

# Economic leverage, the key to a rising China's new foreign affairs strategy

Yifan Hu / Chief Economist, Haitong International  
[yf\\_hu@htisec.com](mailto:yf_hu@htisec.com)

## Abstract

The Chinese economy is already the world's second largest economy, with over three decades of strong growth behind it and more room to grow, and its economic power has translated into increasing political power. China's historical, economic, and institutional backgrounds set a particularly challenging backdrop for a rising power in a Western dominated international system.

It has become increasingly important and urgent for China to establish a new foreign affairs strategy to address changes in international structures and environment, and its own changing stature as it moves up the economic competitiveness pyramid. China's non-intervention policy has been a successful strategy in an early stage of development, but with increasing interests abroad, this strategy is no longer in China's interests. Under the new circumstances, it could be an active and better strategy for China to leverage its rising economic power in international affairs to better promote its interests worldwide and utilize cooperative opportunities to improve its ties with various countries. China needs to find the right equilibrium between the necessity to exert a bigger global influence and the need to avoid being too aggressive.

Strategic collaborations between China and the US, Europe, Russia, Japan, emerging neighbor countries and BRICs are the most important among others.

- China-US relations could be strengthened via four main economic channels including improving trade relations, promoting common strategic sectors, rebalancing domestic economies, and coordinating for an optimal policy-mix at a global level.
- China-Europe relations could thrive if based on economic and financial needs of the "old continent." The key areas for cooperation are to maintain a high level of trade by avoiding tariff wars, to increase Chinese investment into Europe, and to maintain China's strategic support amid a continuing debt crisis.
- China-Russia relations could be reinforced by cooperating in the fields of energy and resources, establishing trade agreements and coordinating roles in international organizations as a way towards a better equilibrium of power globally.
- China- Japan relations could improve by exploring synergies at the level of trade, investment, high technology, and environment, as well as coordinating on regional issues despite tensions from history.
- China's relations with emerging neighbor countries and BRICS countries represent an opportunity for a win-win solution for the new world. China's "infrastructure for commodity" model, orderly manufacturing line transferring and spreading RMB impact will promote local developments while building a growing sphere of influence independent of existing global powers.

Communication is equally important as strategy in international affairs, especially for a rising power like China facing great challenges on how to communicate its intentions to the other countries in the system. We recommend attempting cultural bridging, establishing an open, smooth and regular official communication platform, and promoting multi-layer grassroots communication channels to improve China's communication strategy.

A farsighted new foreign affairs strategy together with effective communication will greatly benefit China on its way to becoming a bona fide superpower. Approaching international affairs tactfully and pragmatically while sticking to the bottom line is a good way for China to approach the next several decades.

## **I.A rising China calls for a new economic-focused diplomatic strategy**

### **The economic rise of China translating into political power**

Over the past three decades, China's growth has been a wonder to behold. The average year-on-year growth rate for the period of 1980-2012 was 9.9%, a sweltering pace. As of the end of 2012, the nominal GDP has grown roughly to 27 times its 1980 value. Today, China's GDP ranks second in the world, below only the US. The catching up process has been impressive as China successively overtook Germany in 2007 and Japan in 2010. The weight of Chinese GDP was close to 15% of world GDP in 2010 compared with less than 5% in 1990. Furthermore, China has managed to maintain robust growth through the global financial crisis and ongoing European debt crisis, while many economies suffered significant economic malaise if not outright recessions. Based on our assumption of growth rates at 7% YoY and 2% for China and the US respectively over next 10 years, together with the possibility of 10-15% RMB appreciation, China will likely replace the US to become the number one economy in the world by 2023.

China's exports have been on a track of continuous rapid growth, representing 11% of world exports today from only 1.1% in 1982, higher than the 8% weights of the US and of the Euro zone. Meanwhile, China's imports have shown an upward trend, registering at 10.1% of world total imports today, compared with the 12.7% of the US and 11.6% of the Euro zone. China has built up a large pool of foreign exchange reserves totaling USD 3.5 tn by 1H13, the highest in the world, accounting for over a third of the world reserves. China has therefore become the largest creditor of developed economies.

Backed by rising economic power with the promotion of a "go out" strategy, outbound investment of China amounted to USD 87.8 bn in 2012, representing 6.3% of total global FDIs in that year and being the 2<sup>nd</sup> runner up after the US and Japan. China's cumulative outbound investment has surged in recent years, reaching USD 531.9 bn in 2012, about 18 times the level of 2002. The position of the investment overseas accounted for 6.4% of the GDP in 2012, up from 2.5% in 2000.

All of these factors allow China to have a louder voice and more bargaining power in international affairs, showing that China's economic power has been gradually shifting into political power. China has accumulated more voting power in most international institutions, and played an increasingly significant stabilizing role after the financial crisis and during the ongoing European debt crisis.

### **A call for a new strategy for foreign affairs**

China's rising economic and political power and its transition from different stages of development mean that its foreign affairs approach has to be redefined. Non-interventionist in a recent past, the stance of Chinese foreign policy has become progressively awkward. China's increasing influence and growing interests overseas requires a higher degree of intervention and protection.

The history of the US represents a good example of the transformation in foreign policy associated with the emergence of a super power. Contemplating the initial policy of isolation and the subsequent historical evolution of the Monroe Doctrine in the US is a way to understand how a country's foreign policy changes with levels of economic development and with scales of assets overseas during a country's rise to the level of a superpower.



At the early stages of its economic development, during which it had a weak presence outside and poor military forces, the US had adopted a neutral and isolationist foreign policy. In parallel with stronger presence and investments abroad, the Monroe doctrine, applied from 1823, transformed this US foreign policy in a more assertive manner but still on a defensive mode. At its core, the Monroe doctrine aimed at discouraging European colonization of North and South America. The Monroe Doctrine was a foreign policy declaration that any future aggression by European powers in the Americas would be perceived as a threat to the US; in essence, expecting the European powers to stay away from the Americas, in exchange for the US not interfering with European politics and existing colonies. This phase of US foreign policy development perhaps similarly reflects China's attitude for the last several decades; with relatively limited foreign interests, the focus was mainly to protect domestic interests.

At the turn of the 20th century, the US was gradually rising to superpower status. The Monroe doctrine was amended in a more interventionist manner by the Roosevelt Corollary in 1904, along with increasing US interest overseas. Foreign investments from the US increased to over 5% of GDP at that time (similar to China's ratio today). This was seen by many as a departure from the previously defensive stance of the US towards a more aggressive declaration of regional hegemony. From intervention in case of instability in America, the US strategy became implicitly pre-emptive with the containment strategy, justifying the deployment of foreign affairs resources and possibly military interventions to protect US national interests. Defensive at its creation, this doctrine therefore became more and more assertive with the rising power of the US at the world level. It is interesting to note that, similar to China's current economic status, the US had just completed its transition from an agricultural to an industrialized country with a strong manufacturing infrastructure in place at that time, with GDP per capita at roughly USD 4000-5000 and outbound investment at about 5% of GDP.

With China's rise to a superpower status and with increasing interests abroad, it has become increasingly important and urgent for China to establish a new foreign affairs strategy to face the challenges and seize the opportunities brought by its new status in a new international structure and environment.

## **II. A new diplomatic strategy leveraging economic power suitable for a rising superpower**

China has gradually become a rising economic and political power worldwide, while other developed countries have struggled to regain growth momentum following the global financial crisis and during the ongoing European debt crisis. Still in the process of developing its economy, China has been abruptly thrust into the spotlight as a superpower by recent events, and this rapid rise has drawn concern from the Western countries as well as neighboring countries. With China's rise to a superpower and increasing interests abroad, together with concerns and fears of both Western and neighboring countries, it has become increasingly important and urgent for China to establish a new foreign affairs strategy to face the new challenges and opportunities for its new status in a new international structure and environment. Communication is equally important as the new foreign strategy, especially in a context of a "trust deficit" between China and the rest of the world. China would benefit from improving communication to promote cooperation and diplomacy, which could be done through a variety of methods, both official and non-official.

