

Fighting disruption axis with attitude

Johan Van Overtveldt

2024-10-17

Russia, Iran and above all China form the backbone of an axis bent on destabilizing the Western political and economic order. The Russian and Iranian economies are basket cases and as such incapable of supporting a prolonged war effort. China on the contrary has developed a formidable economic and industrial machine. Nevertheless, China faces huge challenges and massive problems.

To say that today's world is in a rather problematic shape is one hell of an understatement. Mounting geopolitical tensions, with outright wars raging in Europe (Ukraine) and the Middle East, add gasoline to other wildfires currently having ruinous political, economic, financial and social consequences. In the Western world, and certainly in Europe, there's a nagging feeling that we find ourselves on the losing side in all of this turmoil.

Aren't the Chinese clearly winning in the economic war with the West? Isn't their autocratic political and economic model conquering the hearts and minds of an increasing number of politicians and citizens, not only in emerging countries but also in the West? How long will the brave Ukrainians be able to successfully counter the onslaught of Putin's army? Which country will be the next victim of the Russian military power play? How long before Iran and its acolytes start to really hit back and will the Israeli democracy, despite all its recent military successes, be able to survive these attacks?

AXIS

Underlying these and similar questions is the prevailing feeling in the West that the "others" increasingly have the upper hand in all these fights. Although several more countries belong to this group, the "others" essentially are Iran, Russia and above all China. The internet trolls orchestrated by these three regimes invariably refer to the "axis of resistance", Western commentators more often use the label "axis of disruption". Whatever the correct moniker, this group of countries rejects the Western order and its basis of political democracy and economic freedom. They are also increasingly prepared to use whatever means at their disposal to undermine that Western order.

YES, WE CAN

But are we mistaken that these anti-Western axis members have the upper hand? Are we truly no longer able to withstand the pressures that adversaries, in this case China and the others, are constantly unleashing upon the Western world? My short answer to these questions is that, yes, we can successfully deal with the pressures and challenges unleashed by the anti-Western powers. One, if not perhaps the main reason for this optimistic take is based on a closer look at the situation in which the three major axis powers find themselves in. This

examination reveals that, despite persistent rhetoric to the contrary and loud sable rattling, they each face huge, even existential internal problems.

IRANIAN ECONOMY: DESTROYED

Iran is the most straightforward case. The theocratic regime has completely destroyed Iran's once flourishing economy. Investment has already been declining for many years. Power outages due to a crumbling electricity and natural-gas network are becoming more and more frequent. Massive unemployment, persistent inflation and an unstoppable fall of Iran's currency exchange rate have substantially impoverished the majority of the Iranian population. Immediately after his election in May, the new Iranian president Masoud Pezeshkian openly admitted that the Iranian economy is in big trouble and that an easing of the multiple sanctions against his country is a necessary condition to improve the situation. Only a pervasive and often violent repression can, for the time being, keep the public discontent with the theocratic autocracy somewhat in check.

No wonder then that Iran is behaving rather timidly in the conflict with Israel. The simple fact is that they do not have the resources and the economic potential needed to back up a full engagement in a major conflict. The support the Teheran regime is giving to Vladimir Putin's war efforts in Ukraine, mainly through the delivery of short-range ballistic missiles and drones, is only augmenting the pressure on the faltering Iranian state. Despite all these difficulties, Iran is described by Moscow as an "important partner" with whom Putin's regime is "developing our cooperation and dialogue in all possible areas".

RUSSIA: RUNNING OUT OF MONEY

Vladimir Putin's Russia is maybe not as much in a pickle as the ayatollah's Iran, but for the Kremlin the sky is darkening . The most forceful case for the

troubles Russia is and will be facing is made by Anders Aslund. Aslund is generally recognized as a specialist on the Russian economy and currently serves as chairman of the International Advisory Council at the Center for Social and Economic Research (CASE). Aslund concludes that “the financial, technological, and demographic hurdles facing the Russian economy are more formidable than is commonly understood”. For starters, sanctions, despite all the loopholes and shortcomings of the current regime, do bite and shave off annually 2 to 3% of GDP. Successful Ukrainian drone attacks have caused serious disruptions in Russia’s supply chains. The only sectors of the Russian economy that are growing are the military and related infrastructure, where Putin’s cronies are pocketing impressive profits that are skillfully siphoned off.

Another red light flagging trouble is the policy interest rate of Russia’s central bank, which stands at 19% while inflation is officially only 9%. Anders Aslund offers a logical explanation for this absurdity: “Most likely the authorities are repackaging inflation as real growth”. Hence, don’t believe the official numbers on growth and inflation. In reality, the latter is higher and the former is lower than the official numbers.

