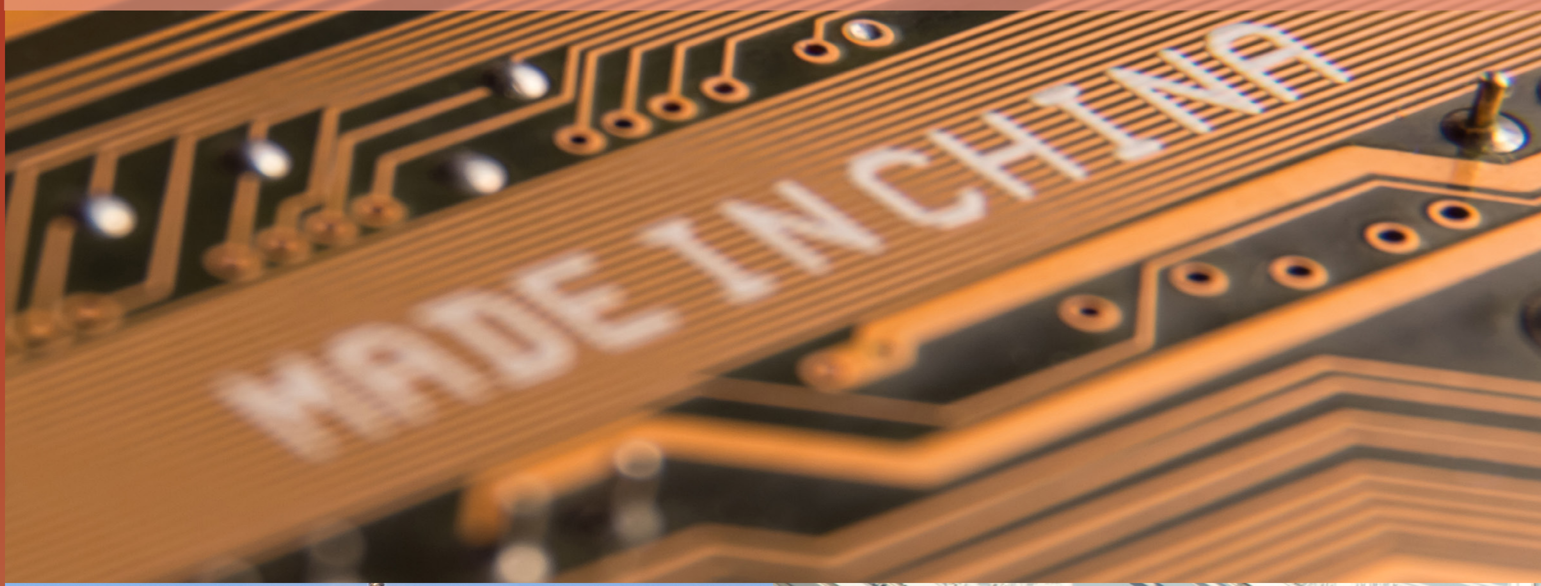
THE NATIONAL BUREAU *of* ASIAN RESEARCH

NBR SPECIAL REPORT #76 | FEBRUARY 2019

ANSWERING CHINA'S ECONOMIC CHALLENGE

Preserving Power, Enhancing Prosperity

By Charles W. Boustany Jr. and Aaron L. Friedberg



THE NATIONAL BUREAU *of* ASIAN RESEARCH
NBR SPECIAL REPORT #76 | FEBRUARY 2019

ANSWERING CHINA'S ECONOMIC CHALLENGE

Preserving Power, Enhancing Prosperity

Charles W. Boustany Jr. and Aaron L. Friedberg

The first report of

THE TASKFORCE ON TRANSFORMING THE ECONOMIC DIMENSION OF U.S. CHINA STRATEGY

THE NATIONAL BUREAU *of* ASIAN RESEARCH

The NBR *Special Report* provides access to current research on special topics conducted by the world's leading experts in Asian affairs. The views expressed in these reports are those of the authors and do not necessarily reflect the views of other NBR research associates or institutions that support NBR.