China has become the second largest economy in the world through its past three decades of unparalleled fast growth, and is seeking to walk the path that took the US a century to do in the next three decades, in transitioning from a manufacturing society to a more consumption-orientated society with higher labor productivity through technological development. China's rise and transition from different stages of development will mean that the focus for managing foreign affairs will change over time as well. China's "no intervention" foreign policy for the past decades has appeared increasingly awkward in dealing with international affairs due to its rising power as well as increasing investments and interests overseas. At varying stages of economic development, there will be different agendas and views for policymakers. In the course of China's rise to a superpower status, China will have both increasing influence and interests worldwide, and consequently, there will be a need for notable changes in foreign policy direction in the next 30 years.

Despite military force, economic power will play an increasingly important role in international affairs. Tackling unemployment and boosting growth have increasingly become the winning tickets for politicians in the power struggle process of most economies, therefore countries that can help drive global growth and produce positive spillover effects are the kings of the game. China is a superpower on the rise, with vast amounts of still untapped potential for further growth, implying a good timing and opportunity for China to play economic cards strategically in maneuvering a new win-win scope of diplomatic relationships. In doing so, China first needs to identify its dynamic position in the global competitiveness pyramid, and then establish strategic relations with major economies accordingly.



Based on the definition from the World Economic Forum, competitiveness is composed of three main categories: basic requirements including institutions, infrastructure, macroeconomic environment, healthcare and primary education; efficiency enhancers including higher education and training, goods market efficiency, labor market efficiency, financial market development, technologic readiness and market size; and innovation and business sophistication. Our pyramid is a ranking of the current competitiveness of several countries in the international system. Currently, the US ranks at the top, and is likely to remain in that spot for at least the next several decades. Despite the recent financial crisis, the US remains at tier 1, as it is one of the highest GDP per capita countries in the world, has high value added, and is still the largest national economy in the world in nominal terms by a good margin. In the next tier, Japan and Germany are developed economies with traditionally high competitiveness, but are currently facing significant socioeconomic issues. Following Japan and Germany are countries such as the four small Asian Dragons including south Korea, Singapore, Hong Kong, and Taiwan. The four Asian Dragons have become either financial centers or hubs for technological innovation in Asia.

China is in the fourth tier along with other BRICS such as Russia and India, as it still has lower efficiency and competitiveness relative to the economies listed in the first three tiers. As it begins to evolve towards increasingly value added manufacturing and services, as institutional arrangements have improved, as urbanization continues, and as innovation and technological improvements are more encouraged, China will move up from tier 4 to tier 3 in competitiveness. It is vital for China to properly manage relations with upper tiers and within its tier in the process of rising. In this paper we focus on China-US, China-Europe, China-Russia, China-Japan and the China-Emerging neighbor countries ties over the next several decades

## 2.1 New strategic China-US relations

The Sino-US relationship is arguably the most important bilateral relationship in the world, and is tightly bound by economic ties and increasing cultural ties. This relationship frequently undergoes tensions due to a variety of economic and political issues, and is likely to continue to do so in the future. Especially following the global financial crisis and during the ongoing European debt crisis, China has suddenly been thrust towards the forefront of the discussion as a potential superpower. There has been increasing discussions of a G2 world, where the US and China are the two superpowers in the international system to bail out the global economy. As the two largest national economies in the world, these countries are set to play the primary roles in shaping the global economy in the decades to come.

As a rising economic and military power, China is a concern for Western countries, especially the US, evidenced by President Obama's push for reallocating military resources to the Asia-Pacific region, a move known as the "pivot strategy". An assessment report covering US military interests, named "Sustaining U.S Global Leadership: Priorities for 21st Century Defense" was announced on January 6, 2012. In this report, the US linked its economic and security interests closely to regional development ranging from the Western Pacific Area and Eastern Asia to the Indian Ocean and Southern Asia. It is evident that the redirection of the US military strategy focuses much more on China rather than other powers in this region.

The China-US bilateral relationship is unfolding with an interesting dynamic. One way to describe it would be a pair of wary Siamese twins that do not trust each other but are nonetheless irrevocably joined together; both countries deal with mutual distrust despite growing increasingly interdependence economically. From the US perspective, they would like to further cooperation while hedging against the risk that China will develop along a different path than what they would prefer; the US would obviously prefer China's rise to benefit both parties in a complementary manner, rather than having China's rise be at the expense of American prosperity and security. Consequently, they have continued to try to strengthen cooperation and trade ties, while at the same time hedging against risk by adopting a policy of containment, where the US has increased its influence and presence in countries surrounding China in a physical and economic buffer. The two channels where the US is particularly containing China are from a naval perspective, where US has a presence in maritime shipping routes that China must go through to reach open waters, and in terms of energy commodities. The US is also linking up with India, a regional competitor with many similar characteristics to China, which may be to hedge against China's power in the region. China can respond to this policy of containment by attempting to strengthen ties with neighbors; as a driver of economic growth, and due to geographical proximity, China has an advantage over the US in securing stronger ties with countries in Asia.

The US and China economies are largely complementary and have great potential to work together to strengthen economic ties, reform economic structures and contribute to global regulation. The potential of economic cooperation could encompass the following areas:

- Strengthen trade relations
- Promote common strategic sectors
- Rebalance domestic economies
- Coordinate for an optimal policy-mix at a global level
- Collaborate at a financial level

### 2.1.1 Strengthen trade relations

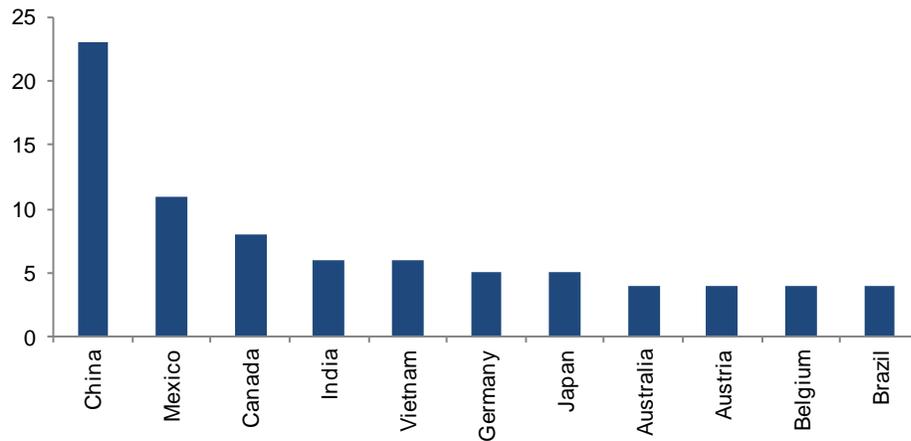
China's largest trade partner is the US, and the US' second largest trade partner is China. The Chinese and US economies are mostly complementary and have intertwined deeply with each other. The US has greatly benefited from China's cheap products as well as low-cost financing for the past years, and will continue to be better off as long as China can keep acting as the driver of world growth. However, the potential of trade between China and the US remains largely untapped. Sino – US trade can be developed via four different channels.