Some analysts point to the reduction of Russia’s foreign debt as a strong point for Vladimir Putin. Indeed, Russian foreign debt was halved over the past decade to \$300 billion but the reality is that Russia cannot borrow anymore abroad. Half its foreign exchange reserves have been frozen in the West. Constrained liquidity, not least because of collapsed exports, implies that with an annual budget deficit of around \$40 billion, Russia is bound to run out of money by the end of next year. This is even despite the efforts to increase tax receipts. On top of these financial and budgetary constraints, Russia is also running out of soldiers. American intelligence estimates that 120 000 Russian soldiers have been killed in Ukraine and another 180 000 injured.

Putin has decreed that 180 000 soldiers must be mobilized but that will be increasingly problematic given the manpower needs of the war machinery. In 2022 alone more than a million Russians fled the country and this flight continues. This exodus represents a significant present and future brain drain as most of those fleeing the country are well-educated.

Aslund's truly pessimistic outlook on Russia's economy, and hence its potential to continue the war in Ukraine, is probably somewhat overdone. Nevertheless, the conclusion seems warranted that the picture that Putin and his cronies want to present to the world and to the Russian population is far from reality. A major further consideration is to what extent the Russian population will continue to accept considerable cuts in spending on, for example, health and education. Also testing the resilience of the Russian population is the drastically reduced availability of high-quality Western products. Meanwhile, Putin's cronies (and Putin himself) continue to amass huge riches off the back of ordinary citizens.

Against the above, the frequent cry is that China is powerful and rich enough to make up for all the weaknesses of the two other anti-Western axis powers. With their might, the machinery behind Russia's and Iran's disruptive and chaos-oriented actions can be reoiled and kept going. While it is undeniable that China has been able to build up over the past four decades an economic powerhouse that is second to none in the world, major weaknesses in the overall Chinese set-up have become increasingly visible.

BIG TROUBLE IN BIG CHINA

As a starter, and maybe most surprising, there is the Chinese political system. Since Xi Jinping stepped up to the highest throne within the CCP (Chinese Communist Party) hierarchy in 2012, the dictatorial nature of the regime has

been continuously strengthened. Xi Jinping is competing with Mao Zedong in terms of achieving absolute dominance of China's political system. More than ever since Deng Xiaoping initiated reforms in 1979, the CCP's and hence Xi's grip on power is now almost absolute. No disagreement with Xi Thought is tolerated and a deeply totalitarian electronic control and supervision system is relentlessly rolled out and reinforced.

Such an environment is anathema to an innovative entrepreneurial climate that thrives on discussion, trial and error, diverse ideas and going against the consensus. The more a country approaches the frontiers of technological advancement, the more that kind of entrepreneurial spirit is needed. Ideas and initiatives that may undermine or endanger the absolute grip of Xi and the CCP on citizens' life are scrupulously banned, whatever their relevance for economic development. The 2023 crackdown on e-commerce firms was very much testimony to this reality. If anything, Xi Jinping and his entourage have become ever more fanatical about this. Martin Wolf, the ever-thoughtful Financial Times commentator, was spot on when two years ago he predicted that "the despot [jvo: Xi Jinping]) will become increasingly isolated and defensive, even paranoid".

Intensifying data and news manipulation is one of the results of this dramatically changed political climate. Open and public critical discussion of policy matters is increasingly risky for those engaged. Data on the state of the economy are routinely manipulated for political and propaganda purposes. The publication of data series that become annoying for the regime are stopped, the data on some aspects of industrial production being a clear example. The contradictions between official data and the lived experience of citizens, firms and investors are rising day by day. A clear example is to be found, as revealed by The Economist, in the blatant discrepancy between customs data and balance of payments data. The political control of educational processes has also been

tightened, furthering Xi's demand to impose "socialist education with Chinese characteristics".

Xi Jinping and the CCP now prize, in the words of *The Economist*, "security over prosperity, greatness over growth, sturdy self-reliance over the filigreed interdependence that distinguished China's past economic success". Under Xi's iron grip China completely walked away from the reform guidelines that he himself introduced in 2013. These reform proposals focused on reduction of state intervention in the economy and emphasized the market as the "decisive force in resource allocation". A more liberalized financial system and a shift from reliance on investment and exports towards household consumption as main driver of economic growth were also greatly emphasized in the 2013 reform agenda. Under present-day Xi, China has gone in the completely opposite direction.

The shift away from a market-driven to a state-directed economic and industrial policy translates into a massive mobilization of financial, human and technological resources in the sectors prioritized by the political agenda setters. Massive subsidies are injected, protection of the Chinese market is ruthless and careful exchange rate management is organized to support exports. This is the background to China's overwhelming presence in, for example, the electric vehicles and batteries sector. But naturally *creative destruction*, that often painful but absolutely necessary process fueling economic progress, is largely eliminated in such a system. Once a path has been selected, there's no turning back or correcting. Market forces are replaced by political choice. Innovative developments going in other directions to that chosen by the political elite are blocked off. No wonder more and more entrepreneurs are choosing to leave the country, not to mention the drive by the rich Chinese to extract their fortunes from the country. It is also no wonder that projections for China's productivity

are turning ever gloomier, except, of course, those produced by the Chinese authorities.

