrastructures.

Economically, the Regional Comprehensive Economic Partnership (RCEP) free-trade agreement, dating from November 2020, was signed by 15 Southeast Asian economies (the 10 ASEAN countries, plus China, South Korea, Japan, Australia and New Zealand). It provides for the abolition and reduction of border taxes, as well as the facilitation of cross-border investment. These nations account for 30% of global GDP, making up the world's largest free-trade area. The RCEP brings together a number of pre-existing agreements between the countries involved. It is part of a drive to strengthen China's role in regional value chains, by supplying a growing share of intermediate products for re-export, particularly in the textile sector.

China is also seeking to reinforce political and economic integration with emerging countries, through institutional infrastructures

More generally, China is stepping up its trade with emerging countries, benefiting from the growth in their domestic demand and their growing role in international value chains. China, for example, has become the leading foreign supplier of value added for final demand in ASEAN countries. As a result, at the beginning of 2023, the share of emerging countries in China's exports exceeded that of developed countries for the first time, reflecting a trend that has been gradually building over the last two decades.

At a political level, the Shanghai Cooperation Organization (SCO), set up in 2001 by China, Russia and four Central Asian states (Kazakhstan, Kyrgyzstan, Uzbekistan and Tajikistan), was extended to India and Pakistan in 2016, and since 2021 Iran has been in the process of joining. In recent years, Beijing has also relied on its partners in the Forum on China-Africa Cooperation to reject UN motions condemning its actions in Xinjiang and Hong Kong. China is also strengthening its bilateral geopolitical alliances, as demonstrated by its position on the war in Ukraine. Given China's continuing strong dependence on trade with Western countries, the fear of sanctions initially led Beijing to comply, at least in appearance, with Western measures against Russia and to reduce its material support. Since then, its increasingly open support for Moscow has shown that China is prepared to position itself as a discordant voice in relation to the United States and Europe.

In 2022, China relaunched its quest for global influence through two multilateral initiatives: the Global Development Initiative – a complement to the BRI signed by over a hundred

countries and aimed at providing global public goods and not just infrastructure – and the BRICS group (Brazil, Russia, India, China, South Africa). The last annual BRICS summit in August 2023 saw the inclusion of six new members (Saudi Arabia, Argentina, Egypt, United Arab Emirates, Ethiopia and Iran), which will increase the size of the group to half of humanity (47% of the world's population), and almost a third of the world's GDP by value. The general feeling within this group of emerging countries is that the current institutional system (World Bank, IMF, United Nations) is unfairly biased in favor of the interests of developed countries, and that concerted action between emerging nations can be a tool to counter Western sanctions and export controls.

All in all, China is seeking a strategic repositioning in multilateral globalization that will restore the Middle Kingdom to a key role.

2.5. A challenge for China: strengthening support for its new world order project

Through the Belt and Road Initiative, China has indicated that it wants to build a "community of common destinies". This closer integration will depend on the willingness of the Belt and Road countries to join China's grand project. Suspicions about Beijing's final objectives and negotiating strategies, and fears of excessive financial dependence on any one country, have damaged the BRI's image and fueled anti-Chinese opinion around the world.

In his keynote speech at the second Belt and Road Forum for International Cooperation held in Beijing in April 2019, President Xi Jinping stressed the need to increase transparency and tighten governance criteria in investment choices along the Belt and Road, in order to converge with international standards. The "greening" of the initiative – *i.e.* promoting investment and financing to support the energy transition – was also highlighted as a key objective.

suspicions about Beijing's final objectives and negotiating strategies, and fears of excessive financial dependence on any one country, have damaged the BRI's image

The commitment to adjusting the operating methods of Chinese firms abroad is not just about improving the BRI's image in the international community. It also stems from the need to make the management of the huge funds invested in projects more efficient and to limit the risk of losing negotiating power in countries where its investments become too high.

