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Briefing: Why There Might Be a US-China Trade War

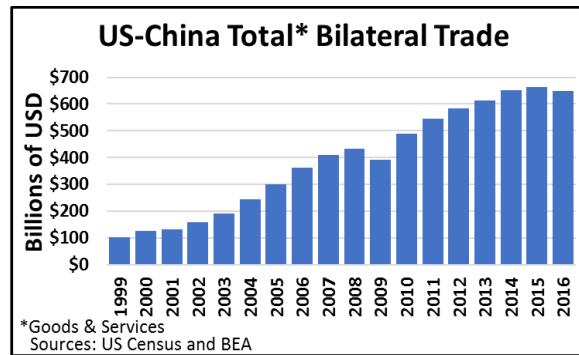
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Purpose and Outline: This brief examines the US-China economic relationship and argues that their respective economic policies have become inherently conflictual. These policies are grounded in conflicting perceptions about their economies and the costs and benefits of the trade relationship. After a quick overview of both economies and the US-China trade deficit, the brief therefore outlines these perceptions and concludes by assessing their validity.

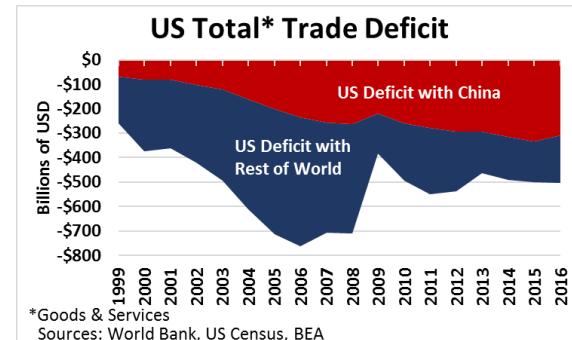
I. Economic and Trade Overview

The US and China are without economic parallel on the global stage. With economies valued respectively at \$19.3 trillion and \$23.1 trillion, they together compose roughly 34 percent of the world's gross domestic product (GDP) when their economies are adjusted for purchasing power parity (PPP).¹ Much of the prosperity enjoyed by Americans and Chinese is of course grounded in their bilateral trade in goods and services,² which in 2016 totaled \$649 billion. Importantly, the gigantic sizes of the US's and China's economies mask critical differences in the nature of their economies, and these contrasts influence perceptions about trade in both Washington and Beijing.



II. Perceptions about Trade

The American View: Having been surpassed by China in terms of national-level GDP in 2014, many Americans, including President Donald Trump, worry that the US is declining economically, and that "unfair" international trade policies and practices are to blame. Although the US suffers a total trade deficit with many countries, China is singled out both because of the size of its economy and because of its direct contribution to America's global trade deficit. On the latter point, the trade deficit with China has constituted more than 50 percent of America's overall deficit since 2009, peaking at 67 percent in 2015 when it composed \$309 billion of a \$505 billion international trade deficit.



¹ This brief measures GDP at PPP unless otherwise stated.

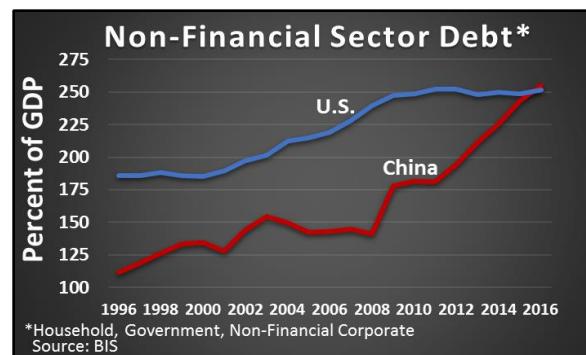
² This brief examines "total trade"—i.e., trade in both goods and services. Because most analyses consider only trade in goods, the data and findings presented here will differ somewhat from other research.

The fact that China exports to the US many of the cheap and low-tech manufactured products that are no longer made in America contributes to a sense that Chinese exports have “hollowed out” American industry.

Also galling are three restrictions that Beijing often places on foreign companies operating in certain industries within China. First are demands that foreigners transfer valuable technology as a price for market entry. Second is a policy mandating that foreign companies must partner with Chinese businesses. Moreover, within these joint ventures, foreign companies are generally not permitted to own a controlling stake. Finally, Beijing restricts market access in the service industries that America typically dominates globally —e.g., internet technology, insurance, and finance. Most famously, while Google, YouTube, Facebook, and Twitter dominate much of the globe, they have no presence in China due to aggressive state censorship.