- To reduce the level of protectionism
- To lift restrictions on high tech products
- To develop trade in intermediate products
- To participate to free trade agreements

### To reduce trade protectionism

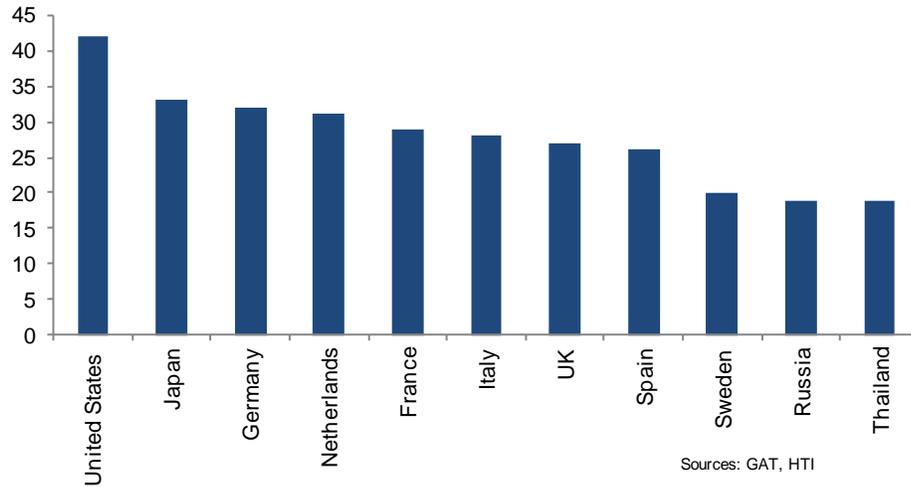
The GAT (Global Trade Alert) has initiated an inventory of protectionist measures taken since November 2008. It appears clearly that China is at the top of the list of the countries targeted by the US administration. The same is true for the US relatively to the Chinese administration. The issue has been discussed in recent summits, as both countries have expressed their willingness to reduce protectionism, which is still on an upward trend. They both advocated free and fair trade. In this context, the limitation of protectionist measures, amid lower level of growth for the two countries, should contribute to increase their potential of growth. There is a mutual interest in reducing the level of protectionism between the two countries.

**Commercially harming measures taken by the US  
(Since November 2008)**



Sources: GAT, HTI

**Commercially harming measures taken by China  
(Since November 2008)**

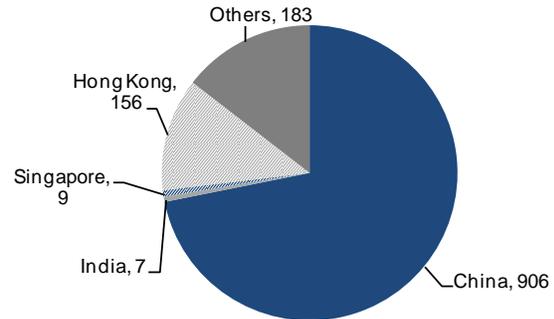


### **To lift restrictions on high-tech products**

The solution for narrowing the large trade gap of the two countries should come from a rise in the US exports to China rather than a fall in China's exports to the US. To achieve Obama's ambition to double the exports in a 5-year horizon, the US self-interest is to lift certain constraints on exports of high technology itself or high-tech products as well as promote services exports. In his 2013 and 2012 visits to the US, China's president Xi Jinping reiterated China's wish to see trade restrictions be progressively removed. The current export restriction list in the US includes about 2400 different products in nine categories. They range from nuclear, biotechnology, electronics, information security, sensors and lasers, navigation and avionics, marine, to propulsion systems. A gradual strategy pursued step by step and product by product would probably be the best approach for the two countries to obtain concrete steps toward barrier removals. The best way to progress in this area consists of developing joint programs of research, focusing on the commercial exploitation of the different technologies, developing relations with the historical partners of the US, and keeping an open mind for both sides.

The US administration has recently toughened the tone of its accusation of China for cyber espionage. The White House estimates the cost of cyber-theft between USD 250 bn to USD 1000 bn per year. In the coming months, the US Congress could vote for a legislative arsenal allowing the identification of companies and countries practicing the hacking and cyber espionage, and envisaging the blockage of imports of products benefitting from these activities. Chinese products are already the main victims of the US administration regarding the value of goods seized for intellectual property rights violations.

Value of goods seized in the US because of intellectual property rights violations (USD bn, 2012)



Sources: FT, US custom and border protection office

### To develop trade in intermediate products

Another way to improve trade relations can be explored at the level of intermediate products such as machinery. The US is in a process of re-industrialization and has at their disposal a large accumulation of know-how, illustrated by the global domination of Caterpillar or GE. Developing exchanges in this domain would contribute to modernize the capital of production in China, and would contribute to reduce the US trade deficit. The concrete steps to take for doing that are not obvious, as China is catching up quickly and other partners in the world offer the same degree of technology as the US. However, the targeting of intermediate sectors would be much more promising in terms of developing the exchanges. Traditional industries and raw materials depend too much on price competitiveness and therefore remain hampered by the currency issue. Cutting edge sectors are too sensitive, and therefore are subject to different kinds of protectionism. The highest potential of progress in trade between China and the US therefore has to be found in intermediate industries, i.e. machinery, manufacturing, energy, infrastructure, food processing, electronics, electricity, chemical industry, car and motor parts and etc.

### To participate in free trade agreements

China signed a free trade agreement with ASEAN countries in 2002 (Brunei, Burma, Cambodia, Indonesia, Laos, Malaysia, Philippines, Singapore, Thailand, Vietnam, China), reducing the tariffs on 90% of imported products. The pace of multilateral and bilateral trade agreements implicating China and other Asia Pacific countries has recently accelerated as the US presence in this area increased. The Trans-Pacific Partnership (TPP) represents a free trade agreement between 12 nations, the US (negotiating), Australia (negotiating), Brunei (signatory), Canada (negotiating), Chile (signatory), Japan (negotiating), Malaysia (negotiating), Mexico (negotiating), New Zealand (signatory), Peru (negotiating), Singapore (signatory) and Vietnam (negotiating). This area represents 40% of World trade. This agreement has been criticized for being favorable to corporations to the detriment of workers and being particularly harsh on intellectual property rights, which could represent an obstacle to the diffusion of cheap medicine toward poorer countries. The participation of the US to this agreement, beside other bilateral free trade agreements in Asia Pacific (Thailand, New-Zealand, Indonesia, Malaysia, Taiwan) aim also to impose norms of trade in this area. The implementation of different kind of norms, as also envisaged in the EU/US free trade area, on environment, intellectual property rights, health, etc., could be used as protectionist tools by the US and other countries against China or as instruments of geo-strategy. In this "containment" race, an involuntary harmonization of norms will happen, leading to a reinforcement of trade.

### 2.1.2 Promote common strategic sectors

Both China and the US have identified strategic sectors to develop in the medium-term. China's 12th five-year plan and Obama's industrial policies after the financial crisis have quite a few overlapping highlights reflecting great potential to cooperate between the two superpowers. These industries are related to healthcare, new energy, IT and infrastructure.