The National Bureau of Asian Research is a nonprofit, nonpartisan research institution dedicated to informing and strengthening policy. NBR conducts advanced independent research on strategic, political, economic, globalization, health, and energy issues affecting U.S. relations with Asia. Drawing upon an extensive network of the world's leading specialists and leveraging the latest technology, NBR bridges the academic, business, and policy arenas. The institution disseminates its research through briefings, publications, conferences, Congressional testimony, and email forums, and by collaborating with leading institutions worldwide. NBR also provides exceptional internship opportunities to graduate and undergraduate students for the purpose of attracting and training the next generation of Asia specialists. NBR was started in 1989 with a major grant from the Henry M. Jackson Foundation.

Funding for NBR's research and publications comes from foundations, corporations, individuals, the U.S. government, and from NBR itself. NBR does not conduct proprietary or classified research. The organization undertakes contract work for government and private-sector organizations only when NBR can maintain the right to publish findings from such work.

To download issues of the NBR *Special Report*, please visit the NBR website http://www.nbr.org.

This is the seventy-sixth NBR *Special Report*.

NBR is a tax-exempt, nonprofit corporation under I.R.C. Sec. 501(c)(3), qualified to receive tax-exempt contributions.

For further information about NBR, contact:

The National Bureau of Asian Research
1414 NE 42nd Street, Suite 300
Seattle, Washington 98105

206-632-7370 Phone
206-632-7487 Fax
nbr@nbr.org E-mail
http://www.nbr.org

ANSWERING CHINA'S ECONOMIC CHALLENGE

Preserving Power, Enhancing Prosperity

TABLE OF CONTENTS

THE NATIONAL BUREAU *of* ASIAN RESEARCH

NBR SPECIAL REPORT #76 | FEBRUARY 2019

Answering China's Economic Challenge: Preserving Power, Enhancing Prosperity

Charles W. Boustany Jr. and Aaron L. Friedberg

CHARLES W. BOUSTANY JR. is a Counselor at the National Bureau of Asian Research. He is Co-chair and a Principal Investigator of the Taskforce on Transforming the Economic Dimension of U.S. China Strategy. He can be reached at <tradecenter@nbr.org>.

AARON L. FRIEDBERG is Professor of Politics and International Affairs at Princeton University. He is Co-chair and a Principal Investigator of the Taskforce on Transforming the Economic Dimension of U.S. China Strategy. He can be reached at <alf@princeton.edu>.

EXECUTIVE SUMMARY

This initial report of the Taskforce on Transforming the Economic Dimension of U.S. China Strategy examines the origins, evolution, and troubling implications of China's "mercantilist Leninist" economic policies; considers how the U.S. should define its objectives in responding to this challenge; and explores the prospects for negotiating a satisfactory settlement to the current trade standoff.

MAIN ARGUMENT

The U.S. and China have reached a turning point in their economic relations and are currently locked in a serious trade skirmish, if not yet a full-blown trade war. Negotiations are ongoing, but the possibility of reaching an agreement that will offer a satisfactory long-term outcome for the U.S. is far from clear. China's strategy has been to engage economically with the world while resisting pressure to transform its political system and economic policies. China's leaders view economic policy as an instrument for achieving their grand strategic objectives of preserving the Chinese Communist Party's monopoly on domestic political power and restoring the country to its historic position as the preponderant power in eastern Eurasia and, eventually, the world. Today's controversies over trade, investment, and technology are thus only one part of a much larger rivalry between competing systems and worldviews, and the current standoff over tariffs is only the first skirmish in what seems certain to be a protracted and difficult campaign.

POLICY IMPLICATIONS

U.S. policy for managing the current standoff with China should include the following elements:

- Keep up the pressure and resist demands to lift tariffs in return for anything less than significant, verifiable progress in rolling back China's aggressive and market-distorting trade, industrial, and technology promotion policies. The U.S. should not settle for a deal that simply reduces the trade deficit but otherwise codifies the *status quo ante*.
- Extend time horizons and mobilize public support by raising awareness that failure to address challenges now will likely lead to even greater costs in the future.
- Build maximum aggregate leverage by assembling a coalition of states that share concerns about China's predatory policies and unfair trading practices and working with them to establish trade and investment agreements that adhere to high standards.
- Intensify defensive measures by coordinating with allies and like-minded partners to protect against Chinese economic penetration and exploitation of their national economies.