At the end of 2017, the sale of 70% of the Sri Lankan port of Hambantota to Chinese companies for $1.1 billion on a 99-year lease, in return for a rescheduling of the country's debt to China, caused a stir in the international community. The port is a major trading hub for the region, but concerns have also focused on Beijing's intentions to use it as a strategic military base. This case has raised the question of the risk of a "debt trap" for the most vulnerable countries, which could ultimately threaten their sovereignty. However, Sri Lanka is the only proven case of asset seizure (Kratz *et al.*, 2019). Most cases instead involve extensions of loan terms or partial or even total debt forgiveness. Nevertheless, these past events are not indicative of future decisions. China's negotiating strength could prove considerable, particularly in highly indebted countries, which may find it difficult to find alternative sources of international finance.

Beyond these central issues of sovereignty, China's vast investment projects are a force for development for the recipient countries. With regard to Africa, Lin and Wang (2022) find that projects financed by China made it possible to address bottleneck-related difficulties in 78% of the 214 infrastructure projects carried out between 2000 and 2014. These projects mainly targeted public goods (74%), including electricity, water and sanitation, ports, airports, motorways and railways.

these multiple diplomatic initiatives do not mean that China is about to overthrow the world order

Furthermore, it is crucial to turn China's financial commitment into an opportunity to steer globalization in a direction that is more respectful of global goods. Through the Belt and Road Initiative, which is part of a long-term economic policy framework, China has the opportunity to make long-term investments by moving away from the logic of immediate profit. It therefore has a responsibility to protect a globalized political ecology. The greening of the BRI can be achieved by promoting renewable energies, more efficient energy networks and international cooperation, in particular by sharing data to monitor climate issues more closely. Through its role as an investor, China must prove that it has a responsible attitude. As well as promoting a more sustainable economic model, the diplomatic dividend would also be substantial.

These multiple diplomatic initiatives do not mean that China is about to overthrow the world order. The deep political rifts within the BRICS, particularly between China and India, mean that China will find it difficult to create a truly united group. The US is also pursuing influence measures of its own (albeit less influential) multilateral initiatives, such as the Partnership for Global Infrastructure and Investment, a new version of the Build Back Better World, or B3W, initiative, announced in 2021 but which has struggled to get off the ground, and the Indo-Pacific Economic Framework. Under President Joe Biden, the United States has also deepened its strategic partnership with Japan, India and Australia, and established the Aukus partnership with Australia and the United Kingdom.

Moreover, Beijing has yet to persuade many other countries that it is better intentioned than the United States and its allies. Its conception of multilateralism aims to break down the world

system into a set of bilateral relations, in which its size gives it the advantage. Members of the southern hemisphere may wish to protect themselves from a new form of domination.

2.6. The limits of the Chinese proposal: the risks of confrontation

Greater alignment with international standards, as well as greater participation by foreign companies and financial institutions, were at the heart of Xi Jinping's speech at the second Belt and Road Forum for International Cooperation in April 2019. This stance has set in motion a process of increased monitoring of investments and financing mechanisms set up by Chinese institutions abroad.

However, the major differences in standards and operating methods (transparency, governance requirements) between China and developed countries have severely hampered cooperation between Chinese financing institutions and multilateral development banks. What's more, issues relating to the sustainability of recipient countries' debt have been at the heart of the deterioration in international opinion of the Belt and Road Initiative. The Center for Global Development published a paper in March 2018 (Hurley *et al.*, 2018) that identified eight countries at high risk of debt distress from future BRI-related bilateral financing. President Xi has tacitly acknowledged the deviances of the past by promising to rectify the path taken, in particular by fighting corruption and increasing compliance with international practices. But convergence of standards will require stronger political will on the part of Beijing, which does not seem to be forthcoming at the moment.

