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The Outbreak of a US-China Trade War

- The Trump administration's priorities, the shift from economics and domestic issues to geopolitics

(1) A US-China trade war should shape our views of all events

The shift from Gary Cohn to trade hardliners Ross, Lighthizer and Navarro

President Trump appears to have finally reached the point of asking for a plan for reducing the trade deficit with China. Actions are under way concerning tariffs (steel and aluminum import duties) and trade friction (such as the emergency imposition of emergency import restrictions on solar panels and large washing machines under Section 201 of the Trade Act of 1974). The start of a trade war with China is the only possible interpretation of these measures. Gary Cohn, who was previously at Goldman Sachs, has resigned as director of the National Economic Council. Media reports indicate that Peter Navarro, who had been on the sidelines, has regained a prominent role involving trade policies. President Trump has dealt with deregulation, tax reform and illegal immigration in rapid succession. Now, actions concerning trade war with China have clearly become his highest priority.

Containing China's economy has become the highest priority of the US

There is no doubt that containing China as much as possible is now the most important issue for the United States. China is currently showing increasing signs of becoming an autocratic country centered around a personality cult. (For more information, see the remarks from the article in the Economist and by Yoshihisa Komori of the Sankei Shimbun at the end of this document.) During the election campaign, President Trump promised to name China a currency manipulator on his first day in the White House. Now he has finally reached the point of taking this action. If nothing is done about the increasing strength of China's economy, this autocratic country may replace the United States as the world's premier power. Chinese hegemony would dramatically alter the global order. The Trump administration's stance is that China has grown to this point by benefiting from the "free ride" of a massive trade surplus with the United States. President Trump's real goal is to stop this free ride as quickly as possible. The resignation of Mr. Cohn, who was unable to comprehend this stance, was thus a natural outcome of this situation.

Tariff and North Korea actions are also linked to policies for containing China

China is now the primary target for policies of the US government. As a result, the North Korea problem should be resolved as one element of these China policies. The Trump administration is gradually moving to a position of appeasement regarding North Korea. But President Trump has no option other than to refrain from a military attack while seeking negotiations with North Korea. Using force is not an option because it would most likely give China an even greater chance to take advantage of opportunities. Furthermore, trade friction with countries other than China will probably not increase and the dollar is unlikely to become weaker. Consequently, these events have positive implications for investments.

The rationality behind the emergence of Donald Trump

The emergence of Donald Trump was inevitable even though voters barely selected him over his opponent. It could be thought that his victory might have raised three key issues and solutions for them. The first was economic issues: the income gap, white workers who were left behind as the US economy boomed, the accumulation of idle capital and savings, and the loss of animal spirits. President Trump has responded with

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Keynesian policies, measures to create effective demand and deregulation. The second issue was the crisis sentiment about geopolitical events and international relations. China is becoming stronger, there are concerns about retaining US hegemony, and the international order exists only in name. President Trump has responded with bilateralism, the restructuring of multinational institutions, and the use of force for peace. The third issue involved value systems and stances based on idealism, liberalism and distributism. For example, there was too much emphasis on idealism like political correctness solely for the sake of appearance. President Trump has responded by rigorously enforcing the rule of law, fostering self-responsibility and libertarianism, making big changes in government officials, including a Supreme Court justice, and using Twitter to counter the mass media, which are using existing value systems to criticize the president.

The Trump administration has completed its initiatives concerning the first issue, economics, and the third issue, values. Now he is apparently turning his attention to the second issue, geopolitics and international relations. This shift is clearly evident in the departure of Mr. Cohn, who was in effect the control tower for economic policy.