The United States and China have reached a turning point in their economic relations and perhaps in the broader trajectory of their diplomatic and strategic relationship as well. Since the inauguration of Donald Trump in January 2017, the U.S. government has imposed several rounds of tariffs on a wide swath of Chinese goods, enhanced scrutiny of potential investments by Chinese firms, and begun to explore ways to tighten controls on the sale or transfer of technology by U.S. companies to their Chinese counterparts. Beijing has responded by raising tariffs on selected U.S. products. While it has thus far been cautious, Beijing could easily take other measures to interfere with the operations of U.S. companies in China. Following a meeting between Presidents Trump and Xi Jinping on December 1, 2018, the two sides announced that they would hold back from imposing tariffs on additional items or raising the levels of tariffs already imposed, allowing a 90-day period for further negotiations. Talks are ongoing, with no clear outcome yet in sight.

Washington and Beijing are thus locked in a serious trade skirmish, if not yet a full-blown trade war. Some observers warn that current tensions could mark the start of a process of "decoupling," "disentanglement," or "divorce" between the world's two largest economies, the end of the era of engagement, and perhaps even the onset of a new Cold War.[1] Along with their more immediate effects on levels of trade and growth, decisions made in both capitals in the coming months could restructure the global economy and reshape relations between the two Pacific powers for decades to come.

What follows is the first of two reports drawing on the deliberations of a taskforce launched by the National Bureau of Asian Research in May 2018 to re-examine the economic dimension of U.S. strategy toward China. Sponsored by a grant from the Sarah Scaife Foundation, the taskforce is a nonpartisan effort, co-chaired by former congressman Dr. Charles Boustany Jr. of Louisiana and Professor Aaron Friedberg of Princeton University, that includes over a dozen specialists from a variety of disciplines. The group met five times during the second half of 2018 and will continue its deliberations during the first half of 2019, with a second and final report planned for mid-2019.

The goal of the taskforce is to provide answers to four sets of questions:

- First, what is the nature of the challenge to U.S. interests posed by China in the economic domain? What are Beijing's objectives, how is it seeking to use economic means to achieve them, and what would be the implications for the future security and prosperity of the United States and other countries if it succeeds?
- Second, in light of these considerations, is a satisfactory negotiated settlement to the current standoff between the United States and China over trade issues feasible? If so, what would it look like and how can it be achieved?
- Third, what is the likelihood and what would be the costs, risks, and potential benefits of at least a partial "disengagement" or "disentanglement" of the U.S. and Chinese economies?
- Fourth, drawing back from the details of the bilateral trade and investment relationship, how should the U.S. government restructure its institutions and reshape its policies on taxes, innovation, education, immigration, and other issues so as to engage more effectively in a possibly protracted strategic competition with China?

[1] For an early discussion of the prospects for economic disengagement, see Daniel H. Rosen, "A Post-Engagement U.S.-China Relationship?" Rhodium Group Research, January 19, 2018, https://rhg.com/research/post-engagement-us-china-relationship.

The first report of the taskforce will address questions one and two; the second report will examine questions three and four. A final note: while we have benefited greatly from the insights and expertise of all those who took part in our discussions, the views expressed here are those of the co-chairs alone and do not necessarily represent the opinions of the other members of the taskforce.

U.S. Strategy: Engaging to Transform

For the past quarter century, the United States' China strategy has been premised on the assumption that expanding flows of trade and investment between the two countries not only would be good for the U.S. economy but also would have a positive impact on China's external behavior and on the evolution of its economic policy and domestic political system. China's deepening relationship with the United States and broader integration into global markets would, it was hoped, give the country a stake in stability and encourage its leaders to see themselves as "responsible stakeholders" in the existing international order.[2] As China's integration deepened and its economy matured, Beijing would move away from state-directed planning, abandon its long-standing interventionist and protectionist practices, strengthen the rule of law, and place greater reliance on market mechanisms.[3] Finally, as had happened earlier in Europe and other parts of Asia, economic growth and the emergence of a new middle class in China would give rise eventually to irresistible demands for democratizing political reforms.[4]