- **Healthcare.** The two economies face a similar challenge of an aging population with the necessity to control healthcare costs. The protection of seniors has to be improved in the two countries. Given these priorities, the access to cheaper Chinese products and transfers of technologies between the two countries would be in their mutual interest. Therefore, freeing access to local markets represents a necessity to make this virtuous circle happen.
- **New energy.** Cooperation between the US and China is well advanced in this area. The Chinese and American sides agreed on different programs related to smart power grids, large scale wind power development, and distributed energy including natural gas, shale gas, and bio-jet fuel. The dispute on solar panels between China on the one side and the US and Europe on the other side, is currently intensifying but won't hamper a broad cooperation on environment and energy production, as reflected by the agreement on hydrofluorocarbons.
- **IT.** The two countries have similar directions that develop household access to new technologies related to information and communication. To achieve this goal, China needs further open its market and the US needs transfer its technology and high tech products.
- **Infrastructure.** This includes not only construction projects but also urban engineering, commute transports, waste disposal, and etc. This is an area in which the exchange of expertise would be positive for both countries.
- **Agriculture.** The US is the world largest exporter of agricultural products and China is its biggest customer. President Xi was present when Chinese Agriculture Minister Han Changfu and U.S. Agriculture Secretary Tom Vilsack signed a five-year partnership plan on food security, food safety and sustainable agriculture in February 2012. This sector is one of the most promising regarding the Sino - US relations.
- **Cultural goods and multimedia.** The progress observed in China on intellectual property rights and large Chinese investments from China into the US in the entertainment industry announce a strong development of trade between the two countries in this sector. Dalaian Wanda Group acquired in 2012 the theater operator AMC entertainment for USD 2.6 bn. A survey of the law firm Manatt, Phelps & Phillips showed that more than 100 American and Chinese professionals of this industry expect a significant increase in the number of M&A between the two countries. The emergence of the middle class in China and the corresponding needs in terms of entertainment production, as well as a deep and modern market in the US is attractive for investors of the two countries.
- **Financial activities.** The rise of the middle class in China represents another opportunity of development for the US financial industry. The supply of services in commercial banking, payment processing (credit cards), investment banking, insurance products will continue to register high growth in the coming years. In parallel with progressive opening of the Chinese capital account, the US exports of financial services and direct investments in China will continue to top the performances of Western countries in this area. Symmetrically, Chinese banks will assume a growing role in the US as a presence in the most developed and deep financial market in the World is a necessity for accessing USD denominated assets, liquidities and expertise. The difficulties of European banks in this sector represent an opportunity for Chinese financial institutions to win market shares.

### **2.1.3 Rebalance domestic economies**

Both China and the US are facing great challenges to rebalance their domestic economies. Leaders of the two countries have committed to rebalance domestic economies, in other words, China is to transform to a domestic consumption oriented economy while the US is to move toward re-industrialization with lower leverage. The US and China have complementary goals and can make joint efforts to reduce their domestic imbalance, using trade and investments.

- To coordinate the China – US policy mix. The US government has recently tightened its fiscal policy; while China's fiscal policy remains supportive of the domestic economy. This global policy mix should contribute to reduce the US trade deficit and at the same time foster consumption in China. A coordination of economic policies could be envisaged with the engagement on an expansionary consumer-oriented policy in China coupled with a restrictive bias of the fiscal policy in the US.
- The reduction of imbalances could find some solutions at the level of monetary policies, in particular via the coordination of the exchange rate policy of the two countries. The US has progressively softened the tone of its rhetoric on the degree of appreciation of the RMB, which keeps a gradual trend of appreciation. This equilibrium has to be preserved by the two countries as it lowers the price of imported products in China and therefore fosters domestic consumption, while it contributes to the reduction of US trade deficit.
- Trade policies have also to be coordinated. US restrictions on high-tech products exports could be lifted.
- China and the US could envisage a coordinated action to influence the level of domestic saving rates, considered as being too high in China and too low in the US. China and the US could envisage programs of cooperation in healthcare. A reduction of healthcare costs could contribute to lower Chinese household saving rates. To increase the saving rate in the US would probably consist of elevating healthcare costs via a diminution of government support, which is a necessity for the stabilization of debt. Programs of cooperation could be developed on aging issues.
- The opening of the capital account in China will also reduce the two countries imbalances as real exchange rate variations will adjust more closely to the state of macroeconomic fundamentals. The role of exchange rate as a shock absorber and corrector of global disequilibrium will be reinforced.

### **2.1.4 Coordinate for an optimal policy-mix at a global level**

The potential and reality of cooperation between China and the US has been increasingly strong in addressing issues in their bilateral relationship. Their room for cooperation on global affairs is also huge, not only for the long term but also for short-term urgent issues, such as how to stabilize the world economy amid great uncertainty. The stimulus policies implemented in a coordinated manner by China and the US after the financial crisis were the main contributions to global recovery. Today, the Chinese policy is still well adapted to the current situation at a global level, characterized by higher risks and an increasing global unemployment rate. The Chinese central government pursues the implementation of major infrastructure investment projects focusing on affordable housing, water conservancy in rural areas, emission reduction and energy-saving. This policy is contributing to stabilize the world demand and contributes at the same time to increase the potential of the economy. On the American side, the progressive transition toward an austerity policy represents another central element for the stabilization of world demand. Such support from the Chinese and American governments compensates the negative shock on world activity originating in the austerity policy of Euro zone countries.

### **2.1.5 Collaborate at a financial level**

China and the US have a high incentive to collaborate at a financial level. All the segments of Chinese financial markets have registered a strong growth albeit representing a transition model in terms of liberalization (see the table below of the World Economic Forum establishing a classification of financial models). On the US side, the progression of financial activities has recently decelerated in a context of restructuring in the aftermath of the 2007-2009 crisis. China has the momentum and the US more expertise. There is a strategic interest in collaborating for these two countries at a financial level as both expertise and momentum contribute to the stability of a financial system. The World Economic Forum survey on the development of financial systems shows indeed that China reaches a higher degree of stability thanks in part to a sound level of growth and a lower frequency of crisis. It shows that the liberalization of the Chinese financial system has to keep its pace of progressive implementation. The following sectors are the areas in which a development of trade and partnerships are the most promising.

- Insurance industry. Life insurance and non-life insurance products' penetration rate is significantly lower in China. There is a strong potential to develop insurance products, which is consistent with the development of consumption. With a higher degree of protection, Chinese households will be more inclined to consume. The subscription to such products would not represent an increase of the saving rate given the high level of liquidities and deposits.
- Payment processing is a sensitive issue given the content of high technology of these activities. China's credit card market will open up to international operators in the coming years.
- Securitization. The US is a World leader in terms of securitization. The high level of private credit in China (120% of GDP) could give the occasion to cooperate in this area for freeing some assets from the balance sheet of Chinese banks. According to the World economic Forum, China is around the 50<sup>th</sup> rank in terms of tier 1 ratio at 9.7% compared to 12% for the US.
- Money market. China has one of the highest M2/GDP ratios at 170% of GDP compared to 60% for the US. At the same time, money market products have a low penetration rate. This configuration highlights a high potential of trade and collaboration in this segment.
- Interest rate derivatives (swaps and options) and foreign exchange derivatives (swaps and options) have also a low penetration rate in China. The US expertise could be useful in this area.
- The cooperation in financial activities between the US and China must give the priority to a strong cooperation the level of supervisory and regulatory activities.

The financial collaboration between China and the US can also extend to currency issues and public debt issues. The two countries could be interested in both promoting the internationalization of the RMB as it could make it appreciate further and contribute to the reduction of global imbalances. The gains linked to the promotion of the RMB as a reserve currency could be significant as it would lower the negative impact of a RMB block of countries manipulating their currency to not suffer from China's competitiveness, and it would produce net positive gains of seigniorage via a higher capacity to issue debt internationally. The diversification of international reserves to the profit of the RMB would also diminish the global risk related to the US public debt. China expects the US to clarify its plan of fiscal consolidation to get some reassurance regarding the stability of Treasury securities value. The transition toward a model of growth less dependent on exports and investment would also be facilitated by the internationalization of the RMB.

