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Yuqing Xing

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Yuqing Xing*

Abstract

This paper provides a comprehensive analysis of the on-going China-US trade war, similar to the Thucydides Trap in terms of competing for global economic dominance. It analyzes what the US attempts to achieve through the trade war and why China has been refusing the reciprocal trade relations urged by President Trump. It also identifies social and economic changes in American society, which motivate President Trump to impose punitive tariffs on Chinese goods. It emphasizes that the trade war is asymmetric and China will definitely suffer more losses than the US if the trade war escalates further. At the end of the paper, it suggests that, to avoid the devastating result of the Thucydides Trap, China should further open its domestic market to American companies and actively pursue negotiations with the US for resolving the dispute.

Key Words: China, US, Trade War

JEL: F13

* National Graduate Institute for Policy Studies, 7-22-1, Roppongi, Minato-ku, Tokyo, 106-8677 Japan. Email: yuqing_xing@grips.ac.jp.

1. Sino-US Trade War: a New form of the Thucydides Trap

The Ancient Greek historian Thucydides observed that when a rising power threatens to displace the existing power, war is almost inevitable. This is so-called "Thucydides Trap." In the last 500 years, among 16 cases in which a rising power threatened to displace a ruling one, 12 ended in war.[1] With $19.4 trillion GDP, the US remains the top economic superpower in the World. After the rapid growth of the last few decades, China has been catching up and has substantially shortened its distance from the US. In 2017, China's GDP amounted to $12.8 trillion, about 60% of US GDP. If China could continue its high economic growth, it would be highly likely that in twenty years the Chinese economy would surpass that of the US and turn into the largest economy in the world.

Given its rapid economic growth and the gigantic size,, China appears to be a viable challenger to the US's dominance in the world economy. The surging US trade deficit with China, as well as the ambitions of "Made in China 2025" (announced in May 2015), further reinforce concerns of the US about the threat of China's rising economic power. The ongoing Sino-US trade war is not a military conflict, but rather is similar to the Thucydides Trap hypothesis in terms of competing for global economic dominance. The trade war launched by the Trump administration is a rational response of the US to the rising economic power of China. The Trump administration expects to use a trade war to rewrite the trade rules, force China to further open its market to American firms, and abandon unfair practices distorting the competition between American and Chinese firms, and so that the US could compete with China on a level playing field.

On April 3, 2018, on the order of President Trump, the Office of the US Trade Representative (USTR) released a list of $50 billion in Chinese products subject to a 25% punitive tariff. The list covers more than 1,300 categories of products, ranging from hi-tech products to consumer goods such as diswashers, televisions and automobiles. The measures follow the 301 investigation led

[1] Allison, G (2017). "The Thucydides Trap". Foreign Policy, 9 June 2017. https://foreignpolicy.com/2017/06/09/the-thucydides-trap/

by Trade Representative Robert Lighthizer on China's unfair trade practices, (notably forced transfer of American technology and intellectual property).[2]

The USTR actions officially started the trade war with China. Just a few hours after the USTR released the tariff hit list, the Chinese government hit back at the US with the same tariffs on $50 billion of American goods, including soybeans, car and chemicals.[3] The almost immediate response signified that Sino-US trade relations have entered tit-for-tat mode. This is the first round of the emerging trade war.

In May and June of 2018, trade delegates of the two countries negotiated in Washington DC and Beijing, but failed to make any significant progress. On Sept. 17, President Trump escalated the trade war by ordering the USTR to levy a 10% tariff on an additional $200 billion in Chinese goods.[4] In response to the second wave of tariffs, the Chinese government vowed to fight back with both quantitative and qualitative measures. On Sept. 18, 2018, the Chinese government announced that it would charge 10% to 5% tariffs on an additional $60 billion American goods.[5] That was the second round of the trade war.

The trade war is asymmetric. In 2017, China imported $130 billion American products.[6] After the first two rounds of fighting, the Chinese government had marked $110 American goods for retaliatory tariffs. If the tit-for-tat trade war continues and goes into the third round, only $20 billion in American goods could be targeted. On the other hand, the US imported $505 billion in Chinese products in 2017.[7] The Trump administration has designated $250 billion worth of Chinese products, about half of US imports from China, for the levying of tariffs. Without doubt, the US would have more leverage than the Chinese government if the tit-for-tat trade war were to

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[2] USTR (2018), USTR Issues Tariffs on Chinese Products on Responses to Unfair Trade Practices, 3 April 2018. https://ustr.gov/about-us/policy-offices/press-office/press-releases/2018/june/ustr-issues-tariffs-chinese-products

[3] Chinese Ministry of Commerce (2018). "The list of American goods for tariffs".

[4] White House (2018). Statement from the President, Sept. 17, 2018, https://www.whitehouse.gov/briefings-statements/statement-from-the-president-4/

[5] Chinese Ministry of Commerce (2018). 关于对原产于美国的部分商品加征关税的公告 ， Sept. 18, 2018. http://www.mofcom.gov.cn/article/ae/ai/201809/20180902788241.shtml

[6] US Bureau of Census (2018). "US Trade China", 2018. https://www.census.gov/foreign-trade/balance/c5700.html

[7] Ibid

continue. President Trump actually threatened to escalate the trade conflict to a full scale war by imposing tariffs on all imported goods from China.[8]

China and the US are the two largest economies in the world. The bilateral trade of the two nations amounted to $635 billion. Compared with Japanese-US trade friction in 1980, the scale of the Sino-US trade war is much larger and more dangerous: not only has it been undermining the growth and stability of the two national economies, it has also been raising the risk to the stability of the world economy. If the war were to continue, it might trigger an economic recession in China, which is facing a number of economic challenges, such as sky-rocketing housing prices, mounting debt in both public and private sectors, and weakening momentum of domestic investment and consumption.