Engagement would thus help China grow richer and stronger, but it would also change the country in ways that made Beijing far less likely to challenge U.S. interests. These expectations and assumptions were widely shared on both sides of the aisle in American politics. As then candidate George W. Bush stated in 1999: "Economic freedom creates habits of liberty. And habits of liberty create expectations of democracy...Trade freely with China, and time is on our side."[5] Or as President Bill Clinton explained in a 2000 speech advocating China's inclusion in the World Trade Organization (WTO): "The more China liberalizes its economy, the more fully it will liberate the potential of its people...And, when individuals have the power, not just to dream but to realize their dreams, they will demand a greater say."[6]

Economic engagement with China was part of a larger post–Cold War effort, led by the United States, to build a truly global international economy for the first time since the end of World War I. This was to be an open, rules-based system in which goods, capital, ideas, and people would flow

---

2 This was the term introduced by then deputy secretary of state Robert Zoellick in a speech to the National Committee on U.S.-China Relations. It was intended to challenge China's leaders to do more to contribute to upholding the existing international order. See Robert B. Zoellick, "Whither China? From Membership to Responsibility" (remarks to the National Committee on U.S.-China Relations, New York, September 21, 2005), https://2001-2009.state.gov/s/d/former/zoellick/rem/53682.htm. For an earlier variant of the argument that China's integration into the world community would foster its "adherence to internationally-recognized norms and standards of behavior," see the testimony of Peter Tarnoff, then undersecretary of state for political affairs. Peter Tarnoff, "China and MFN," testimony to the U.S. House International Relations Committee, Subcommittee on International Economic Policy and Trade, Washington, D.C., May 16, 1996, https://1997-2001.state.gov/current/debate/516tarnf.html.

3 For an early critique of this view, see Robert E. Lighthizer, "Evaluating China's Role in the World Trade Organization over the Past Decade," testimony before the U.S.-China Economic and Security Review Commission, Washington, D.C., June 9, 2010, https://china.usc.edu/sites/default/files/article/attachments/uscc-lighthizer-testimony-20100610.pdf.

4 For an overview of the various claims about the beneficial effects of engagement, see Kurt M. Campbell and Ely Ratner, "The China Reckoning: How Beijing Defied American Expectations," *Foreign Affairs*, March/April 2018, 60–70, https://www.foreignaffairs.com/articles/china/2018-02-13/china-reckoning.

5 George W. Bush, "A Distinctly American Internationalism" (speech at Ronald Reagan Presidential Library, Simi Valley, November 19, 1999), https://www.mtholyoke.edu/acad/intrel/bush/wspeech.htm.

6 See President Clinton's remarks at the Johns Hopkins University School of Advanced International Studies, available at "Full Text of Clinton's Speech on China Trade Bill," *New York Times*, March 9, 2000, http://movies2.nytimes.com/library/world/asia/030900clinton-china-text.html.

freely to every corner of the earth, with occasional disputes resolved by international tribunals according to objective standards and agreed principles. American planners also hoped that the collapse of the Soviet Union would enable the final triumph of freedom, clearing the way for liberal democracy to spread across Eurasia and around the world.

This project was bold and optimistic, but it was hardly simple-minded. To the contrary, it was rooted in liberal, Enlightenment beliefs, extending back to the eighteenth century and deeply held by many of the American founders and by subsequent generations of U.S. policymakers, that trade promotes both national welfare and international understanding, that self-governing republics are inherently less aggressive than autocratic regimes, and that the spread of democracy will eventually usher in an era of lasting world peace.[7] What the Clinton administration referred to as a policy of "enlargement" also found justification in modern social scientific research showing that rising per capita income levels are associated with transitions to democracy and that, whatever their differences, democracies tend not to make war on one another.[8]