Classification of countries by degree of financial sector liberalization with financial stability score

Early-stage financial markets	Conservative		Transition		Liberal			
		Advancing financial markets			European		Non-European	
Tanzania	5.17	Saudi Arabia 6.32	UAE	5.86	Switzerland	6.06	Singapore	5.69
Peru	4.96	Mexico 5.19	Chile	5.53	Norway	5.69	Hong Kong	5.51
Czech Republic	4.89	Brazil 4.98	Malaysia	5.4	Germany	5.13	Australia	5.42
Slovak Republic	4.89	Kazakhstan 4.51	Kuwait	5.25	Denmark	5.02	Canada	5.26
Indonesia	4.52	Poland 4.42	South Africa	5.12	Sweden	4.97	Japan	4.93
Colombia	4.47	Russia 4.38	<b>China</b>	<b>5.06</b>	Netherlands	4.94	Israel	4.83
Nigeria	4.03	Bangladesh 4.37	Finland	4.99	Belgium	4.73	<b>United States</b>	<b>4.41</b>
Romania	4	Morocco 4.33	Panama	4.58	Austria	4.62	Jordan	4.04
Venezuela	3.58	India 4.12	Thailand	4.56	France	4.35		
Ghana	3.31	Pakistan 4.03	Bahrain	4.23	UK	4.31		
Argentina	3.18	Egypt 3.92	South Korea	4.2	Italy	3.73		
Ukraine	3.16	Vietnam 3.26	Philippines	4.06	Ireland	3.66		
Kenya	3.05		Hungary	3.37	Spain	3.57		
			Turkey	3.29	Portugal	2.85		
					Greece	2.14		

Source: World Economic Forum

## 2.2 New strategic China-Europe relations

China and Europe have developed strong relations over time, now being the largest trade partners of each other. The ongoing European debt crisis offers opportunities for China to assist Europe in a time of need and thus strengthen ties for the future. Investment from China into Europe is likely to accelerate in the years to come, and investors seeking to enter Europe should target their investments in industrial or sector specific clusters rather than by country borders.

### Points strengthening China-Europe relations

A number of elements make the relations between Europe and China easier in comparison with the relationship with the US:

- The unilateralism of the US is off-putting to both China and Europe.
- Unlike the US, Europe does not have a containment strategy for China.
- The relations are purely commercial, and are less influenced by military issues.
- The Taiwan and Japan situations do not have any impact on Europe – China relations.
- Political and military power are fragmented in Europe, and so in contrast with the US, each European country approaches relations with China from a less dominant position and is encouraged to cooperate.
- There is a competition between the US and Europe for penetrating the Chinese market.
- There is a common view between China and Europe on the necessity of a strong regulation of the market.
- The current account is broadly balanced in the Euro zone, meaning less incentive to accuse China of currency manipulation.
- The US and Europe are strongly opposed in trade disputes, as they broadly have the same structure of specialization.
- China and the Euro zone are committed to the existence of the Euro currency, and more broadly to the emergence of new global currencies to counterbalance the privileges linked to the USD, and for the purpose of diversifying their foreign exchange reserve portfolio.
- Joint projects with Europe can bring new opportunities in Africa.

### **Europe remains a major trade partner of China**

As a main trade partner of China, Europe de facto represents a highly strategic partner. China exports toward Europe include machinery, mechanical appliances electric equipment, and textile products, while China imports from Europe are mainly machinery, mechanical appliances, electric equipment, vehicles, aircraft, vessels, and associated transport equipment. Potential possibilities for relaxing export constraints in Europe could further promote the two countries' trade relations.

Despite long term trade relations and the large trade volume, trade frictions between these two regions have increased recently. Note that the European Commission opened an investigation in early 2012 on alleged subsidies from the Chinese government to Huawei Technologies and ZTE, telecommunication equipment companies, which have rapidly caught up with European competitors such as Nokia and Alcatel. This dispute could have larger political consequences, as it is related to sensitive sectors, and it is the first time the European Commission, rather than private companies, has taken the initiative in the lawsuit. European countries have become more assertive regarding the trade policy of China after the financial crisis, and blamed their trade deficit with China as the cause of their current difficulties. Their trade balance deficit with China reached EUR 156 bn in 2011 compared with EUR 49 bn in 2000. The European Commission also criticized the rare earth hoarding strategy of China, as well as the lack of openness of the Chinese public market to foreign companies. The unilateral decision of European authorities to tax all airlines, including foreign ones, on greenhouse gas emissions on flights within European territory, has also strained the relations between China and Europe. China has expressed China's strong opposition to EU tariff initiatives regarding Chinese telecommunications products and duties on Chinese solar panels. This harshening of trade relations seems paradoxical in a context of higher financial needs within Europe, where Europe asks for more and more help from China. The best strategy for China is to avoid direct confrontations with the European Commission, while obtaining concessions by negotiating with each individual country where national priorities and common interests will incite governments to adopt a more consensual approach.

### **China's role in stabilizing the world economy during the European debt crisis**

China has backed the Euro zone during its sovereign debt crisis through investing in government bonds of periphery countries such as USD 6 bn in Spanish bonds in 2011, and investing in infrastructures such as harbor infrastructures in Greece, and the electricity grid and energy company in Portugal. China was also actively involved in developing joint projects such as the agreement between China Petrochemical and Repsol, Spain's largest oil company, to expand oil exploration in Latin America. Both Spain and Portugal have significant strategic holdings in Latin America and Africa, two continents where China wants to expand. The Chinese government also mentioned the possibility for investing in the EFSF or ESM via the IMF to provide direct support to the rescue packages. China has a strategic interest in stabilizing the Euro zone, as sharp depreciations of the EUR could lead to a significant decline of competitiveness, especially in relation to products coming from Germany. Besides this short-term interest, extending a hand during the crisis could provide a boost to diplomatic relations in the future.

### **China's investment in Europe to accelerate**

Right now may be a good time to invest in Europe, notably in different kinds of infrastructures. In doing so, the Chinese government or companies have to avoid emanating an image of "vulture" capitalism. We present below the most competitive sectors for the most significant countries.

- Germany: cars, motors, pharmaceuticals, machinery, electronics, banking industry, aeronautical industry, biotechnologies, links with Eastern Europe
- France: all infrastructure (roads, harbors, energy), tourism, food-processing industry, aeronautical industry, water industry, pharmaceuticals, banking industry, luxury industry, energy in particular nuclear energy, links with Africa
- UK: finance, cars and auto parts, telecommunications, pharmaceutical sector, energy, links with the Commonwealth
- Italy: tourism infrastructure, food processing industry, agriculture, cars and motor parts, luxury sector, links with North Africa
- Spain: tourism infrastructure, communications, food-processing industry, cars and motor parts, agriculture products, green energy, links with South America
- Portugal: tourism infrastructure, food processing, energy, links with south America
- Netherlands: harbor infrastructure, energy, electricity, electronics, chemical industry, ICT (information communication technology)
- Greece: tourism industry, harbors, oil refineries, food processing, non ferrous metals
- Ireland: advantageous tax regime making the location of units of production ideal in Europe

Besides these traditional sectors, the European banking industry is worth special attention. The European banks suffer from under-capitalization, as the capital needed is estimated at EUR 117 bn by the EBA (European Banks Authority) at the end of 2011. This amount is probably significantly higher today. It has been estimated between EUR 300 bn and EUR 400 bn. The first strategy for Chinese investors would consist of investing in newly issued capital by European banks. However, the current distrust of the market could make these operations uncertain. European banks will reduce their international presence, notably in the most capital consuming areas, such as the financing of big infrastructure projects or activities of global players such as airlines or energy companies. Some large Chinese banks have already begun to win market shares in these activities.

### **2.3 New strategic China-Russia relations**

The fact that Xi Jinping chose Moscow as his first foreign capital visit after becoming President of China is an indication of the strategic importance of Sino-Russian ties, and the strength of the bilateral relationship in recent years. Besides geo-strategic issues, the last summit between China and Russia was the occasion to announce an agreement between Russia's state-owned energy company Rosneft and the Chinese government, planning a tripling of oil supplies to China in return for a USD 2bn loan. The two countries also progressed on a gas pipeline project. The relations between China and Russia have significantly improved since the beginning of 2000, a thaw embodied by the signature of the Treaty of Good-Neighborliness and Friendly Cooperation. This treaty plans cooperation in numerous areas related to national integrity and sovereignty, economic and social development, cooperation in international institutions, military know-how, science and technology, energy resources, transport, nuclear energy, finance, aerospace and aviation, information technology, fight against criminality and terrorism, and cultural exchanges, among others.