The Chinese View: If Americans worry about being on the losing end of a rigged trading regime, the Chinese Communist Party (CCP) and its leadership remain preoccupied with a two-fold goal: 1) Catching up to the US and its wealthy allies economically; and 2) maintaining their political preeminence domestically. Neither concern is without merit. Indeed, despite its larger GDP China continues to be much poorer than the US on a per-person basis, with a 2017 GDP per capita of just \$15,151 compared with the US's \$54,223. Moreover, Beijing faces far more serious economic headwinds than does Washington, including a rapidly aging population, a shrinking work force, and a quickly cooling economy. Average GDP growth of 10 percent per year, as experienced from 1980-2012, is a phenomenon of the past, having been replaced with a forecasted rate of just 5.1 percent annual growth by 2021.

Sober-minded Chinese realize that a rapidly accrued, massive debt burden greatly compounds their economic problems. While Americans tend to be preoccupied by US government debt, few are aware that China's non-financial sector debt surpassed America's around 2016, when China's reached 255 percent of GDP. More troubling, much of China's non-financial sector debt issuance has been recent, expanding faster than GDP growth by over 80 percent from 2008-2016. When one includes estimates of the indebtedness of financial corporations, total Chinese debt was around 320 percent of GDP in 2016, while the US's was 286 percent. To summarize the economic problems faced by Beijing, China has clearly failed to achieve its goal of getting rich before getting old, and its debt-addicted economy no longer responds robustly to massive infusions of borrowed money. It remains unclear how China will negotiate its way through its current economic difficulties.



Beijing's Mandarins have long-viewed the granting of access to their domestic market to be an opportunity to obtain economy-boosting concessions such as the aforementioned, mandatory technology transfers and China-dominated joint business ventures. Chinese leaders have nevertheless

simultaneously worried that permitting foreigners and foreign ideas into China could erode their ability to control information. They fear in particular that criticism of the CCP and its leadership could lead to widespread social upheaval, the consequent erosion of CCP rule and, eventually, the calamitous defeat and replacement of “Chinese” civilizational norms by “Western” ones. These national security concerns explain why the CCP has only reluctantly granted foreign firms access to sensitive portions of China’s service economy. From the Chinese point of view, it is merely coincidental that the US excels in service provision and that shutting off much of China’s service sector has permitted those portions of the domestic economy to grow largely unfettered by foreign competition.

III. Assessment of Perceptions

Assessing the American View: Although the US’s point of view is not without merit, especially regarding Chinese protectionism in its service industry, careful analysis suggests it lacks nuance in at least four ways. First, the US’s trade deficit with China is not quite as large as it seems. It is inaccurate because both China and US import many of the raw materials and components that they transform into manufactures for export. In 2014, for example, 29.4 percent of the value of Chinese goods exports was produced elsewhere; the corresponding American figure was 15.3 percent. Adjusting the 2014 trade deficit in *goods* in 2014 by the “value-added” data reduces the *goods* deficit that year from \$345 billion to \$226 billion, a not unsubstantial reduction of 34.4 percent. A second problem with American thinking is that most of the US’s lost manufacturing jobs did not fall victim to globalization, but to technology-driven productivity gains. One influential study found that only 15 percent of the US’s missing manufacturing jobs were lost to imports. Third, trade with China has produced some positive results, such as sharply falling prices on many of the consumer goods purchased in the US, including by poor Americans. Finally, America’s low savings rate at the household and government levels, especially, compels a large percentage of the trade deficit. Because the US spends more money than it earns, it must either print money, sell treasury bonds or assets to foreigners, or import goods and services. In recent years the US has done all three, although the Federal Reserve’s recent monetary policy was guided much more by the imperatives of the Great Recession than by the imbalance in American finances.

Assessing the Chinese View: If the US viewpoint is missing nuance, China’s is more difficult to assess because much of it is only indirectly related to issues of trade. Part of the problem is that China does remain underdeveloped compared with the world’s wealthiest countries, is getting old before becoming wealthy, and is suffering from an economy both weighed down by, and addicted to, debt. But these kinds of considerations objectively inform two-way trade only to the extent that China’s trade partners also perceive the health of the Chinese economy to be critical to their own economies. If countries such as the US believe that China is more of an economic burden than a boon, their leaders will undoubtedly be unmoved by reports of China’s deteriorating economy.

Easier to assess are China’s demands for technology transfers and joint business ventures, and Beijing’s closure to foreigners of large swaths of its national service industry. While these practices do not directly contravene World Trade Organization (WTO) policies, they are protectionist measures that contribute directly and powerfully to the sense that commerce with China is not conducted on a level

playing field. Moreover, some of these policies have begun harming China economically. Granting market access to Western banks, for example, would result in money being directed more judiciously to the portions of the economy that are thriving and competitive, rather than to inefficient companies that are politically powerful. Similarly, introducing foreign competition in the insurance industry would compel Chinese companies to improve their underwriting standards and investment policies. Both outcomes would increase productivity in China and reduce China's trade surplus with the US and the world. Until leaders in Beijing perceive that the benefits of fully opening their service industry to foreigners outweigh the costs, the US-China trade relationship will likely remain conflictual.