Theories and ideals aside, support for expanding trade and investment with China also reflected sophisticated calculations of commercial self-interest. Throughout the 1990s and into the early 2000s, representatives of the many U.S. industries that hoped to profit by selling into China's fast-growing domestic market, or from using its vast supply of low-cost labor to assemble products for export to other countries, argued strongly in favor of engagement. The lobbying efforts of a broad coalition of business interests were crucial in ensuring that Washington continued to grant most-favored-nation trading status to China, even after the 1989 massacre of student protesters at Tiananmen Square, and supported its entry into the WTO in 2001.[9] Some of China's policies were acknowledged to be unfair to its trading partners (including suppressing the value of its currency in order to promote exports, using a variety of formal and informal barriers to restrict access to its domestic market, and failing to protect the intellectual property of foreign firms). These problems, however, were assumed to be transitory and were expected to diminish and eventually disappear as China became more fully integrated into the global trading system and more accepting of its rules.

Engagement was not a foolish blunder, nor, even in retrospect, was it a self-evident and obvious mistake. But it was a gamble, and, at least as regards its purported transformative effects, that gamble has thus far failed to pay off. China has obviously become far wealthier and more powerful, but it has not liberalized politically, nor, after an initial period of reform in the 1980s and 1990s, has its economy become progressively more open. To the contrary, instead of giving way to market forces, since the turn of the century the Chinese Communist Party (CCP) has in many respects expanded and intensified its efforts to steer and shape the national economy. By most accounts the political climate in China today is more repressive than at any point since the Cultural Revolution

---

7 See Tony Smith, *Why Wilson Matters: The Origins of American Liberal Internationalism and Its Crisis Today* (Princeton: Princeton University Press, 2017), 1–28.

8 See Anthony Lake, "From Containment to Enlargement" (remarks at the Johns Hopkins University School of Advanced International Studies, Washington, D.C., September 21, 1993), https://www.mtholyoke.edu/acad/intrel/lakedoc.html.

9 On the lasting significance of the 1993–94 debate over most-favored-nation status, see James Mann, *About Face: A History of America's Curious Relationship with China, from Nixon to Clinton* (New York: Knopf, 1999), 274–314. Among the most enthusiastic supporters of engagement were representatives of the high-tech and financial-services industries. Opponents included labor unions, environmental groups, and some older manufacturing industries. For a compendium of statements by various individuals, business groups, and industry associations, including the chairman of Boeing, all living secretaries of the Treasury Department, the U.S.-China Business Council, Business Roundtable, soybean farmers, pork producers, and semiconductor, telecommunications, and electronic industries associations, see "Organizational Statements, Permanent Normal Trade Relations with China," http://lobby.la.psu.edu/040_PNTR/orgstatements_china.html.

of the 1960s.[10] And far from being transformed into a "satisfied," status quo power, China has begun to behave in increasingly assertive and aggressive ways, both toward its neighbors and toward the United States.

Finally, but most important for the purposes of this report, the net economic benefits of engagement for the United States as a whole have become a subject of intense debate and appear far less certain today than was promised and widely anticipated three decades ago. Consumers have no doubt enjoyed lower prices for many products, some firms and industries have clearly profited, and trade with a fast-growing China has contributed to aggregate U.S. economic growth. But recent studies suggest that the rapid expansion in imports from China, especially following its incorporation into the WTO, has had a more disruptive and enduring impact on the U.S. manufacturing sector and on American workers than had originally been expected.[11] In addition to having to pay higher wages than their Chinese counterparts, many smaller companies in traditional manufacturing industries have had to face competition from Chinese firms that first stole their intellectual property and then flooded the market with low-cost substitutes.[12] Meanwhile, even the high-tech and service-sector industries that believed they had the most to gain have grown frustrated with persistent restrictions on their access to the Chinese market and by increasingly aggressive attempts to steal, buy, or extort their intellectual property.[13] Aided by their government, Chinese firms now seem poised not only to squeeze out foreign competitors at home but also to capture a growing share of the global market for a widening array of products and services. Mounting unhappiness over these developments has helped weaken the once-solid foundations of support for engagement from the U.S. business community, clearing the way for a debate over China policy more wide-ranging than at any time since the end of the Cold War. President Trump has given voice to this mix of retrospective grievances and current complaints, and he is pursuing their redress in distinctive, sometimes controversial and potentially risky ways. But he did not create the underlying problems that they reflect.

