Perhaps the most popular term used among strategic analysts in the past year is “Thucydides Trap”—the notion that a rising power and the incumbent power are destined for war—because of the growing rivalry between the United States and China. The worry is that as China’s economy continues to grow, China will gain the means and confidence to challenge American military primacy and influence in Asia. From this perspective, China’s recent economic slowdown is viewed as helpful in putting off the day of reckoning.

While perhaps comforting to some, there is more to fear from China’s current economic weakness than its potential future strength. The empirical evidence about strategic rivalry is actually much more ambiguous than some prognosticators insist. And in the Chinese case, although anxieties have risen because of tensions over China’s irredentist ambitions in the South China Sea and cyber, open warfare over these issues seems highly unlikely or necessary. Even more important, the negative consequences to the world—which must include both China and other countries—from its economic weakness are
not just hypothetical; they are already visible and could become more damaging if not addressed soon.

China avoided the worst of the global financial crisis with an RMB 4 trillion stimulus package. But that binge in infrastructure spending has been followed by a hangover of debt and overcapacity. Domestic demand for electricity, steel, cement, copper, and glass has all fallen off, as have imports and exports. The only thing keeping the country out of recession is resilient employment and consumption data, accompanied by a gradual transition toward services, which is less dependent on infrastructure growth. The International Monetary Fund estimates GDP growth will be 6.8 percent for 2015 and 6.3 percent for 2016. Chinese authorities dispute these figures, but most other independent estimates are even lower. Slower growth would be acceptable if achieved through greater efficiency and higher productivity, but unfortunately, what China calls the “new normal” looks a lot like the old normal, just slower.

Concern about China’s poor economic performance is not only the result of built-up debt, but recent policy swings. Xi Jinping came into power advertising a comprehensive reform package. He started with a range of reforms in finance, utility prices, fiscal affairs, and free-trade zones, but in the past year, we’ve seen a string of policy moves that are decidedly more statist. Having placed constraints on the real estate sector in 2013, authorities in 2014 encouraged investment in the stock market, and then when the expected bubble burst in 2015, they intervened to slow the collapse, suspending trading of many stocks, ordering shareholders not to sell, and reportedly using $500 billion to soak up unwanted shares. The Shanghai Index fell off over 40 percent, and trading volume fell over 70 percent. The stock market fiasco was followed in August by the poorly managed liberalization of the renminbi, which has featured an extended tussle between the market and authorities over the RMB’s value, with the former expecting further depreciation. While authorities spent
billions to maintain the RMB’s strength, Chinese citizens simultaneously shipped their dollars out of the country at record pace, leading to a decline in foreign exchange holdings.

The mistakes of the summer were accompanied by cheap-calorie stimulus, with several cuts in lending rates, ramped-up fiscal spending, and an RMB 3.6 trillion debt-swap program involving local government bonds. The reform package for state-owned enterprises (SOEs) announced in September 2015 highlighted strengthened party control, mergers, minority private investment, and limited competition. And signs emerged that the 13th Five-Year Plan (2016–2020) would bring only incremental liberalization.

Slower growth and greater volatility in the short term mean a rise in debt and corporate losses, which may very well translate into higher unemployment and a slowdown in household consumption. And given the unpredictable mix of market and state in recent policies, doubts are growing about the leadership’s basic competence to govern the economy, which had always been the Communist Party’s strong suit.

From the perspective of the United States and others, slower Chinese growth means less demand for their goods. Commodity prices have fallen off, hurting Australia, Brazil, and the Middle East. And exports to China of manufactured intermediate goods and final products from the United States, Europe, and other industrialized economies have all dropped. American exports to China are estimated to fall by at least 9 percent in 2015, and could fall by a larger amount in 2016 if China’s economy continues to lag. A more slowly growing pie could also translate into greater protectionism, a trend already visible in high-tech goods such as semiconductors and telecommunications.

But the most important emerging negative externalities from China’s economic troubles are volatility in global securities markets and greater pressure on macroeconomic policies for the United States and others. China’s economy is now large enough and its capital markets open enough that problems there spread elsewhere at the speed of light, as investors everywhere move their funds with just the click of a button.

The most pressing challenge then is not faster growth, but more unambiguously market-oriented economic policies that are also more clearly articulated and explained. It is in China’s strong self-interest to calm markets and restore the confidence of investors, domestic and global. Even if further stimulus is warranted, accompanying it with greater liberalization and market access, for example in services, would be an important signal that Xi Jinping is not just a fair-weather reformer.

At the same time, the United States can emphasize even further the benefits to China and to the bilateral relationship of China pursuing an unambiguous reform policy agenda. The conclusion and implementation of the Trans-Pacific Partnership (TPP) would also serve as bright directional arrows pointing China to further open its economy, as remaining outside TPP would put China’s economy at a strategic disadvantage precisely in those high-value-added sectors in which it is hoping to develop greater capacity. Finally, China’s hosting of the G-20 process in 2016 provides another opportunity to strengthen coordination of macroeconomic policies and further hone strategies toward healthier and broad-based growth strategies.

Generating better economic performance in China should be welcomed, not feared. A potential Thucydides Trap is hypothetical, whereas the negative consequences from China falling into a “middle-income trap” are real and potentially upon us.