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Strategic Insights: U.S.-China Relations: Avoiding the Traps

July 19, 2017 | Professor John F. Troxell

Much has been written about the rise of China and the tensions that this has put on the international system. The potential for conflict between the United States and China can be compared to the Peloponnesian War, as told by the ancient historian Thucydides, and the inevitability of that war because of Sparta's fear of a rising Athens. There is no doubt that the rise of China has generated, if not fear, at least significant consternation on the part of the United States and our Pacific allies. Graham Allison points the spotlight on this geopolitical challenge in his newly released book, *Destined for War: Can America and China Escape Thucydides' Trap?* Although states may want to avoid war, "misunderstandings, miscalculations and entanglements can escalate to a conflict far beyond anyone's original intent."¹ The spark that sets off this unfortunate escalatory chain of events is usually driven by the opposing military machines. However, to avoid the Thucydides trap, the main focus of attention should not be on the military dimension of the U.S.-China relationship, but on the economic dimension. The most important trap to be avoided is the trade-security trap.

The trade-security trap is defined by Dale C. Copeland in *Economic Interdependence and War* in which he argues that a "great power's security is very much a function of its position in the global commercial system," and the primary accelerant to war is based on the state's expectations of the future trade and investment environment.² If a state is optimistic about the future trade and investment environment, it will consider the benefits of interdependence to outweigh the vulnerabilities. If, on the other hand, the state's attitude becomes pessimistic about its long-term security prospects because of threats to markets or access to necessary resources, a trade-security spiral could escalate to war. The Great War, fueled by German pessimism about access to markets and natural resources in the face of the other great powers moving toward economic containment at the turn of the 20th century, and the Pacific War driven by Japan's need for economic security in the face of increasingly closed economic spheres and eventual sanctions, are two prime examples of this dynamic at work.³ Fast forward to the campaign tweets of then-candidate Trump, which caused much concern that the economic relationship between the United States and China was headed straight for a trade war. During the campaign, he railed against huge trade deficits, made charges of currency manipulation, and threatened to apply a 45 percent tariff against all Chinese goods.

For several decades, U.S. policy has encouraged the integration of China into the global economy, and "welcomes the rise of a stable, peaceful, and prosperous China."⁴ As a responsible stakeholder and active member of the global economy, China would recognize the value in supporting the rules-based international order, and its growing role in increasingly integrated global supply chains would provide the impetus for further economic reforms. China's transition to a more market-based economy would also generate political reforms. China's economic growth has been astonishing, but the hoped for win-win scenario has not come to pass. The shock to the

Washington consensus and the U.S. economy delivered by the 2008 global financial crisis has emboldened China resulting in a growing reluctance to pursue more economic reforms, adoption of mercantilist policies, increased authoritarian political measures, and an assertive foreign policy throughout East Asia.

In response, President Trump's campaign rhetoric echoed the general themes of economic tension with China espoused in every presidential campaign in this century. However, the tension seems more palpable and the President more determined to follow through with campaign promises to punish China and bring home American jobs. The U.S. merchandise trade deficit with China set a record in 2015 at \$367 billion and was not far off that mark again in 2016. The business climate in China for U.S. and Western firms has turned sour with increasingly discriminatory policies and relentless pressure for technology transfer. Subsidized state-owned-enterprises are on the prowl to acquire Western firms, while reciprocal foreign-direct investment (FDI) in China faces increased restrictions. As Xi Jinping attested at Davos, China has benefited dramatically from participation in the open global economic system, but despite his robust defense of globalization and free trade, and his call to "maintain a level playing field," the economic playing field is anything but level.⁵

U.S. efforts to level the playing field are certainly called for, but before noting specific policy proposals, let us clarify the problem. First, the main culprit in the loss of American manufacturing jobs is technology-driven automation, not Chinese competition. Manufacturing output today is 60 percent greater than in 1980 and is accomplished with 30 percent fewer workers. Christine Lagarde, head of the International Monetary Fund, recently noted that much of the economic pain ascribed to globalization was instead due to the rise of robots taking jobs. The automation genie is not going back into the bottle and many low-skilled manufacturing jobs are not coming back. The fundamental response to global trade is the need to educate and retrain workers for the high-skilled jobs in a competitive American economy, not to battle over low-skilled and low-paying jobs. As Michael Hicks, an economics professor at Ball State noted recently in the *Atlantic*, "The mantra that we've lost good-paying jobs to China is exactly wrong. We've lost the bad-paying jobs to China and gained the good-paying jobs."⁶

Second, China has also been beaten-up over the issue of currency manipulation, which at the start of this century contributed to China's export surge. However, for the past 2 years, China has spent approximately \$1 trillion of its foreign reserves to strengthen the value of the yuan. Retaliation against currency manipulation is fighting the last war.