China's Strategy: Engagement without Transformation

Put simply, the United States' strategy for transforming China through engagement failed because Chinese leaders devised, implemented, and have continued to refine an effective strategy of their own for countering it. Deng Xiaoping and his successors were well aware of what they saw as a trap laid for them by their Western counterparts, and they were determined to avoid it.

10 See Congressional-Executive Commission on China, *2018 Annual Report* (Washington, D.C.: U.S. Government Publishing Office, 2018), https://www.cecc.gov/sites/chinacommission.house.gov/files/Annual%20Report%202018.pdf.

11 See Justin R. Pierce and Peter Schott, "The Surprisingly Swift Decline of U.S. Manufacturing Employment," National Bureau of Economic Research, Working Paper, no. 18655, December 2012 (rev. January 2014); David Acemoglu et al., "Import Competition and the Great U.S. Employment Sag of the 2000s," *Journal of Labor Economics* 34, no. 1, pt. 2 (2015): 141–98; David H. Autor, David Dorn, and Gordon H. Hanson, "The China Shock: Learning from Labor Market Adjustment to Large Changes in Trade," National Bureau of Economic Research, Working Paper, no. 21906, January 2016; and Robert E. Scott and Zane Mokhiber, "The China Toll Deepens," Economic Policy Institute, October 23, 2018.

12 See an interview with Admiral Dennis Blair, co-chair of the Commission on the Theft of American Intellectual Property. "China's Theft of U.S. Intellectual Property Is Hurting Small Businesses: The IP Commission," Fox Business, March 23, 2018. See also the IP Commission's most recent report, "Update to the IP Commission Report—The Theft of American Intellectual Property: Reassessments of the Challenge and United States Policy," National Bureau of Asian Research (NBR), February 2017, http://ipcommission.org/report/IP_Commission_Report_Update_2017.pdf.

13 The fluctuating attitudes of U.S. executives operating in the country can be traced in the annual surveys of the American Chamber of Commerce in China. Even before the latest escalation in trade tensions, fully 75% of those questioned reported that they felt less welcome than in the past, with nearly half complaining that foreign firms were treated unfairly in comparison to their Chinese counterparts. See American Chamber of Commerce in China, "2018 China Business Climate Survey Report," January 2018.

From the start of the process of "reform and opening up" in the late 1970s and the early 1980s down to the present, the CCP regime has sought to extract the benefits of engagement with the United States and the other advanced industrial nations while containing its potentially dangerous and destabilizing side effects. Above all the regime has worked to minimize the possibility of unmanageable pressures for thoroughgoing liberalization of China's economic and political systems.[14]

Principles

As is true for the United States, China's strategy reflects the prevailing ideology of its political system, as well as the interests of powerful groups in Chinese society. But whereas U.S. leaders have historically been believers in liberal democracy and free-market capitalism, China's rulers are adherents of what can best be described as "mercantilist Leninism." And whereas private actors carry the greatest weight in shaping U.S. economic policy, the CCP and the state apparatus that it controls dominate the Chinese system.

Like Lenin (and their own CCP forebears), today's Chinese leaders believe that the Communist Party must retain a monopoly on domestic political power and that, in order to do so, it should have absolute authority over all other actors, interests, and activities in society. As Xi Jinping declared at the start of the 19th Party Congress in October 2017: "government, the military, society and schools, north, south, east and west—the party leads them all."[15] In keeping with this dictum, the CCP regime holds that government must take the lead in guiding and controlling the national economy. China's rulers do not have any principled belief in the practical or moral virtues of freely functioning markets or of private property, and they reject the liberal notion that, to the greatest extent possible, politics should be kept separate from economics. While markets and private economic actors may be useful, their role can be expanded or circumscribed as needed to serve the ends of policy. And, ultimately, economics must always be subordinate to politics.