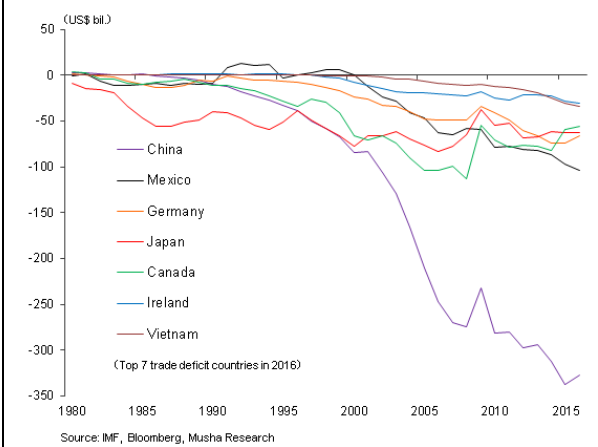
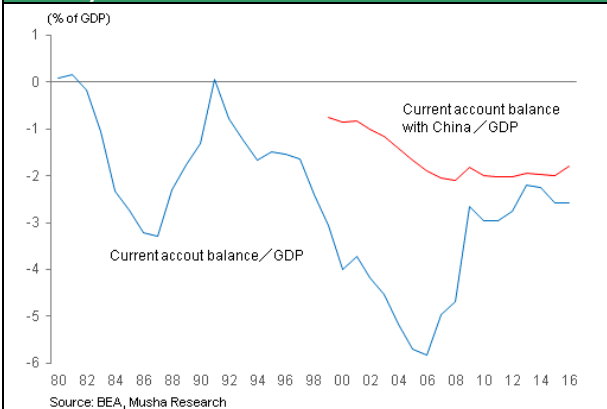
Bilateralism – The actual target is China and the need to end its free ride

The Trump administration is focusing on bilateral rather than multinational negotiations. Leaving the Trans-Pacific Partnership (TPP) and renegotiating NAFTA are two examples of this position. President Trump apparently believes that containing the rising economic strength of China, which is a heterogeneous country, would be impossible by relying on multinationalism. An investigation and negotiations have started that may result in the use of Section 301 of the Trade Act of 1974 against China. Emergency import restrictions have already been enacted under Section 201 of this act for imported solar panels and large washing machines. US Trade Representative Robert Lighthizer, who has a reputation as a tough negotiator regarding China, has stated that it was a mistake to allow China to join the WTO. This equates to a declaration of a trade war with China due to its widespread use of unfair trade practices.

On the other hand, at the World Economic Forum in Davos, Switzerland at the end of January, President Trump said he may start negotiations for rejoining the TPP. The president is considering a return to carefully selected multinational agreements while using bilateral negotiations to greatly increase pressure on China. All these actions are concealing the true enemy: China. The WTO is not the only international organization that is declining. This is also true of the United Nations, where China and Russia have Security Council veto power and are flagrantly making changes. In fact, the restructuring of these international organizations may be the actual goal of the Trump administration. This is why people are probably mistaken to view President Trump as simply a person who embraces unilateralism, isolationism and protectionism.

The US has made big contributions to China's economic growth

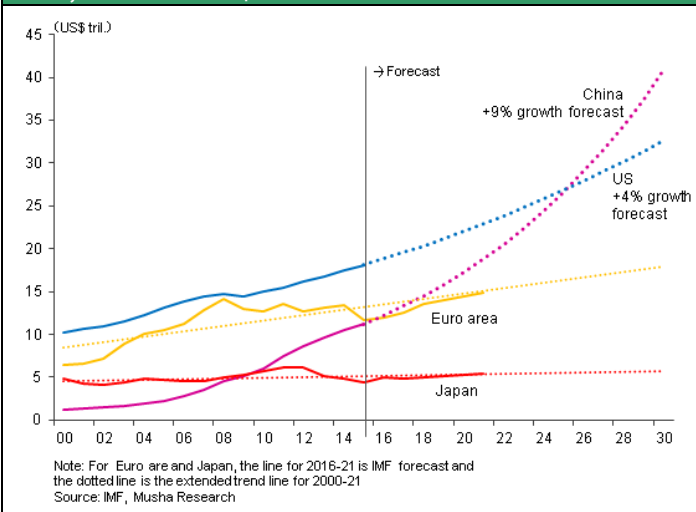
China accounts for about half of the US trade deficit, as you can see in Figure 1. No significant trade imbalances exist with any other country. The enormous trade surplus with the United States has enabled China to grow for many years. Figure 2 shows the US current account deficit as a percentage of the GDP. This deficit peaked at 5.7% of GDP in 2006 and was much lower at 2.6% in 2016. However, the US current account deficit with China has been steady at just under 2% during this period. That means China received a huge amount of income from the United States every year that was equivalent to 2% of the US GDP. This income transfer enabled China to sustain strong economic growth. But now that China is showing signs of challenging US hegemony, the United States can obviously no longer do nothing as this contribution to China's economy continues.