### **The energy issue at the heart of China-Russia relations**

According to the International Agency for Energy, China's share of Russia's total earnings from fossil fuel exports is to grow to 20% in 2035 from 2% in 2010. A pipeline between Russia and China was built up at the end of 2011, allowing for direct exports of oil from Russia to China for the first time in history. China has recently become the most important oil importer in the world, while Russia has one of the most significant oil reserves in the world. At the same time, cheap Chinese manufacturing products are welcomed by Russia. Given the complementary strategies of both countries as well as common interests in defending against the US policy of containment, the two countries have strong motivations and potential for cooperation. Energy is the most promising sector, including a variety of fields such as oil, natural gas, hydroelectricity, coal, and nuclear know-how. Note that Russian government fiscal position fluctuates heavily with energy prices; if energy prices go down, pressures on government budget will intensify as tax revenues from energy falls. The support for the social welfare system, and therefore the probability for the Russian government to be re-elected, depends heavily on energy prices. Therefore the best strategy for both countries is to set up a long-term contract on energy imports, which could bring stability of prices to Russia and secure the long term energy supply for China. China and Russia announced in September of 2013 the signature of a gas supply agreement. This agreement will allow the export of gas from Russia to China via the eastern pipeline for more than a decade. Negotiations on this agreement lasted more than 10 years and there was probably a breakthrough at the level of price discussions. They also announced further cooperation in aviation, military and energy sectors, accompanied with a significant increase of cross border foreign direct investment.

### **A similar economic and political background, and comparable structure can foster trade and investment relations**

China and Russia share a common economic and political background, and a similar structure in many fields. The countries used to be allies in the Cold War, and it is not impossible for them to build upon old alliances and improve relations as they continue to develop and grow.

- A central power still plays an important role in both economies. Both countries have shifted from a centralized to a more market oriented economy, but the central government retains the dominant role in defining strategic sectors and fixing economic priorities. The strength of the governments' roles makes it easier for the two governments to coordinate their economic policies, in the field of infrastructure projects in particular.
- Both governments have common interests in increasing the weight of consumption in their economies. From that perspective, promoting tourism and setting up a free trade zone between the two countries could be attractive to both. The SCO (Shanghai Cooperation Organization) including China, Kazakhstan, Kyrgyzstan, Russia, Tajikistan (Uzbekistan, Mongolia, Pakistan, Iran and India are still in the observer seats) represents the most promising framework for organizing this free trade agreement. It would counterbalance the US presence in Asia Pacific via the Trans-Pacific Partnership.
- Both countries have strong state entities, conglomerates or monopolies. In such a context, it would be particularly beneficial to identify potential strategic partnerships between dominant players to reach a global leadership position. Infrastructures projects with a global dimension related to energy could offer opportunities for cooperation. The aircraft industry, healthcare, or waste disposal could be developed in a joint manner.
- The common needs to improve social protection explain the interest of the two countries to develop joint programs related to healthcare, infrastructure, equipment, education and research.
- Both countries have a common policy of foreign exchange reserve accumulation. Given their significant positioning on the USD and common view on the necessity to negate US containment, China and Russia have spoken in one voice in many fields. Coordination of their monetary policy could be improved with currency swap arrangements and joint interventions in the foreign exchange market. China and Russia have also signed an agreement on a bilateral local currency settlement system in RMB or the Ruble.
- Russia has a strong defense and aerospace industry. Cooperation in these sectors will be difficult for security reasons. However, a large number of Russian companies benefit from the government's investment decisions. In this context, China's interest would reside in investing in defense-related companies and developing trade relations with them on high-end machinery equipment and IT.

### **The BRICS potential**

China and Russia have found the opportunity to speak in one voice on global issues at the BRICS summits, representing an alternative way of multilateralism. They push for less dependence on US dominated international institutions, and for the emerging world to play a larger role. According to different estimates, the BRICS economies have the potential to overtake the joint economies of the US and Euro zone in the coming decades. Despite occasional disagreements, the potential to find converging views in the future could increase. The main issues covered by the BRICS are the following:

- Request more voting power in international institutions such as the IMF and the World Bank
- Announce their intention to create a BRICS bank in order to compete with the World Bank and bring aid to the emerging world. The creation of a BRICS development bank was announced during the BRICS summit of Durban in South Africa in March 2013, which will aim to reduce the reliance of BRICS countries on western financial institutions.
- Favor lowering influence of the USD at global level
- Favor rebalancing global economies
- Share similar views on military issues to an extent

In September of 2013, BRICS countries decided to continue the Durban process and create a USD 100 bn common pool of foreign exchange reserves to combat the excess volatility of exchange rates amid growing capital outflows from the emerging areas. China will contribute USD 41 bn, Brazil, India and Russia USD 18 bn and South Africa USD 5 bn. They also further defined their project of creating a development bank with an endowment of USD 50bn of capital. The bank is expected to be established by 2015.

## **2.4 New strategic China-Japan relations**

The China-Japan relationship is one of the most complex bilateral relationships in Asia. Due to brutal historical conflict, this relationship has a strained nature weighing on it independent of any current issues, and this is a disadvantage right off the bat. The recent tension caused by conflicts over the Diaoyu Islands is a symptom of this distrust rooted in historical reasons. It is likely that political and diplomatic ties will take a long time to fully mend, and the bilateral relationship will likely remain tense until China's ascension to superpower status is complete, and Japan no longer views China as a competitor but rather a neighboring superpower.

Despite political and historical tensions, China and Japan can benefit economically from further cooperation. In the mid-1990s, Japan was one of China's largest trade partners, and this has gradually diminished as Japan experienced stagnation and as China increased trade elsewhere. Japan in particular is at a crossroads. The nation is mired in debt, and the past two decades of stagnation have illustrated Japan's lack of growth drivers. Japan for the better part of the last century has been fairly strongly aligned with Western powers, which led it to a fast rise. Now, it has a chance to realign itself with Asia, currently the world's biggest driver of growth. If Japan faces a choice of being "Asia's Japan" or a "Western Japan," China should give it every chance to choose the former.

As the two largest economies in Asia by a large margin, there is room for increased cooperation, particularly in areas such as technology transfer, renewable energy, and mutual investment. Technology transition might be in fields such as automobile parts, waste disposal, and pharmaceuticals, where Japan has primarily moved on to higher value added industries while China is still in the process of climbing up the value added ladder. Renewable energy is also an area for cooperation, as Japan is advanced in renewable energy technology, while China has abundant cash from foreign reserves. Finally, as far as mutual investment goes, while Japan is one of the largest investors in China (primarily taking advantage of China's cheap labor and manufacturing infrastructure), there is a negligible amount of investment from China into Japan, and this can be increased to bolster their economic cooperation. Furthermore, traditionally Japan has viewed China as an offshore factory for its products, and with China transitioning towards a domestic consumption driven society, there is further opportunity for Japanese investment aimed at China's consumers rather than simply at its cheap labor.