Like the mercantilists of seventeenth and eighteenth century Europe, China's leaders do not regard the aim of economic activity as being solely or even primarily to create wealth or promote prosperity for its own sake. Rather, the purpose of trade and commerce is to generate power, enhancing the ability of those who wield it to shape the behavior of others and to resist the efforts of others to influence or control China's rulers and the Chinese nation. The pursuit of wealth and the pursuit of power are thus inextricably linked: wealth provides the means with which to generate and exercise power, and power enables the further accumulation of wealth.[16]

For this reason, however, international economics, like international politics, must be seen not as a mutually beneficial activity, as the liberal theorists of free trade present it, but as a

---

14 For an overview of the evolution of these efforts over time, see Aaron L. Friedberg, "Globalisation and Chinese Grand Strategy," *Survival* 60, no. 1 (2018): 7–40.

15 Nectar Gan, "Xi Jinping Thought—The Communist Party's Tighter Grip on China in 16 Characters," *South China Morning Post*, October 25, 2017.

16 In his classic 1948 essay on the topic, economist Jacob Viner notes that "all mercantilists, whatever the period [or] country" agree that "wealth is an absolutely essential means to power…power is essential…. as a means to the acquisition or retention of wealth…wealth and power are each proper ultimate aims of national policy," and "there is long-run harmony between these ends." Jacob Viner, "Power Versus Plenty as Objectives of Foreign Policy in the Seventeenth and Eighteenth Centuries," *World Politics* 1, no. 1 (1948): 10.

zero-sum game.[17] This is because, while all nations may be able to become richer at the same time, it is not possible for all of them to grow stronger simultaneously. Power is always relative, and in the long run what matters most is who is most powerful. Despite their rhetoric about "win-win cooperation," China's leaders believe that in any political system, international or domestic, there can be only one winner. So, working with and through the organs of the state, the CCP seeks to manage the economy in ways intended to maintain and enhance the party's power in relation to all other actors in Chinese society, while increasing the power of the Chinese nation in relation to all others in the international system and especially the current global hegemon, the United States.

Two caveats are in order here. First, while they have consistently set the direction of national development, China's leaders have not always been successful in shaping economic activity in precisely the ways they want. Some of their preferred policies have proved to be costly and self-defeating. Even where this is not the case, the Chinese economy is now vast and complex, as are the bureaucratic mechanisms through which policy is made and implemented, and there are many interests at play, including those of individual households and nominally private firms over which the state does not necessarily exert direct, day-to-day control.[18] This is far from a pure top-down, command system. Nevertheless, the regime ultimately has unchallengeable authority to intervene in the national economy as it sees fit, and it is developing and continuously refining the institutional capacity and the policy tools with which to try to achieve its aims.

Second, while the CCP's long-term goals have remained broadly constant, the policies used to pursue them have not; there have been debates and, within limits, variations over time. Since the start of the reform period, the role of market forces and privately owned enterprises has expanded considerably, and during the 1990s and into the early 2000s there were some in the leadership who were evidently prepared to go even further. In retrospect, however, the pace of liberalizing economic reform began to slow soon after China's entry into the WTO, and in certain respects it has gone into reverse under Xi.[19]

While Xi has accelerated the trend away from reform, it would be a mistake to cast him as an aberration or a reactionary throwback who has somehow single-handedly disrupted a natural, evolutionary process that was leading inexorably toward a true market-based system. Although the precise limits of reform were not cast in stone at the start, it is clear that, beyond a certain point, the CCP never had any intention of relinquishing control over the economy. The party's leaders have always recognized that full liberalization would be incompatible with the maintenance of authoritarian, one-party rule. As one recent assessment explains, their approach to reform has therefore been "pragmatic, not dogmatic, and it was never intended, at least not by those in

---

17 As political scientist Robert Gilpin explains, "the basic assumption of liberalism is that the nature of international economic relations is essentially harmonious....Through the free exchange of commodities, removal of restrictions on the flow of investment, and an international division of labor, everyone will benefit in the long run." By contrast, mercantilists (and also Marxists) "begin with the premise that the essence of economic relations is conflictual. There is no underlying harmony; indeed, one group's gain is another's loss." While "for the liberal, the goal of economic activity is the optimum or efficient use of the world's scarce resources and the maximization of world welfare...for the mercantilist it is the distribution of employment and military power among nation-states that is most significant." Robert Gilpin, *U.S. Power and the Multinational Corporation* (New York: Basic Books, 1975), 26–27.