Figure 1: US trade balance by partner country**Figure 2: US current account balance (with China) / GDP**

How to avoid a clash between the US and China

Peter Navarro, a University of California professor, oversees trade policies for the Trump administration. In his book “Crouching Tiger – What China’s Militarism Means for the World,” Mr. Navarro said there will be no change in the pursuit of hegemony by China, which has an autocratic communist government. He believes this pursuit will inevitably lead to a clash with the United States. Avoiding this clash will require weakening the Chinese economy, which is the foundation for increasing the country’s military strength. At the same time, US military strength must be increased. He thinks this is the only way to suppress any desire of China to challenge US global leadership.

Figure 3 shows nominal GDP data and forecasts for the United States, China, Japan and Europe (the eurozone). China’s GDP surpassed Japan in 2009 and the eurozone in 2016. If China’s GDP growth continues at this rate, the country will pass the United States in 2026. But there is no reason to expect the United States to continue giving China a free ride and to do nothing to prevent China from having the world’s largest GDP. This outlook clearly demonstrates the critical importance to the United States of a trade war with China.

Figure 3: GDP trends of US, China, Japan and Euro area, nominal US\$ base

(2) Selected passages, some paraphrased, from “What the West got wrong” in the March 3-9 issue of The Economist:

Last weekend, China stepped from autocracy into dictatorship. This is strong evidence that the West’s 25-year bet on China has failed. After the collapse of the Soviet Union, the West welcomed China into the global economic order and gave China WTO membership. Western leaders hoped that China’s evolution into a market economy would

make the people of China wealthier. Then the people would come to yearn for democratic freedoms, rights and the rule of law. Today the illusion has been shattered. Mr. Xi has steered politics and economics towards repression, state control and confrontation. With politics, Mr. Xi has used his power to reassert the dominance of the Communist Party and his own position within it. He has imprisoned free-thinking lawyers and stamped out criticism and is creating a surveillance state. Increasingly, China holds its authoritarian system up as a rival to liberal democracy.

China's integration into the global economy made the country the world's biggest exporter, created extraordinary prosperity and yielded other benefits. Yet China is not a market economy and, on its present course, never will be. Instead, it increasingly controls business as an arm of state power. Its "Made in China 2025" plan, for instance, sets out to use subsidies and protection to create world leading companies. Western companies still complain of state-sponsored raids on their intellectual property.

China uses business to confront its enemies. Mercedes-Benz was recently obliged to issue a grovelling apology after unthinkingly quoting the Dalai Lama online. When the Philippines contested China's claim to Scarborough Shoal, China suddenly stopped buying its bananas, supposedly for health reasons. This "sharp power" in commerce is a complement to the hard power of armed force. China behaves as a regional superpower bent on driving America out of East Asia. The pace of Chinese military modernisation and investment is raising doubts about America's commitment to retain its dominance in the region.

What to do? The West has lost its bet on China, just as when its own democracies are suffering a crisis of confidence. The Trump administration should ask for changes in China's policies rather than start a trade war. The longer the West grudgingly accommodates China's abuses, the more dangerous it will be to challenge them later. Western societies should shed light on links between independent foundations and the Chinese state. The West should scrutinise investments by state-owned companies to watch for improper actions. The WTO and other international organizations that protect the Western rule of law should be used. President Trump should demonstrate his commitment to America's allies by reconsidering membership of the TPP. To counter China's hard power, America needs to invest in new weapons systems.

(3) The time for optimistic expectations is over – The US is about to drastically alter its China policy

Remarks by Yoshihisa Komori of Sankei Shimbun Co., Ltd. (summary from the March 7 Japan Business Press)

The US policy of "engagement" with China is about to come to an end. The administrations of US presidents have been using an engagement policy until now. They expected that cooperation with China would make the country a responsible member of the global society and start moving toward democracy. However, we must now conclude that this policy has failed. The United States is now at a historic turning point where the basis for its China policy will be revised for the first time since diplomatic relations began about 40 years ago.