China and Japan have complementary fields to work together, mainly the following:

- There is a complementary nature of trade between the two countries. China imports materials and semi-finished products, and then plays the role of an assembler. In contrast, Japan is a supplier of parts and components, with limited assembly processes domestically. Due to different areas of comparative advantage, China and Japan can benefit significantly from bilateral trade.
- There is significant Japanese FDI into China, taking advantage of the low cost labor force in China, but Chinese FDI into Japan is negligible. This is due to the Japanese market being relatively closed, with numerous administrative and tax obstacles for foreign investors. Reducing administrative and legal barriers could give a boost to Chinese FDI in Japan, supporting investment and employment.
- The establishment of joint ventures between China and Japan can be highly profitable as a way for China to acquire the know-how of Japanese firms linked to quality control and management policies. Concepts such as just-in-time (boosting efficiency by delivering materials as they are needed), kaizen (the concept of continuous improvement), kanban (a scheduling system determining what, when, and how much to produce), and quality circles (enlisting the aid of employees of the company for improving quality) could be valuable for improving aspects of the Chinese corporate sector.
- Japan has already gone through population aging. China can learn from the structure of the Japanese pension system and social safety net, to prepare for the turning point of 2020, when the share of working age population of total population will decline. One particularly interesting area for collaboration is automation, which was largely developed in Japan. Collaboration between China and Japan in robotics and all forms of automation can improve China's industry and also assist in tackling the issue of aging.
- There is a common need in both Japan and China to support consumption. The development of tourism and the establishment of free trade agreements represent long-term solutions. Japan expressed its willingness in 2012 to join a tri-lateral FTA (Free Trade Agreement) with China and South Korea.
- The geographic proximity of the countries encourages collaboration on environmental issues and the creation of technology clusters.

## **2.5 New strategic China-Emerging neighbor relations**

China's emerging neighbor countries are in a catching-up process, like China 20-30 years ago. Referencing our global competitiveness pyramid, most of these countries are located in the fourth or fifth tier of the pyramid. These countries were often viewed as China's competitors in the field of low-value added manufacturing products, but there is increasing room for cooperation between them and China when China begins to move up the value added ladder. Emerging neighbor countries are already becoming increasingly important for China, evidenced by their increasing share of China's total trade in recent years.

The relationships between China and its emerging neighbors are important on several levels. First, intra-country trade in the region has remained strong despite the global crisis. Regional trade agreements could provide both parties with more access to export markets. The ACFTA (ASEAN China Free Trade Agreement), effective in 2010, is an example of this, which has helped lowered tariffs between China and the ASEAN countries by over 90%. Under the agreement, the average tariff rate of China's goods imports from ASEAN countries is lowered to 0.1% from 9.5%. The reduction of tariffs and removal of trade barriers are the best ways to develop trade relations in the region. This policy will also divert some trade from the US and other countries, benefiting members of the ACFTA. Besides for increases in trade flows between them, such agreements could foster intra-industry trade, promote specialization and concentration of activities, encourage technology transfer, and increase productivity. This approach can develop infant industries at the regional level.

Secondly, there will be increasing room for cooperation in production and investment has increased when China starts to move up the value-added ladder in a transition toward a domestic-consumption oriented economy. As relocation of the low value added production to the emerging neighbors is to happen sooner or later, instead of letting it happen spontaneously at the private level, a good strategy is for China to guide an “orderly” transfer of some production capacity to emerging neighbors that have good relations with China. This model could be particularly effective in China’s case, as it has both a huge resources and market, and thus can offer and control both upstream and downstream flows. Together with matching investment, this “orderly” transfer could help local economies’ development on one hand, and on the other hand, it could create an economic dependence on China, and motivate their willingness to keep strong economic and political ties with China. Smooth relationships with neighbors could provide China with more freedom to focus on its own growth and on big global scenarios. To incentivize countries to improve ties with China, China could start this process with friendly neighboring countries such as Thailand, Nepal, and Pakistan, and then extend the process to strategically important neighboring economies.

Third, it is currently good timing for China to become a regional leader, as it will help to neutralize the containment strategy of the US. Similar to strong ties of North American countries under the US leadership, China could benefit greatly from playing a more active leadership role in dealing with regional affairs and promoting regional growth.

Last but not least, China can further improve relations with neighboring emerging countries through accelerating the pace of RMB internationalization, especially for use in cross-border trade. Currently, this is already a process in motion, as ASEAN countries among others are able to settle portions of trade using the RMB. China has also signed currency swap agreements with several neighboring countries. By accelerating the process, China can strengthen the RMB’s position, and aim to have it become the reserve currency for the regional bloc, thus extending ties and expanding its influence.

## **2.6 China’s strategic role in international organizations**

Over the next several decades as China continues to rise to superpower status, it will be particularly important for China to focus on improving ties with large countries as well as to increase its participation and influence in international organizations such as the IMF, World Bank, and United Nations. Failing to manage these strategic relations tactfully could increase tension between China and key global players, and ultimately hinder China’s rise. China has increased its efforts to improve international relations with large countries and expand its roles and stakes in international organizations.

### **China and IMF & World Bank: the insider – outsider approach**

After the financial crisis, due to China’s contribution towards stabilizing the global economy, China’s voting power at the World Bank increased to 4.42% in April of 2010, up from 2.77% previously, becoming the third largest contributor. Similarly, China’s voting rights at the IMF are expected to increase to 6.07% in the coming years from the current 3.81%.

The financial crisis and the debt crisis provide good opportunities for cash rich emerging countries like China to exert their influence in these international organizations traditionally dominated by the US and Europe. China's strategy at the international institutions can be emphasized in a threefold manner.

- China could gradually gain influence via higher capital contribution and more high-quality Chinese staff, while it continues to accept the rules set by Western powers. China could penetrate institutions recognized by major competitors, and progressively gain influence once inside. This is the best way to withstand the US containment strategy and a good way to win more support among international partners.
- Chinese representatives at these institutions need to move away from the old ideologies, and introduce more flexible measures via implementing more pressure on developed economies and suggesting new forms of regulation.
- China could set up alternative institutions and structures outside the IMF and World Bank to regulate the world in a bilateral and multilateral manner. For example, China substituted for the World Bank in helping Chad in 2008, and replaced the IMF and the US in different aid programs for Cambodia in 2008 and 2010. China recently bypassed the IMF in terms of the size of its financial assistance for Africa. China has also made large efforts to promote regional trade and monetary liaisons. For example, China has played an important role in the establishment of the free trade zone ACFTA in 2010, the regional reserve fund among ASEAN+3 in 2009, and various currency swap agreements with neighboring countries after the financial crisis.

#### **China and UN: a growing role in peace keeping**

China has increased its contribution to the UN in terms of peace keeping operations in the recent years. China is a member of the Permanent Security Council, and continues to play a fundamental role in international conflicts and counterbalancing the influence of OTAN countries. The increasing participation in UN operations has not altered the independence of China, as the Chinese authorities discuss on a case by case basis whether or not to participate in the UN operations. China could benefit significantly from its operations at the UN. Benefits can include conducting joint military operations with other leading nations for modernization of the PLA, improving China's image, raising influence in Africa, and counterbalancing the policy of ex-colonialist countries in unstable countries.

#### **III. Effective communication to narrow "trust deficit"**

Communication is equally important as strategy in international affairs, especially for a rising power like China facing great challenges on how to communicate its intentions to the other countries in the system. As a country grows in power at an alarming pace, it is natural for the established powers and neighboring countries to feel a degree of apprehension and question whether or not the rising superpower will pose a threat to the national interests of any given country. In turn, China's historical experience, where it was often attacked whenever it became weak, motivates China to continue to build up its strength. This creates what can be described as a "trust deficit" between China and many other countries in the world.

The trust deficit is mainly caused by the differences in China's cultural and political background when compared to the backgrounds of other leading countries. Another reason is the recent financial crisis dragged down major developed economies such as Europe, while China maintained strong growth; as China rises while others shrink, they will not only be nervous but also likely bitter, which explains why many politicians and media sources in other countries use China as a scapegoat. Finally, distrust is a vicious cycle, where a lack of trust leads to actions and communication that further breeds distrust. As a result, a failure to address the issue will result in the trust deficit growing wider.