Finally, trade statistics are largely based on outdated constructs from the 1930s that assumed all manufactured products had a single country of origin. In the 21st century's globalized economy, manufacturing has been disaggregated and commoditized and relies on integrated global supply chains of intermediate components. China happens to be the place for final assembly, and thus is credited with the full value of a product. However, studies by the Organization for Economic Cooperation and Development (OECD) and the World Trade Organization (WTO) examining global value chains indicate that upwards of a third of Chinese exports reflect foreign content, and that the U.S. bilateral trade deficit is anywhere from 25 percent to 50 percent less than the official amount.

Therefore, concerning U.S.-China trade policy, we must recognize that a trade war is not the answer. Violations of existing agreements, such as dumping excess steel or other products into the U.S. market, should be vigorously pursued through the WTO. In addition to actions through the WTO, the Trump administration should press for investment reciprocity—open all sectors in China to U.S. FDI, or severely restrict Chinese investment in the United States.⁷ The administration's

business acumen should be applied to the Bilateral Investment Treaty negotiation and further open the Chinese economy to market forces.

Withdrawing from the Trans-Pacific Partnership (TPP) agreement was a blow to the U.S. strategic position in the Asia-Pacific region. The geostrategic gain and the potential gravitational pull for expansion, inherent in the TPP, far outweigh any direct economic implications, which were judged to be positive but rather minimal for the U.S. economy. Fortunately, the United States has existing bilateral free trade agreements (FTA) with most of the major TPP partners, and if the President stands by his promise that “we’re going to have a lot of [one-on-one] trade deals”⁸ then it should be possible to negotiate an FTA with Japan, thus recouping some of the effort put into the TPP, while strengthening the U.S. economic position in East Asia.

Other than the precipitous withdrawal from the TPP, the Trump administration is actually off to a decent start concerning economic relations with China. An outgrowth of the Mar-a-Lago meeting in April was an agreement to pursue a Comprehensive Economic Dialogue. Initial negotiations resulted in the “100 Day Plan” that was announced on May 10, 2017. This plan contained four quick-wins: increased agricultural trade, opening the financial services market, forward movement on investment reciprocity, and enhanced energy trade. Secretary Ross commented, “U.S.-China relationships are now hitting a new high, especially in trade.”⁹ Quite a change from the campaign rhetoric and initial salvos after the election. Both states have pledged to move forward on a “One Year Plan.”

Economic competition will remain fierce, but that is what capitalism and open markets are all about, and it is what the United States is supposed to be good at. We need to continue to push for a level-playing field in all trade and investment relationships, but do so within the context of open markets and increased interdependence. We cannot forget that Chinese imports also generate lots of American jobs in transportation, retail, and by servicing these products, and we should also recognize that low cost imports from China (and Mexico, Vietnam, etc.) benefit all consumers, particularly those at the lower end of the economic ladder. The U.S. economy has so many inherent advantages, and achieving economic prosperity for America is much more dependent on reforming and strengthening our domestic economy. Building trust and confidence in the increasingly interdependent U.S.-China economic relationship should forestall a hazardous trade-security spiral, contribute to the economic prosperity of both nations, and help to put a lid on the Thucydides trap.

ENDNOTES

1. Graham Allison, “Destined For War?” *National Interest*, Iss. 149, May/June 2017, p. 10.
2. Dale C. Copeland, *Economic Interdependence and War*, Princeton, New Jersey: Princeton University Press, 2015, pp. 3, 7.
3. *Ibid.*, pp. 123, 149.
4. Barack Obama, *National Security Strategy*, Washington, DC: The White House, February 2015, p. 24.
5. “Xi Jinping delivers robust defence of globalisation at Davos,” *Financial Times*, January 17, 2017, available from <https://www.ft.com/content/67ec2ec0-dca2-11e6-9d7c-be108f1c1dce>.
6. Michael Hicks, “America Is Still Making Things: Manufacturing is dead. Long live manufacturing,” *The Atlantic*, January 6, 2017, available from <https://www.theatlantic.com/business/archive/2017/01/america-is-still-making-things/512282/>.

7. David Dollar, *The future of U.S.-China economic ties*, Washington, DC: The Brookings Institute, October 4, 2016, available from <https://www.brookings.edu/research/the-future-of-u-s-china-trade-ties/>. Dollar describes this approach as “responsible hardball.”

8. Steve Holland, rpt., “Trump says plans lots of bilateral trade deals with quick termination clauses,” Reuters, January 26, 2017, available from <http://www.reuters.com/article/us-usa-trump-trade-idUSKBN15A2MP>.

9. Tom Phillips, “US hails China trade deal as sign relations are ‘hitting a new high’,” *The Guardian*, May 12, 2017, available from <https://www.theguardian.com/world/2017/may/12/us-hails-china-trade-deal-as-sign-relations-are-hitting-a-new-high>.

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