2. What are the Two Countries Fighting For?

Fair Trade vs China's Developing Country Status

President Trump has repeatedly claimed that trade between China and the US is unfair, because US tariffs on Chinese products are much lower than those that China has imposed on American goods. For example, the US charges a 2.5% tariff on Chinese cars while China taxes American cars at 25%. This asymmetric tariff structure has given the advantage to Chinese exports entering the US market, but it has hindered American products' access to the Chinese market. In other words, the openness of the two markets is unbalanced. Chinese market is relatively more closed than that of the US. That unfair trade is one of the major reasons driving the growth of the US trade deficit with China.[9]

According to the estimates by the World Bank,[10] the average tariff of China in 2016 was 10.9% much higher than the 3.57% level of the US. China's tariffs on consumer products are even higher, more than 15% before China unilaterally cut them on July 1, 2018. In addition, the

[8] Lambert, L (2018). "Trump threatens tariffs on all $500 billion of Chinese imports", Reuters, 20 July 2018. https://www.reuters.com/article/us-usa-trade-china/trump-threatens-tariffs-on-all-500-billion-of-chinese-imports-idUSKBN1KA18Q

[9] White House (2018). "President Donald J. Trump is confronting China's Unfair Trade Policies", 29 May 2018. https://www.whitehouse.gov/briefings-statements/president-donald-j-trump-confronting-chinas-unfair-trade-policies/

[10] World Development Indicator, World Bank, 2018

Chinese government has been utilizing non-tariff barriers, such as standards, licenses and documentations, to hinder the importation of foreign goods. President Trump stated “We cannot continue to let people come into our country and rob us blind and charge us tremendous tariffs and taxes and we charge them nothing.”[11]

President Trump insisted on defining fair trade as reciprocity, meaning that China should not levy higher tariffs on American goods than those charged by the US on Chinese products[12]. As a response to that US demand, the Chinese government slashed tariffs on thousands of consumer goods on July 1, 2018.[13] Now, the Chinese tariff on automobiles is 15%, still higher than the 2.5% levied by the US on equivalent products. Again, on November 1, 2018, the Chinese government unilaterally reduced tariffs on thousands of intermediate inputs.

The Chinese government disagrees with the defining of fair trade as reciprocity, arguing that the tariffs of a country should be designed according to its level of economic development, insisting that China remains a developing country. It is “unreasonable and unrealistic” to demand that China adopts tariffs which reciprocal to those of the US. As a member of the WTO, China has no obligation to offer reciprocity to developed countries.[14]

It is true that the WTO agreement contains “special and different provisions”, offering special rights to developing countries. WTO provisions state that developed countries should not expect developing countries to provide reciprocal tariff reduction in trade negotiations. That is why tariffs in developing countries are generally higher than in developed countries. Those special provisions are intended to promote the participation of developing countries in international trade and enhance their access to the global market.[15] However, the WTO does not provided a

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[11] Shepardson, D (2018). “U.S. to push for reciprocal tax on trade partners: Trump”, Reuters, 13 February 2018. https://www.reuters.com/article/us-usa-trump-trade/u-s-to-push-for-reciprocal-tax-on-trade-partners-trump-idUSKBN1FW22Q

[12] Morgan, D (2017). “Trump objects to terminology of border adjustment tax”, Reuters, 13 April 2017. https://www.reuters.com/article/us-usa-trump-tax-idUSKBN17E2DM

[13] State Council (2018). “News press held by The State Council Information Office on the reduction of tariffs of imported consumer goods”, 2018. http://www.mof.gov.cn/zhengwuxinxi/caizhengxinwen/201806/t20180601_2915138.htm

[14] Qing Ying (2018). “Ministry of Commerce: Reciprocal Tariffs are neither Making Sense nor Reasonable, Caixin, April, 12, 2018

http://international.caixin.com/2018-04-12/101233416.html

[15] WTO (2018). “Special and differential treatment provisions”, WTO, 2018. https://www.wto.org/english/tratop_e/devel_e/dev_special_differential_provisions_e.ht

definition of "developing country." Any WTO member can self-declare "developing" status. Once a country is assigned "developing" status, it will remain a developing country forever, regardless of its economic development. That is why even today Korea, Singapore and Israel are still "developing" countries under the WTO.

When China joined the WTO in 2001, its GDP was $1.34 trillion and its GDP per capita was slightly more than $1,000. China declared itself "a developing country" and was accepted as a developing country member of the WTO. After almost two decades of high growth, China has become the second largest economy, with $12.8 trillion GDP and the largest exporting nation in the world. A critical question is whether China should continue to be treated as a developing country in the global trading system.

The debate about China's developing country status is not new. In a speech delivered at China's Development Forum 2013, Pascal Lamy, former Director General of the WTO, stated that "China should do much more than other poor and weak economies and should not use its developing country status as a cover to avoid taking more international obligations.[16] That is one of the focal points of the Sino-US trade dispute. Automatically giving up "developing" status means China should shoulder more responsibilities in terms of opening its domestic market to foreign goods.

The World Bank has designated $12,700 per capita as the high income country threshold. By the World Bank standard, China has not yet achieved the status of high-income country. That standard is often cited in debates as a justification of China's developing country status. The world trading system, however, is governed by the WTO, not the World Bank. Using the standard of the World Bank is a questionable motion.

WTO's special provisions for developing countries are designed to facilitate exports from developing countries, which are not competitive and have difficulties accessing the world market. China has surpassed Japan, Germany and the US to emerge as the largest exporting nation in the

[16] Lamy, P (2013). "China should be more active in global economic governance," WTO, 2013 https://www.wto.org/english/news_e/sppl_e/sppl274_e.htm

world. In 2017, its annual exports totaled $2.2 trillion, much higher than those of the 28 European Union (EU) countries ($1.98 trillion) and the US ($1.57 trillion).[17]

Not only does China rank as the world No.1 exporter of labor intensive products, it is also the No.1 exporter of high-tech products in the world. In 2017, China recorded a $127 billion trade surplus with the US in advanced technology products. The Chinese yuan has been included in the special drawing rights (SDR) of the IMF, along with the US dollar, the Japanese yen, British pound and euro. The Chinese yuan is the only currency of a developing country included in the SDR basket. In recent years, China initiated and funded the Asian Infrastructure Investment Bank and BRICS Development Bank. From 2000 to 2014, the overseas investment of the Chinese government totaled $3543 billion, just $40 billion less than that of the US, the largest donor of official development assistance in the world.[18]

All of these impressive economic achievements indicate that China has grown to be a great economic power. Within the WTO, however, China continues to enjoy tremendous benefits and advantages of poor countries. It is natural and reasonable that China's developing country status be questioned and challenged by the US. Larry Kudlow said "China is a first-world economy, behaving like a third-world economy." The largest exporting nation in the world, China is insisting on maintaining its developing nation status, which contradicts the objectives of the WTO special provisions. It is now time that China becomes a more equal partner in international trade with developed countries.