Since the establishment of US-China diplomatic relations in 1979, engagement was the nucleus of the China policies of the administrations of all US presidents. The United States helped China to become more prosperous and powerful. The belief was that this assistance would draw China into the existing international order, making the country more free and open. China would then be a responsible member of the global society. This scenario is the engagement policy. However, by eliminating term limits on the presidency, China has opened the way for President Xi Jinping to remain in office indefinitely. Moreover, China has repeatedly taken actions that went in the opposite direction of US expectations (aggressive overseas expansion, ambitious military buildup, disregard for international norms, unfair trade practices, and increased oppression and strengthening of dictatorship at home). As a result, the United States has been forced to admit that its policy of engagement was a failure.

Let's look at how the US news media, knowledgeable observers and the Trump administration have each reacted to the results of engagement. A February 28 New York Times editorial illustrates the media's response. Titled "Xi Jinping Dreams of World Power for Himself and China," the editorial includes the following statement. "Since China began to open to the West in the late 1970s, the United States and its allies have tried to integrate it into the political and economic system they built after World War II, hoping that economic progress would lead eventually lead to political liberalization. Mr. Xi's move proves that policy has failed and that China will set its own path, challenging the liberal order based on the rule of law, human rights, free-market economics and a preference for elected leaders." The New York Times therefore proclaimed that the long-standing China policy of the United States ended in failure. The Washington Post made similar remarks in a February 27 column titled "Will Xi Jinping be China's ruler for life?" This article noted that the United States expected China to switch to a political system and rule of law based on what the public wants. The article criticized this end of term limits for the president, saying this is a move in the opposite direction of US expectations. Furthermore, the article stated that this marked the demise of a long-standing US policy.

Next is the views of knowledgeable observers. Kurt Campbell played a central role in China policies as Assistant Secretary of State for East Asian and Pacific Affairs in the Obama administration. An article titled "How Beijing Defied American Expectations" by Mr. Campbell was in the latest edition of Foreign Affairs magazine. Mr. Campbell explained that the basis for China policies of successive US administrations was the hope that building deeper commercial, diplomatic and cultural ties with China would result in internal growth and alter the country's words and deeds in a positive way. But it is now clear that changing China's actions as the US wanted is not possible. A frank recognition of the failure of previous US government China policies to achieve goals will be needed in order to determine how to deal with China from now on. Mr. Campbell was one of the key people in the Obama administration who backed an extremely reconciliatory approach to China. Now, a person who adopted this position is honestly admitting that his policies were wrong.

Steven Bannon, former White House Chief Strategist in the Trump Administration, is a hardliner regarding China. He is firmly opposed to engagement. Immediately after leaving the White House, Mr. Bannon was invited by the Council on Foreign Relations, a major diplomatic policy research organization, to give a speech about US-China relations. He gave the speech with the expectation of being criticized for his tough stance regarding China. However, during the question and answer session afterward, bipartisan former bureaucrats, diplomatic professionals and people from the academic community said that the Trump administration's China posture was still too weak. Mr. Bannon and the Trump administration were both criticized for being too weak about China. Apparently, Mr. Bannon was surprised to see this reaction.

The third is the Trump administration's reaction. The president spoke on February 23 at a general assembly of a conservative political organization. Mr. Trump pointed out that since joining the WTO in 2000, China has grown to become an enormous trading country with an annual US trade surplus of about \$500 billion. It means that the US decision to support China's WTO membership was a mistake. Support for WTO membership was at the heart of the US engagement policy for China at that time. Therefore, this statement signifies that Mr. Trump is critical of engagement. Furthermore, in the National Security Strategy announced in the middle of December 2017, the Trump administration stated that this China engagement policy will be eliminated. "For decades, U.S. policy was rooted in the belief that support for China's rise and for its integration into the post-war international order would liberalize China. Contrary to our hopes, China expanded its power at the expense of the sovereignty of others. China gathers and exploits data on an unrivaled scale and spreads features of its authoritarian system, including corruption and the use of surveillance."

As you can see, the United States has advanced to the stage where the China engagement policy has already been abandoned. The fundamental shift in the US stance regarding China will also significantly influence Japan in many ways.