The current set-up of the Chinese economy is, contrary to mainstream thinking in the West and despite the deployment of impressive resources, anathema to successful long-term development. Another element weighing negatively on future growth prospects is China's demography. China faces an aging of the population which is at least as pronounced as it is in most Western countries. China's population is set to start declining substantially from around 1.4 billion people to towards 800 million by the end of the century. If the replacement rate does not increase significantly, the fall in the population can be even much larger. Currently the replacement rate in China stands at 1.1 births per woman whereas 2.3 births per woman are needed for a stable population. Putting extra pressure on China's demographic problem is the substantial net emigration that takes place each year. The fact that considerably more resources will be needed to take care of the elderly leaves less to invest in the productive sectors of the economy, another factor that will tend to further reduce future productivity growth.

Not only are there significant longer-term issues for China, also in the shorter run the country's authorities face massive challenges. Youth unemployment is an immediate concern. Officially the youth unemployment rate now stands around 18%, but like many others this number has little credibility. In June 2023 the official statistic was peaking at 21.5% but then the authorities suspended publication of this statistic. A few months later a new statistic was introduced that pushed the number down substantially. Non-governmental estimates of the youth unemployment rate are in the 30% to 45% range. No wonder discontent among Chinese youngest generation is rising considerably.

The major short-term problem for the Chinese authorities is however the real estate crisis, and the related problems in the sphere of banking and debt accumulation. By the end of the 2010s a huge real estate bubble developed in the slipstream of irresponsible monetary and regulatory policies. Extreme forms of leverage were commonplace among China's real estate developers. Giant companies like Evergrande and Country Garden quickly went belly-up once the bubble burst. Up to 30 million, or even more, Chinese households have paid for apartments that have never been completed. The IMF estimates that \$1 trillion is needed to clean up the real estate mess. It is generally recognized that the apparent incapacity of the Chinese authorities to deal adequately with this problem is a major factor inspiring Chinese citizens, who hold up to 70% of their wealth in real estate, to shore up their saving efforts and refrain from more consumptive expenditures. The switch from an investment and export driven economic model to one fueled more by consumption is blocked because of these developments emanating from the real estate bust.

The real estate crisis, now in its fourth year, is also weighing heavily on the banking sector. 40% of the outstanding loans in the Chinese financial system are real estate related. Here also official statistics on NPLs (non-performing loans) are manifestly incorrect. The official number of only 1.5% NPLs is flatly contradicted by a host of non-official data. These data put the NPL ratio in the 6 to 7% range. NPLs are considered to be a real risk to the financial institution concerned once they reach 5% of outstanding loans. Especially rural and small-city banks are directly affected by these NPLs, making it harder for the authorities to get a clear overall picture.

The real estate crisis and the related banking troubles are closely connected to the economic policies followed by the Chinese authorities over the last decades. Another problematic result of that strategy is the meteoric rise of

debt and leverage levels in China. Again, official statistics throw up numbers that cannot be relied upon. There is a growing consensus among non-governmental economists that the overall debt to GDP ratio is now hovering around 300% of GDP and rising further rapidly. The public sector debt ratio is close to 90% of GDP while private debt, most of all in the corporate sector, has risen to more than 200% of GDP. One of the darkest spots with respect to the debt picture is the amount of debt weighing on local authorities. They have been very creative in establishing structures such as ad hoc investment vehicles that allow the authorities to hide, at least for some time, the true extent of indebtedness in the system.

NEEDED: ATTITUDE CHANGE

China, Russia and Iran form the core of an “axis of disruption” fighting the dominance of the Western political and economic order. The impression prevails in the West that we are gradually losing this existential battle against this China-led axis. We should throw off this fear, not least because the problems and challenges facing these axis members are stark. In the case of Russia and Iran this reality is obvious, in the case of China less so. But even Xi Jinping’s China is far from being in perfect shape.

Western leaders must look the members of the axis of disruption straight in the eye. We should not look for confrontation but should not be afraid of it either. Major policy adjustments (military, economic, financial and social) are needed to be able to confront these adversaries in a credible way. We certainly have the means and the intellectual capacity to stand up to those who want to destroy our political and economic system and to impose their more dictatorial regime. What is, however, most needed is a fundamental attitude change. We are wise to recall one of the many quips of Winston Churchill: “As long as we

have faith in our own cause and an unconquerable will to win, victory will not be denied us". Restoration of these values is an absolute imperative.