Forced Technology Transfer vs "Market for Technology" Practices

In addition to the debate about fair trade and reciprocal tariffs, the Trump administration accused China of intellectual property theft and forcing American companies to transfer their technologies to their Chinese partners.[19] In March of 2018, the USTR released the 301 report on

[17] WTO (2018). "Who are the developing countries in the WTO?", https://www.wto.org/english/tratop_e/devel_e/d1who_e.ht

[18] William & Mary (2018). "China's Global Development Footprint", AIDDATE, 2018.

https://www.aiddata.org/china

[19] White House Office of Trade and Manufacturing Policy (2018). "How China's Economic Aggression Threatens the technologies and Intellectual Property of the United States and the World", June 2018. https://www.whitehouse.gov/wp-content/uploads/2018/06/FINAL-China-Technology-Report-6.18.18-PDF.pdf

China's acts, policies and practices related to technology, intellectual property and innovation.[20] The 301 report documents a few cases of forced technology transfers. One is related to the transfer of new energy vehicle (NEV) technologies. The Chinese government only subsidizes domestically produced NEVs, not imported ones. To enter the fasting growing Chinese NEV market, foreign NEV producers have to set up joint-ventures with Chinese partners. The Chinese government requires that, joint-ventures should own at least one of three technologies (battery, driving system and control system) to receive the NEV subsidy. In 2017, the Chinese government made it compulsory for joint-ventures to have the intellectual property of all three technologies to receive the subsidy. In short, transferring technologies from foreign companies to the joint ventures, where Chinese partners typically hold 51% of shares, is a requirement for foreign auto-makers to enter Chinese NEV market.

Another example is related to the procurement of the C919, a large passenger airplane developed by Commercial Aircraft Corporation of China (Comac). China has emerged as the largest market for large passenger aircrafts, which until now has been monopolized by Boeing and Airbus. Developing the capacity to manufacture large aircrafts has been a top priority of China's industrial policy. In the age of global value chains, it is not necessary that all parts and components of the Comac 919 be produced by Chinese companies. Comac has sourced many C919 parts and components from foreign suppliers. For example, the engines of the C919 are supplied by the American company General Electronics (GE). However, Comac requested foreign companies to set up joint-ventures in China in order to quality as suppliers of the C919. The Trump administration regards this situation as a case of forced technology transfer.

Technology transfer agreements have been a feature of China's strategic approach to foreign investment since China opened up trade with the rest of the world in the early 1980s. In many industries, Chinese authorities allow foreign investors access to the Chinese market only if the foreign party agrees to form a joint-venture with a local firm. This practice is referred as "market for technology," adopted as an effective means for Chinese companies to learn advanced technologies from their foreign partners. Volkswagen's entry into the Chinese automobile market through its alliance with Shanghai Auto Company is a typical example.

[20] USTR (2018). "Findings of the investigation into China's acts, policies, and practices related to technology transfer, intellectual property, and innovation undersection 301 of the trade act of 1974", 22 March 2018. https://ustr.gov/sites/default/files/Section%20301%20FINAL.PDF

When China joined the WTO in 2001, the Chinese government promised not to use technology transfer as a prerequisite for approval of the importation of foreign goods or foreign investment.[21] From the point view of the Trump administration, given its entry into the WTO, China should stop requiring foreign investors to enter partnerships with Chinese companies. Continuously imposing joint-venture requirement as a necessary condition for accessing the Chinese market violates China's WTO commitment. The 301 report claims that the technology transfer that accompanies such partnership is unfair to American companies and deprives them of the right to earn market-based royalties.

The Chinese government refutes all accusations of forced technology transfer and stealing intellectual property. It claims that technology transfer from foreign investors to Chinese partners constitutes pure business decisions and is mutually beneficial.[22] Dong Yan, the Director of the Institute of the World Economy and Politics, Chinese Academy of Social Science, argued that there are no Chinese laws demanding foreign investors to transfer their technologies to Chinese partners.[23] On the other hand, it is mysterious that neither Chinese government officials and nor Chinese scholars have ever challenged any specific cases cited in the 301 reports.

Market Distortion of Subsidies and Industrial Policy

Industrial policy has played a critical role in the nurturing of China's industrial capacities. The Chinese government, including both the central and local governments, has proactively applied various industrial policies to support the development of strategic industries, notably NEVs, photovoltaic solar panels and flat-panel displays. Fiscal subsidies, preferential tax treatments, and commercial loans with interest rates lower than market rates are common policy instruments for the encouragement of investment and the expansion of Chinese companies in targeted industries. Prof. Justin Yifu Lin of Peking University, former vice president of the World Bank, has long been a vocal supporter of China's industry policy. He argues that industry policy is

[21] Ibid.

[22] "Ministry of Commerce: US accusations of forced technology and intellectual property theft contradict historic facts and are not acceptable", Xinhuanet, 12 July 2018. http://www.xinhuanet.com/politics/2018-07/12/c_1123118652.htm

[23] Qi, Z. (2018). "The US accusation of forced technology transfers is groundless". 9 April 2018.

http://finance.people.com.cn/n1/2018/0409/c1004-29912963.html essential for the government of middle-income countries to efficiently allocate scarce resources and facilitate technological innovation and industrial upgrading. He claims that the government has necessary information and capacity to identify the industries compatible with the comparative advantage of the country.[24]

In 2015, China's State Council[25] launched Made in China 2025, an official document that outlines a blueprint for the Chinese industry policy for the next ten years. It emphasizes the development of future oriented industries: integrated circuits, artificial intelligence, robotics, biotechnology, aerospace equipment, new energy vehicles and new materials, and aims to achieve 40% self-sufficiency in the core parts and basic materials of those industries by 2020 and 70% self-sufficiency by 2025.

In a competitive market, government subsidies of exports tend to worsen national welfare. However, if an international market is not competitive, then the incumbent firms of the market can earn rents. So, it is welfare enhancing for a national government to use fiscal subsidies to help its firms enter the market and compete with existing players. This is referred as "strategic trade policy" by Brander and Spencer.[26] The success of Airbus is often cited as remarkable evidence for the efficacy of "strategic trade policy." Having received more than $22 billion in subsidies from the European Union,[27] Airbus finally broke the monopoly of Boeing and grew into to a capable competitor in the large passenger aircraft market.

Generally speaking, incumbent firms that cannot obtain subsidies are victims of "strategic trade policy." Many American companies lead the technology frontiers of the industries targeted by Made in China 2025, and have been monopolizing the international markets of those industries. For instance, Intel and ADM monopolize personal computer CPUs and Qualcomm dominates the market for chipsets embedded in Android system mobile phones. With government subsidies, Chinese firms could catch up with leading American firms, thus undermining the monopoly of American companies and eroding their global maker shares.

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[24] Lin, J. Y (2017). "New Structural Economics and Industrial Policies for Catching-Up Economies", in *Advances in the Theory and Practice of Smart Specialization*, ed. S. Radosevic, et al, pp. 183-199.