Communication should therefore play an important role in alleviating the trust deficit along with the rise of China. Improving China's communication strategy, particularly through advocating the school of thought of complex interdependence and re-emphasizing China's peaceful history, would go a long way towards smoothing the transition to superpower status. China would benefit from improving communication to promote cooperation and diplomacy through a variety of methods, both official and non-official, including

- Promoting cultural bridging to narrow trust deficit
- Establishing open, smooth and regular official communication platforms
- Promoting multi-layer grassroots communication channels

#### **Promote cultural bridging to narrow trust deficit**

Currently there is a trust deficit that is widened in China's case by a lack of mutual understanding, and a cultural disconnect between China and the rest of the world. This is not to say China is anywhere near the era of isolation. The days of China being "five to ten years behind the trend" are fast disappearing as the increasingly wealthy population, aided by the spread of the Internet culture, is more and more in tune with global trends. However, the cultural transfer seems to be largely one way, mainly with foreign cultures permeating in China rather than Chinese culture spreading across the world. This is a strange phenomenon for a country with the world's largest population; neighboring Asian countries such as Japan and South Korea have a larger cultural permeation in the world, despite only having a fraction of China's population. Due to basic human psychology, we are predisposed to be more wary of individuals that are different from ourselves; consequently, cultural bridging will help China appear less "foreign" and narrow the trust deficit.

Cultural bridging can take place across a variety of forms. Historically, cultural bridging often took place through the actual physical migration of individuals; for instance, a former colony such as Hong Kong is heavily steeped in British culture after occupation, while culture-specific locales such as Chinatowns, Little Tokyos, and Korea towns all over the world are imprinted with Asian cultures, largely due to migration. In this respect, China is strong with numerous individuals studying and working overseas, and can further increase its influence in this arena by hiring more foreigners to work in Chinese companies as well as continuing to provide ample opportunities for foreign exchange students.

However, in the late 20th and early 21st century, media became the predominant tool for cultural dispersion. Particularly successful countries such as the US and Japan were able to spread their cultural influences over the world by exporting various forms of cultural media such as pop music, Hollywood movies, and Japanese animation. While it would be a stretch to say that all individuals are familiar with American and Japanese culture due to media, the reach of these cultural mediums is significantly wider than any Chinese media. Currently, the influence of Chinese media forms worldwide is negligible.

Some major moves last year, including the decision of Chinese media groups to engage in joint ventures with American media firms such as DreamWorks and Disney, as well as decisions to purchase AMC, America's largest movie theater chain, are steps towards cultural bridging. These actions can sow the seeds for two way cultural exchange, if not eventual cultural integration. It would be beneficial to continue and expand on actions of this nature; fostering similarities in culture will help reduce the amount of distrust between China and other countries.

### **Establish open, smooth and regular official communication platforms**

It is important for China to establish a more consistent and open platform to smooth communications. Improving what is currently a suboptimal communication channel can help alleviate a lot of the distrust and friction in international relations, across a variety of issues. Along with cultural bridging, establishing an open, smooth, and regular official communication platform can foster mutual understanding and trust in various fields including trade, military and others.

In terms of trade, China's trade with its large partners is greatly complementary and benefits both sides. China has made great efforts in improving transparency in trade and flexibility in its currency, however, without an effective, efficient, and consistent communication platform the progress is not fully seen nor understood by its counterparties. Consequently, the counterparties assume there is neither enough progress nor clear efforts on the part of China. The US side sometimes indeed does not understand constraints on the Chinese side, according to the report by Brookings Institute. Communication therefore could help build up good faith for both sides.

In terms of military affairs, where the current communication strategy often comes across as fairly heavy-handed, there is a degree of distrust from the international community stemming from how China has communicated on key issues such as the South China Sea and increasing military expenditure. China can benefit from engaging in deep discussions with countries such as the US and neighboring nations about core security interests and military principles. If accommodations can be reached to assure mutual restraint and provide every country with a reasonable degree of assurance that their security is not threatened, trust can be significantly deepened.

Besides trade and military, there are a variety of other issues that can be addressed via smoother communication. The report by Brookings Institute also gives several insights on areas for improvement in particular for the Sino-US relationship. In sum, domestically, China can address popular sentiment by detailing the importance of international relations as a whole, as well as outlining the positive aspects of individual bilateral relationships, particularly with the US. Internationally, China can seek to engage in more multilateral dialogues, where the presence of multiple parties can prevent discussions from becoming confrontational, with two parties on different sides. Finally, China can discuss a broader spectrum of issues ranging from economic to political with other countries, and set some of the norms, rules, and expectations for acceptable practices. By improving communications with other countries, it will be easier for China to implement their broader strategy successfully.

### **Promote multi-layer grassroots communication channels**

Communications can be approached using a multi-layer structure. Currently, a lot of the communication is taking place through government channels; either directly from government communiqués or through government sponsored think tanks. Consequently, communications coming from China may sometimes have a "sterile" feel, and come from similar angles. Additionally, purely governmental communication often leads to a deficiency of sincere communication, as they are often driven by set agendas and limited by restrictions; opening up more grassroots avenues for communication can help alleviate this problem.

Expanding China's communication structure to create more layers can add depth and different perspectives to China's communication strategy. This also allows for different areas of focus; think tanks can communicate more on economic issues, while the government may focus more on political and diplomatic issues, and NGOs on other issues such as environmental and social concerns. Multiple layers can augment rather than fragment China's communication strategy, and opening up more layers can bring valuable new perspectives and ideas to Chinese society.

Japan is a good example of a country successfully exercising this strategy. Japan started the process in the 1970s along with its surge of economic power, and exponentially escalated it in the 1980s and 1990s. For example, Japan's NGOs expanded to over 200 in 1990s from 20 in 1970s. Japan's government encouraged think tanks such as the Japan Center for International Exchange (dedicated to strengthening Japan's role in international networks of dialogue and cooperation), and NGOs such as AAR Japan (Association for Aid and Relief, Japan) to change Japan's image across the globe. Besides its own think tanks and NGOs, the Japanese government provided significant funds to international organizations such as the World Bank and IMF, and encouraged Japanese companies to build up strong connections with the influential American think tanks and NGOs, especially to promote trade and business. Japan's expansion of international influence was in line with its rise to an economic superpower, and was in part due to international expectations that they should begin to shoulder more of an active role in the international system. China will be approaching a similar scenario over the coming years, and could preemptively set up the think tank and NGO infrastructure, as well as gradually establish links with the influential think tanks and NGOs overseas. If Japan was able to successfully change its international reputation despite a significantly more aggressive history, it stands to reason that China can also make improvements on its international image. It is necessary for the Chinese government to encourage and support these groups if China decides to adjust their communication strategy to a multi-layer structure.

**Conclusion: A new economic and foreign affairs strategy for a rising superpower: "an iron fist in a velvet glove"**

A farsighted new foreign affairs strategy together with effective communication will greatly benefit China on its way to becoming a bone fide superpower. Approaching international affairs tactfully and pragmatically while sticking to the bottom line can be expressed as an "iron fist in a velvet glove" strategy. This presents a gentle, pleasing outer demeanor while encompassing a stronger core. This is to say, even if China's bottom line issues dictate that the message must be harsh, deftly communicating with other countries will improve relations or at the very least not strain them as much as a stiff, unyielding interaction would. The US is arguably the country that has mastered this idea of the "iron fist in a velvet glove" the most, able to pursue its own agenda but still claim a mantle of righteousness. Particularly on issues that are likely to strain relations, such as trade or territorial disputes, it could be beneficial for China to organize its communications in a multi-dimensional manner, being rigid when the situation calls for it, and flexible when there is room for negotiation.