China also has an opaque policy regarding its international financial commitments. Although it has become the world's largest bilateral lender, it does not declare official loans abroad (*i.e.* those made by the government, state-owned enterprises and public banks), which make up the bulk of its commitments. The country is not a member of the Paris Club, an informal group of 22 public creditors whose role is to restructure the debt of countries in difficulty in an orderly fashion, and is therefore not subject to the transparency requirements concerning these commitments. In particular, Beijing stressed that the China Development Bank (CDB), one of the three state-owned development banks, was acting as a commercial lender and as such would not disclose data relating to its overseas loans. However, it is estimated that the CDB is responsible for almost 40% of outstanding international engagements, via loan lines that are limited in number but cover large amounts (notably for Angola, Venezuela and Pakistan). Many financial flows are therefore not reported in official statistics or IMF, BIS or World Bank reports. A working paper by the Kiel Institute for the World Economy (Horn *et al.*, 2021) estimates that a third of China's overseas loans to emerging countries are "hidden". This has major implications for risk analysis and undermines China's ability to credibly position itself as a leading international financial center. Finally, China has an unclear policy on restructuring its debtors' debts.

Tensions with the United States have had major consequences, with the virtual cessation of diplomatic relations with China, and the economic and strategic implications outlined above. With the European Union, tensions were exacerbated by China's growing influence in Eastern Europe. China has deployed the "17+1" diplomatic initiative, also known as the China-CEEC (Central and Eastern European Countries) Summit. In March 2019, taking into account this diplomatic step forward, the European Commission described China as a "systemic rival promoting alternative models of governance". However, Chinese companies invested just €9 billion in the 12 EU member states of the "17+1" between 2000 and 2018, compared with €140 billion in the rest of the EU over the same period (including €47 billion in the UK alone). Chinese investment remains a very small minority compared to European investment in the region (Hillman and McCalpin, 2019). Furthermore, Lithuania announced its withdrawal from this cooperation area in May 2021, describing it as a "divider" in the European project. The other two Baltic countries, Estonia and Latvia, have followed Lithuania's example, and the Czech Republic has also indicated its desire to withdraw from the group, thus testifying to China's relative diplomatic failure in Central Europe.

We have seen that China is deploying economic and institutional initiatives with emerging countries to develop a community whose aim is to act as a counterweight to the Western powers, primarily the United States. However, there is no real common political project; for example, China is in almost open conflict with many South-East Asian countries over issues of sovereignty in the China Sea. So this counterweight does not necessarily mean a total reversal of the balance of power. Most of the emerging countries may also wish to retain their independence beyond the geopolitical divide between China and the West. This seems to be reinforced by the extreme risk posed by a potential crisis over the Taiwan question, the economic, financial and diplomatic repercussions of which are impossible to anticipate.

Conclusion

China's 14th five-year plan inaugurated structural change in the Chinese model towards innovation-led development, with the aim of restoring China's central place on the world stage. This is the "dual circulation" aiming to achieve a socialist market economy by 2035, embodied in an "eco-civilization". This global project has begun, but it faces immense challenges.

The domestic part of the strategy involves developing the domestic consumer market for an enlarged middle class. It relies on political ecology and digital innovations to raise China's ambitions. To achieve this, R&D efforts have been

strategically intensified to ensure that China's production tools move up the technological ladder. But an ageing population, climate change, financial vulnerabilities and dependence on foreign inputs in high-tech sectors are still major challenges for China.

The international part of the transformation of the growth regime aims to restructure globalization for a new multipolar geopolitical order. This project consists of proposing an alternative to the system organized around the Bretton Woods institutions, by making China the leader of the emerging countries. It has come up against the resurgence of antagonism between China and the United States, which has hardened considerably and seems irreconcilable. Potential sources of conflict are multiplying, from the technological race to artificial intelligence to the urgent need to respond to climate change, and are accentuating the fragmentation of the world.

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This article reflects the personal views of the authors and should not be construed as reflecting the Banque de France's or the Eurosystem's position on the subject.

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Policy Brief

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