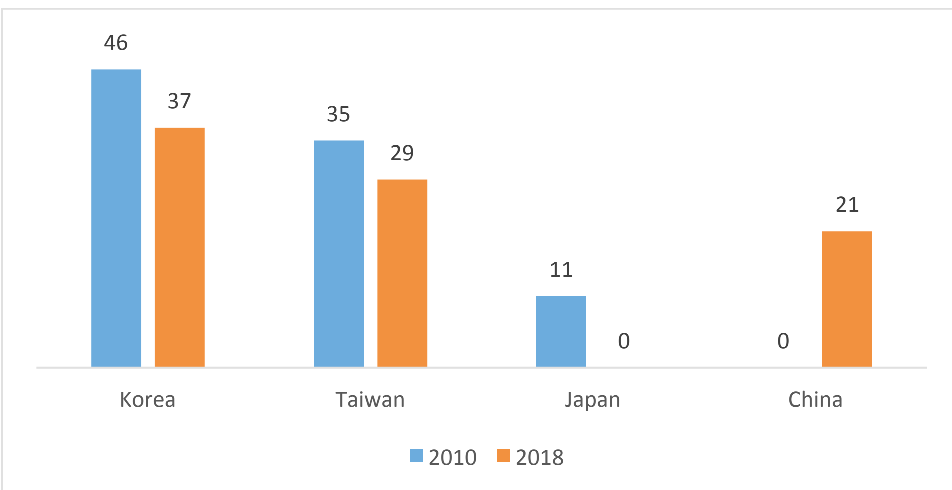
[25] State Council (2015). "Made in China 2025", http://www.gov.cn/zhengce/content/2015-05/19/content_9784.htm

[26] Brander, J and Spencer, B (1985). "Export subsidies and international market rivalry", Journal of International Economics, 1985.

[27] Boeing (2016). "Boeing Statement on WTO Ruling", 2016.

Integrated circuits (IC), including CPUs and IC chips of mobile phones, are at the top of the agenda of Made in China 2025. The Chinese government has allocated huge financial resources to the facilitation of technological innovation in the sector. It is estimated that the pool of IC investment funds totals 730 billion yuan, of which 140 billion yuan is committed by the central government, 240 billion by local governments and 350 billion by firms and venture capital.[28] The US government has neither the financial resources to match the Chinese subsidy, nor the legal authority to promote a particular industry. Faced with competition from Chinese firms backed by massive government subsidies, American companies may struggle to maintain their technological leadership and dominance in the global market. The Trump administration claims that Chinese industry policy and subsidies are harmful to US industry, as it could give Chinese companies a huge advantage over American companies and distort market competition. The massive subsidies may eventually lead to excess capacity and result in the dumping of Chinese products in the global market.[29]

Figure 1 Share of the China's Flat-Panel Display Market by Country (%)



Source: Sturgeon, Taglinio and Thun (2018).

A joint study on the development of flat panels in China, shows that the state-led development strategy for nurturing the Chinese TV flat-panel industry has been very successful. In 2010,

[28] Sturgeon, T., Taglioni, D. and Thun, E (2018). "Value added in China's mobile phone handset industry", presentation at the workshop of GVC Development Report, Beijing, March 2018.

[29] White House (2018). "President Donald J. Trump is confronting China's Unfair Trade Policies", 29 May 2018. https://www.whitehouse.gov/briefings-statements/president-donald-j-trump-confronting-chinas-unfair-trade-policies/

foreign companies from Japan, Korea and Taiwan basically monopolized the Chinese market for flat-panel displays. Thanks to massive local government subsidies and various preferential policies, by 2018, Chinese firms, most of them state-owned enterprises, built up a large capacity for TV flat-panel production and gained 21% of market share at the expense of their foreign rivals. Japanese firms were completely edged out of the market (Figure 1).[30]

The Trump administration alleges that China's industrial policy and subsidies constitute unfair trade practice and the agenda of Made in China 2025 is a planned economic aggression towards the US and the world economy.[31] It urges China to drop Made in China 2025. It is not clear whether the Chinese government will shelve Made in China 2025 to alleviate trade frictions. However, reports on and discussions of Made in China 2025, have disappeared from the Chinese media. This may indicate that the Chinese government is attempting to lower the profile of its industrial policy to ease US concerns.

3. Social and Economic Changes in American Society behind the Trade War

China's unfair practices, alleged by the Trump administration, have been prevailing even since China's entry into the WTO. Neither the Clinton administration nor the Obama administration took confrontation approaches to force China to change its course. Why does the Trump administration regard these issues as major problems for the bilateral trade relations, and even resort to a trade war? The winds of the change are fundamentally rooted in social and economic changes in American society in the last few decades.

<u>Huge US Trade Deficit with China</u>

The US trade deficit with China has risen sharply since China joined the WTO. In 2001, it was $83 billion, about 19.7% of the total US trade deficit. By 2017, it surged to $375.6 billion, accounting for 46.5% of the total trade deficit (Figure 2). The Trump administration blames unfair Chinese trade practices for the huge bilateral trade deficit and is requesting China to lower its tariff and non-tariff barriers so American companies can have equal access to the Chinese market.

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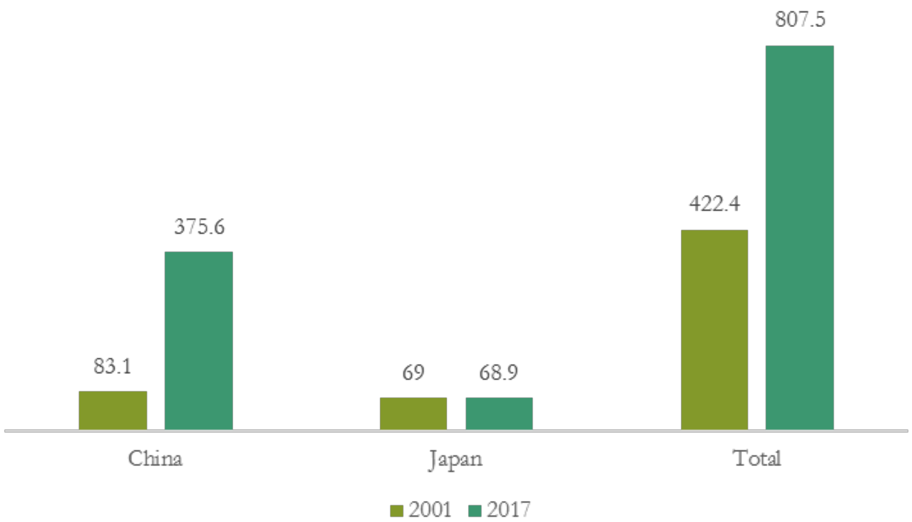
[30] Ibid.

[31] Ibid.

Figure 2. US Trade Deficits with China and Japan (billion dollar)



Source: US Bureau of Census.

However, Chinese scholars and government official disagree. They insist that structural reasons rather than China's protectionism and mercantilist policy are driving the huge trade imbalance. The low savings rate in the US and the "Triffin Dilemma" are the two commonly cited structure reasons. The low savings rate is assumed to drive Americans to consume beyond their means, and the "Triffin Dilemma" implies that the US trade deficit should be permanent and continue to rise, since the US should channel sufficient dollar liquidity through trade deficits to support the international financial system, centered on the US dollar.

However, using the low savings rate and "Triffin Dilemma" to explain the US trade deficit with China is a fundamentally flawed argument. Theoretically, low savings rate may be a major reason behind overall US trade deficit, but not necessarily the reason for the bilateral trade deficit with China. Low savings rate cannot explain why almost half of the US trade deficit ends up with China. In other words, low savings rate argument cannot explain the disproportion distribution of US trade deficit to its trade with China. Furthermore, the ratio of US trade deficit to GDP changed little from 2001 to 2017. The ratio in 2001 was 4.0% and rose slightly to 4.2% after 16 years. If low savings rate was one of major factors responsible for the bilateral trade deficit, US trade deficit with China should rise proportionally to US GDP. However, it jumped more than fourfold from 2001 to 2017, greatly outpacing US GDP growth.

The Triffin dilemma is a critique to the Breton Woods System. Under the Breton Woods System, the US dollar was designated as the only currency for international transactions. All other countries pegged their currencies to the US dollar, with the dollar backed by gold at the fixed price $35 per ounce gold. Thus, the US had an obligation to supply dollar liquidity to the world economy. Having a current account deficit would then be inevitable for the US. If it eliminated the balance of payments deficit, it would deprive global trade of the international liquidity.[32]

In 1971, President Nixon abandoned the Bretton Woods System and unilaterally cancelled the convertibility of the US dollar to gold. Since then, the world economy has moved into the regime of free floating exchange rates. The US no longer has the obligation to provide dollar liquidity to the rest of the world. Besides the US dollar, there are now other currency choices for settling international trade. The British pound, the Deutsche mark, the Japanese yen, the Swiss franc, and now the euro, all have been used for international transactions. Even if the Triffin dilemma was one of the reasons for the US trade deficit, it would be difficult to explain why almost most half of the necessary dollar liquidity flew to China.

In fact, global value chains are the only structural factor that could partly explain why almost half of US trade deficit originated from its trade with China. In recent decades, China has been used as an assembly center for various manufacturing products sold in the US market. For example, all iPhones sold to American consumers are first assembled in China and then shipped to the US. To assemble iPhones, China imports a lot of intermediate inputs from third countries, such as Japan, Korea, Taiwan and Germany. The value of these intermediates becomes part of China's trade surplus to the US. A substantial share of China's trade surplus with the US is in fact a transfer from third countries.[33]

<u>Declining US Manufacturing Industry</u>

The manufacturing industry plays a crucial role in the nurturing of the middle class in industrialized countries. Jobs in the manufacturing industry offer steady wage increases and stable fringe benefits because of productivity growth. By working in factories, even workers

[32] Bordo, M.D and McCauley, R. N (2017). "Triffin: Dilemma or myth?", BIS working paper. No. 684, 19 December 2017. https://www.bis.org/publ/work684.htm

[33] Xing, Y and Detert, D (2010). "How the iPhone widens the US trade deficit with PRC", Working paper No. 257, ADB Institute, December 2010. https://www.adb.org/publications/how-iphone-widens-united-states-trade-deficit-peoples-republic-china

without college degrees can achieve the dream of middle class—having a house and a car. However, the number of US manufacturing jobs shrank sharply. From 1999 to 2011, the US lost 5.8 million manufacturing jobs. Imports from China are blamed in part for the elimination of US manufacturing jobs. According to Autor, Horn and Hanson,[34] imports from China directly resulted in the loss of 550,000 manufacturing jobs. Including all indirect effects of Chinese imports, such as linkage and consumption effects, China's imports destroyed 2.4 million US jobs from 1999 to 2011. Those findings were published in the most prestigious economic journal, "American Economic Review" (AER), in an article titled "The China Syndrome: Local Labor Market Effects of Import Competition in the United States." To date, citations of that paper have exceeded 1600.

In 2016, AER published another paper, "Surprisingly Swift Decline of Manufacturing Jobs in the US" by Pierce and Schott.[35] The authors found that granting Permanent Normal Trade Relations to China, which eliminated potential tariff increases on Chinese imports, significantly contributed to a sharp decline in US manufacturing jobs. Industries more exposed to the change experienced greater employment loss and increased imports from China. The paper was cited almost 500 times in just two years.

American society has been debating the benefits and costs of trade with China for a long time. In 2004, US Public Broadcasting Service aired an one-hour program "Is Wal-Mart Good for America?."[36] It emphasized the job losses linked to the import of cheap Chinese goods by Wal-Mart, the largest retailer in the US (with more 4,000 stores and accounting for almost 10% of US imports from China). Robert Scoot,[37] a researcher at the Economic Policy Institute, estimates that Wal-Mart imports from China caused the loss of 400,000 US jobs. Prof. Peter Navarro, Assistant to President Trump and the Director of Trade and Industrial Policy of the White House, published a well-known book "Death by China: How America Lost its Manufacturing Base," in

[34] Autor, D, Horn, D. and Hanson, G. H (2013). "The China Syndrome: Local Labor Market Effects of Import Competition in the United States", *American Economic Review*. Vol 103 (6): 2121-68, 2013

[35] Pierce, J. R. and Schott, P. K (2016). "The Surprisingly Swift Decline of US manufacturing employment", American Economic Review. Vol 106 (7), 163-62, 2016

[36] PBS (2004). "Frontline: Is Wal-Mart good for America?", 16 November 2004. https://www.pbs.org/wgbh/pages/frontline/shows/walmart/

[37] Scott, R. E. (2015). "A conservative Estimate of the Wal-Mart Effect", Economic Policy Institute, 9 December 2015. https://www.epi.org/publication/the-wal-mart-effect/

which he accused Chinese imports of stealing American jobs and damaging the US manufacturing industry.

Because of the methodological flaws of these studies, US academics had rarely echoed those studies' criticism of the importation of Chinese goods. The publication of the above two articles in AEA signals a change in American academic opinion on Sino-US trade. The detrimental effects of Chinese imports on US employment have been gradually recognized and are now taking center stage in US academics.

<u>Rising Income Disparity</u>

Income disparity in the US has been a serious social problem. It has divided the American society. Most of the newly generated wealth of recent decades had been pocketed by the top 1%, or even the top 0.1% of Americans.[38] Many factors have contributed to the widening of income disparity between poor and rich, as exemplified by super-managers with multi-million dollar annual salaries, stock options, and higher returns on capital than the rate of economic growth. Globalization driven by trade liberalization and free capital mobility has also contributed substantially to the increase in income disparity in the US. Globalization primarily benefits the owners of capital, who can allocate their capital globally, and workers who are able to immigrate either legally or illegally to nations with high income. Workers who are not mobile, but have to produce goods competing with cheap imports, are the losers of globalization.

Efficiency and equity are the two objectives of resource allocation. In any economy, those two objectives cannot be achieved simultaneously without compromise. The unprecedented globalization since 1990s mainly improved the efficiency of resource allocation. As a consequence, equity has been compromised. Income disparity in the US has risen to a record high, almost matching that of the period before World War Two. From 1972 to 2013, the average annual income of the top 10% of Americans increased 70%, from $161,000 to $273,00. In contrast, the other 90% Americans saw their average annual income fall 15%, from $35,411 to $31,652. A Pew Research Center survey on the wealth of American families reveals a similar divergence between the top rich and the rest. From 1983 to 2013, the average wealth of the top 21% American families doubled from $318,100 to $639,400; the average wealth of the middle

[38] Piketty, T. (2017). Capital in the twenty-first century, Harvard University Press.

46% of families remained roughly constant, rising slightly from $94,300 to $96,500. In the same period, the wealth of the bottom 33% shrank to $9,300 from $11,400.[39]

Globalization is identified as one of factors driving down the minimum wage and the average wage of US manufacturing workers, in turn suppressing the income growth of low and middle income families and worsening income disparity. In 2013 the median real hourly wage of American automobile workers was $15.83, some three dollars less than ten years ago; during the period of 1979 to 2009, the real minimum wage fell from $8.38 to $7.25 per hour. Import competition and inflows of legal and illegal immigrants largely attributed to that fall in the real wages.[40]

More than a half century ago, Stolper and Samuelson[41] published "Protection and Real Wages" in the Review of Economic Studies. The paper demonstrates theoretically that, free trade, which generates net benefits for a country as a whole, always creates winners and losers, thus widening income disparity. When a nation opens to trade, even after taking relatively cheap imports into account, the real wage of workers in the sector competing with imports falls. The workers are the losers in international trade. Stolper and Samuelson suggest that tariffs could protect those losers. President Trump won the presidential election largely because of the votes of the losers left behind by globalization.

President Trump Promotes "America First"

During his presidential campaign, President Trump promised to American voters that American First would be the principle of his presidency. On September. 17, 2017, President Trump addressed the 72nd annual UN general Assembly in New York. He announced his American First policy to leaders from all of the world. He stated that, "as President of the United States, I will always put America first", and "The United States will forever be a great friend to the world, and especially to its allies. But we can no longer be taken advantage of, or enter into a one-sided

[39] Gordon, R.J. (2014). "The rise and fall of American growth", Princeton Press.

[40] Ibid

[41] Stolper, W.F. and Samuelson, P.A. (1941). "Protection and Real Wages", The Review of Economic Studies. Vol. 9(1): 58-73.

deal where the United States gets nothing in return. As long as I hold this office, I will defend America's interests above all else."[42]

The American Frist implies that President Trump cannot accept or tolerate any unfair trade rules and agreements. He has taken a series of unilateral actions to address the "unfairness" in international trade agreements. On day one at the White House, President Trump withdrew from TPP because it was a "bad" deal for America; he requested the re-negotiation of NAFTA, "the worst trade deal the US ever signed"; and ordered the 301 investigation of China's unfair practices related to technology transfer and intellectual property, and took its outcomes as legitimate reasons for the US to initiate a trade war.

President Trump also threatened to quit the World Trade Organization (WTO) if it did not treat the US better.[43] Of the 164 countries in the WTO, the US has the most open market and its average tariffs are the lowest. The US has huge trade deficits with its major trading partners, namely Japan, China and the EU, all of whom impose higher tariffs than the US on average. US market is indispensable for all other WTO members. Ironically, the WTO operates on one nation one vote rule. The voting power of the US is the same as that of any other member, no matter how small its economy. Even worse, to make any changes in WTO rules, consensus among the members is required. This implies that any member has de facto veto power. Reforming the WTO under the US initiatives is almost impossible.

The Trump administration is resorting to unilateral actions against its trading partners to reshape the global trading system because of its frustration with and disappointment in the WTO. In 1971, President Nixon exited the Breton Woods system as the US could no longer afford to redeem the dollar held by foreign governments with gold at the fixed price $35/ounce. Nixon's action shocked the world and prompted the collapse of the gold system. Today, the unilateral actions of the Trump administration have marginalized the WTO. A US withdraw from the WTO would severely cripple the post-World War II multilateral trading system originally through the US initiative.

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[42] Swanson, K. (2018). "Read: Trump's full speech to the UN General Assembly", VoX, 19 Sept 2017. https://www.vox.com/policy-and-politics/2017/9/19/16333290/trump-full-speech-transcript-un-general-assembly

[43] Micklethwait, J, Talev, M. and Jacobs, J. (2018). "Trump Threatens to Pull U.S. Out of WTO If It Doesn't 'Shape Up'", Bloomberg, 30 Aug 2018. https://www.bloomberg.com/news/articles/2018-08-30/trump-says-he-will-pull-u-s-out-of-wto-if-they-don-t-shape-up

4 Risks of the Trade War to the Chinese Economy

Tariffs raise the burdens of consumers and reduce their welfare. The US has started collecting tariffs on $250 billion in Chinese goods while China doing the same on $110 billion in American goods. Neither China nor the US would be immune to the detrimental effects of such a tit-for-tat trade war. There is no doubt that this emerging trade war is hurting both economies. The longer the trade war lasts, the higher the damage will be. The trade war is surely a lose-lose scenario.

ZTE, China's second largest maker of telecommunication equipment, is a noteworthy victim of the trade war. Amid rising trade tension between the US and China, the Trump administration announced a ban preventing American companies from selling components to ZTE. American-made microchips and software are essential for ZTE to manufacture its products, so the ban triggered the halt of ZTE stock trading and put the company's survival in question. After intensive negotiations between the governments of the two countries, the Trump administration lifted the ban, but requested that ZTE to pay a $1 billion penalty, put $400 million in escrow with an American bank and allow a team of American compliance monitors to supervise ZTE's operations for 10 years.[44]

The trade war also hit China's stock markets. The confidence of Chinese investors has been severely undermined by the uncertainty of the trade war. The index of Shanghai stock exchange broke the resilience threshold of 3,000 and fell below 2,700, plunging more than 20% since its peak in late January of 2018. The Shanghai Stock Exchange lost its title of second largest stock exchange to Tokyo stock exchange. Moreover, the Chinese yuan suffered from spillover from the trade-war. China's trade surplus with the US accounted for 85% of its overall trade surplus. The trade war will definitely worsen China's trade balance and exert a pressure on the yuan. The yuan weakened by almost 10% against the dollar to 6.90 yuan from a high of 6.28 in March. To some extent, the depreciation reflects market expectation of an evolving Sino-US trade war. Steady depreciation of the yuan may provoke capital outflows and endanger China's fragile financial system, so maintaining the stability of the yuan has been a top priority of the Chinese government.

[44] Ballentine, C. (2018). "U.S. Lifts Ban That Kept ZTE from Doing Business with American Suppliers", New York Times, 13 July 2018. https://www.nytimes.com/2018/07/13/business/zte-ban-trump.html

It is clear that China would lose much more than the US, because China has a $375 billion trade surplus with the US. Moreover, China's exports to the US accounted for 2.7% of its GDP, while US exports to China amounted to about 0.7% of its GDP. Relatively speaking, the Chinese economy is more dependent on the US market than vice versa.

China has been functioning as an assembly center of manufacturing products for the global market. A substantial portion of China's imports from the US has nothing to do with China's domestic demand, serving rather as intermediate inputs of exports. For instance, China imported $230 billion in IC chips from the US in 2015. Most of those imported IC chips were used for making iPhones, Sony digital cameras and Dell computers, all destined for foreign markets. On the other hand, China's exports to the US, such as textile products and ICTs products are final goods consumed by American consumers. This asymmetric dependence suggests that the Chinese economy is more vulnerable than the US to the trade war.

Many Chinese firms export goods to the US via global value chains (GVCs) led by foreign multinational firms. The Chinese firms simply receive orders to produce items demanded by lead firms of GVCs. The Chinese firms do not decide what to produce, where to sell it, or how to price their exports. If there are alternative factories in other countries, such as Vietnam, Indonesia, or India, which can produce the same products at comparable costs, the 25% tariff imposed on Chinese goods will prompt lead firms of GVCs to seek alternative suppliers in third countries and reduce their orders from China.

The Japanese company Mitsubishi Electronics used its Chinese subsidiary to produce machinery for the American market. To avoid US tariffs, it has decided to relocate part of its production facilities in China back to Japan. Asahi Kasei, one of the largest Japanese chemical firms, has also reshored the Chinese subsidiary (that had been serving the US market) back to Japan.[45] Many foreign companies have been employing China as an export platform to serve the US market. If the trade war continues, it is highly likely that more and more foreign companies will either move back home or to third countries.

[45] Nikkei (2018). "Mitsubishi Electronics relocated the Chinese factory to Japan because of the trade frictions", 28 Aug 2018. https://www.nikkei.com/article/DGXMZO34688880Y8A820C1TJ2000/

Will the trade war stop? Or, will it escalate to a full scale war with both sides levying tariffs on all imports from each other? Will the Chinese government target American companies with operations in China? These questions are already discouraging future foreign investment in China, and even worse, induce the relocation of foreign firms already in China to third countries. The uncertainty of the trade war is difficult to quantify, but the war could easily lead to cascade effects.

5. Rational Choices for China to Deal with the Trade War

Negotiation not Retaliation

Trade wars are always initiated by countries with trade deficits. It is not surprising that the US, which has a $375 billion trade deficit with China, fired the first shot in the ongoing Sino-US trade war. The aggression of the US should not be considered a sufficient reason for China to retaliate and carry on with tit-for-tat strategy. The experience of Japan in dealing with trade disputes with the US in the 1980s shows that proactive negotiations are a better choice than tit-for-tat strategy. In 1981, the American auto industry was mired in recession. Rising imports of Japanese cars prompted protectionism against Japan. In response to US criticism against the rapid growth of Japanese car imports, the Japanese Ministry of International Trade and Industry (MITI) initiated "voluntary exports restraint" (VER) and set an annual limit of 1.68 million units. The VER effectively alleviated the concerns of US auto industry, a major force behind the protectionism.[46]

As US trade deficit with Japan continued to rise, US trade friction with Japan escalated. The Reagan administration requested that Japan boosted its domestic demand by means of structural reforms and opening Japanese market to American companies through trade liberalization. The Nakasone administration set up many bilateral committees with US counterparts. Each committee focused on one industry, of which the US had complained about trade barriers. Because those committees failed to make any significant progress, former prime minister Nakasone proposed the appreciation of the yen as a solution. It was expected that yen

[46] Berry, S., Levinsohn, J. and Pakes, A. (1999). "Voluntary Export Restraints on Automobiles: Evaluating a Trade Policy", *American Economic Review*. pp. 400-431.

appreciation would be able to correct the bilateral imbalance between the two nations. The Regan administration agreed to Nakasone's proposal, which eventually led to "Plaza Accord", a famous agreement among US, Japan, UK, France and Germany for a joint intervention in foreign exchange markets to drive down the value of the US dollar. The intervention brought a sharp appreciation of the yen against the US dollar and instigated the age of clean floating of the yen.[47]

Debate remains as to whether the VER and the Plaza Accord effectively decreased US trade deficit with Japan. However, these initiatives surely prevented trade disputes from escalating into a trade war and effectively mitigated the tensions between the two nations. In recent decades, China has benefited tremendously from trade with the US, now the largest market for Chinese exports. Millions of jobs were created by Sino-US trade. It is in China's best interest to actively pursue negotiations with the US and prevent further escalation of the war. Apparently, tit-for-tat engagement is more damaging than constructive negotiation. As a matter of fact, if the Chinese government did not retaliate for the 25% US tariff imposed on the first $50 billion in Chinese goods, there would be no legitimate reasons for the Trump administration to levy 10% on other $200 billion in Chinese goods.

<u>Further Opening the Domestic Market</u>

When China entered the WTO in 2001, admitted as a developing country, it was seen as acceptable that China applied various trade instruments, such as tariff and non-tariff barriers, to shelter its domestic industries from foreign competition. Now, China has grown into the largest exporting country in the world, and "Made in China" products have successfully penetrated almost every corner of the global market. It is time for China to fulfill its responsibility to promote trade liberalization by further opening its domestic market, to imports from other countries.

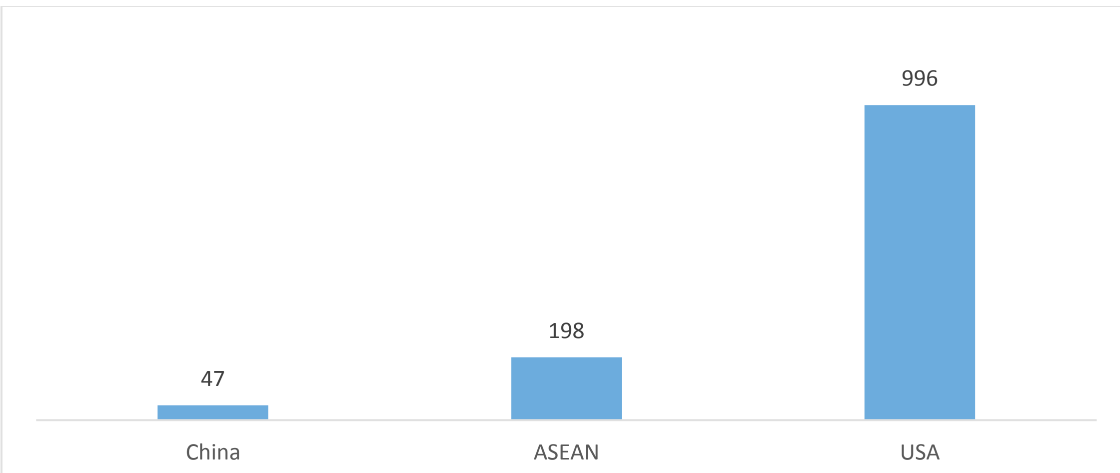
Despite $1.84 trillion in imports to China in 2017, most of which are natural resources and intermediate inputs, foreign access to the Chinese consumer goods market remains very limited. In 2017, China imported $65.7 billion in consumer goods, about 3.6% of its total imports.[48] On average, consumer goods import per capita was just $47, much less than $198 for ASEAN

[47] Funabashi, Y. (1989). "Managing the dollar: from the Plaza to the Louvre", *Institute for International Economics*

[48] Lest, S and Zhu, H. (2018). "The WTO still considers China a 'developing nation.' Here's the big problem with that", CNBC, 25 April 2018. https://www.cnbc.com/2018/04/25/what-trump-gets-right-about-china-and-trade.html

countries and $996 for the US (Figure 3). It is estimated that China's domestic retail sales (reaching $5.7 trillion in 2017) have surpassed those in the US. However, China's import of consumer goods accounted for a merely 1.15% of retail sales. Chinese tourists' zealous shopping behavior overseas and the popularity of parallel trade among Chinese consumers suggest a shortage of foreign consumer goods in the Chinese market. There is great potential for China to further open its home market to foreign goods. It is time for Chinese consumers to embrace "Made beyond China." The Trump administration's demand for fair trade and reciprocity actually aims to open the Chinese market to American products.

Figure 3 Imports of Consumer Goods per Capita (US Dollar)



Source: the author's calculation and Thorbecke (2016)

A large but closed home market is meaningless to foreign producers. If and only if China opens its market to the rest of world, the size of the Chinese market can be used as a bargaining power at trade negotiation tables. The Trump administration confidently launched trade wars against both China and its major allies, simply because US market is the most open and is indispensable to those countries. Hank Greenberg, founding chairman and CEO of American International Group, writing in the Wall Street Journal, publicly advised Chinese leaders in the Wall Street Journal, "you can't expect to keep receiving favorable trade and investment terms unless you reciprocate." Mr. Greenberg has been a long-time friend of China and supportive of China's entry into the WTO. Regarding the Sino-US trade war, he commented "It is in China's interest to reform, the US is right to press to level the playing field."[49]

The Chinese government has unilaterally slashed its tariffs twice. China could do more to lower tariffs, for instance cutting its tariff on automobiles to 10% or even lower and reducing its tariff on American beef. In addition to tariffs, non-tariff barriers remain a major obstacle to imports. Regulations and documentations for governing the imports of foreign food, cosmetics and pharmaceutical products are badly in need of simplification. Google, Facebook and Twitter are not available in China. Protecting national security is a legitimate reason to ban these digital services in China. Given the monopoly of Baidu and Tencent in China's domestic market, there is a question as to whether the "national security" argument actually functions as a non-tariff barrier to foreign digital service providers. Gradually lifting the ban on foreign digital service providers, among whom the US has a comparative advantage, would ease the tension between the two nations.

Strengthening Economic Integration with Japan and the EU

Besides the US, Japan and the EU are also important markets for Chinese exports. Strengthening economic relations with Japan and the EU would reduce China's dependence on the US market and act as a counter to the protective measures of the US. Many Japanese and European companies are rivals of American companies. If Japanese and European companies could enjoy preferential treatment in the Chinese market, they would gain an advantage in the competition with American companies, which could pressure the Trump administration to soften its stand on the Sino-US trade disputes.

After President Trump withdrew the US from TPP, Japan turned to the EU and signed the Japan-EU Economic Partnership agreement, which removes 99% of Japanese tariffs on EU products and 94% of EU tariffs on Japanese imports. The agreement opens the EU market to Japanese automobiles and the Japanese market to beef, dairy products and wines from the EU. That agreement may encourage the US return to multilateral trade negotiations, such as TPP.

[49] Greenberg, R. M. (2018). "Some friendly advice for China's leaders," Wall Street Journal, 21 Aug 2018. https://www.wsj.com/articles/some-friendly-advice-for-chinas-leaders-1534890276

The Japan-EU agreement abolishes most of the protection of the Japanese agriculture sector, trading the interests of Japanese farmers for those of auto workers. Japanese famers are the losers in the agreement; they had been loyal supporters of the incumbent party—Japan's Liberal Democratic party (LDP). Politically it was very risky for the Abe administration to betray the LDP's long-term loyal constituents. This is the cost that the Abe administration has to pay for pursuing access to alternative markets and implicitly counterbalancing the US withdrawal from TPP.

A China-EU FTA and a China-Japan-Korea FTA are both possible options for China to counterbalance the pressures of the US. To achieve these objectives, China should make substantial concessions in terms of opening its domestic market. The China-Japan-Korea FTA (CJK) has been delayed for a long time because of deteriorated bilateral political relations between China and Japan. Conclusion of If CJK would form a free trade block covering the three largest economies of Asia. This would offer an alternative for China to expand its overseas market, and to attract investment and acquire advanced technology.