18 For one assessment of the obstacles to the regime's ability to control economic activity, see William J. Norris, *Chinese Economic Statecraft: Commercial Actors, Grand Strategy, and State Control* (Ithaca: Cornell University Press, 2016).

19 While observers differ on the precise timing, most agree that, following the replacement of President Jiang Zemin and Premier Zhu Rongji by Hu Jintao and Wen Jiabao at the end of 2002, Beijing "generally did not pursue economic reforms as aggressively as before. Instead, the Chinese government increasingly emphasized the state's role in the economy, diverging from the path of economic reform that had driven China's accession to the WTO." Office of the U.S. Trade Representative (USTR), "2015 Report to Congress on China's WTO Compliance," December 2015, 3. In sum, "reform attempts under President Hu Jintao (2002–2012) to shift away from large-scale infrastructure and export-led growth toward an economy driven by consumption and high-technology failed to overcome entrenched interests and were largely put aside to spur economic growth following the global financial crisis." U.S.-China Economic and Security Review Commission, "2015 Annual Report to Congress," November 2015, 7.

control, to lead to political change."[20] Beyond a concern for institutional self-preservation, there are also narrower and more personal, pecuniary interests at play: the existing system for allocating resources helps enrich those with access to power, most notably the members of the CCP elite and their families. Loosening the party's grip and giving ever more scope to the market would likely cost some of them their fortunes, even if it did not immediately endanger their lives.

Policies

Reflecting its basic principles and preferences, Beijing has been pursuing economic policies designed not only to sustain growth but to acquire power: reducing the ability of other countries (especially the United States) to exploit China's engagement in the global economy to exert leverage over it and beginning to use economic means with increasing skill and sophistication to try to exercise influence over others. Although the details and full dimensions of its vision are not yet clear, the CCP regime evidently seeks to use economic as well as military, diplomatic, and political warfare instruments to reshape the world in ways that it believes will enhance its interests, bolster its security, and preserve its rule.

Sustaining growth. Continued growth is necessary to create the jobs and produce the rising incomes that the regime hopes will placate the Chinese people and forestall demands for political change. It also generates the resources needed to fund large domestic security forces, the increasingly elaborate and costly physical and virtual surveillance systems that Beijing believes are essential to maintain order at home, and the military capabilities, overseas investment projects, and political influence operations with which the regime seeks to achieve its external objectives. Growth is thus vital to achieving Xi Jinping's "China dream" of the "great rejuvenation of the Chinese nation."[21] More than that, it is essential to regime survival; from the party's perspective, it is quite literally a matter of life and death.

For this reason, the CCP has become increasingly anxious about the waning efficacy of a development strategy that has depended on a seemingly endless supply of low-cost labor to produce an ever-expanding volume of manufactured exports, combined more recently with massive injections of capital to fund domestic construction and infrastructure projects. Beijing is eager, indeed desperate, to sustain growth without altering its model in ways that would require the CCP to relinquish control over the economy. Its most visible and controversial initiatives are intended to help resolve this conundrum. Thus, one key reason for the strong drive to acquire technologies associated with the so-called fourth industrial revolution in manufacturing as part of the controversial Made in China 2025 plan is that they offer the possibility of boosting productivity and output, thereby enabling China to preserve its position as a manufacturing and export superpower, even as its working-age population dwindles and wages rise.[22] Among the motives behind Xi's signature Belt and Road Initiative are the desire to develop fresh markets for Chinese exports in the emerging economies and the need to find work for China's massive state-owned enterprises by redeploying some of their excess capacity to build ports, roads, railways, and pipelines overseas rather than simply continuing to add yet more infrastructure

[20] Stewart Paterson, *China, Trade and Power: Why the West's Economic Engagement Has Failed* (London: London Publishing Group, 2018), 64.

[21] Zhao Yinan, "'Chinese Dream' Is Xi's Vision," *China Daily*, March 18, 2013.

[22] This plan has been extensively analyzed by Western observers. See, in particular, Jost Wübbeke et al., "Made in China 2025: The Making of a High-Tech Superpower and Consequences for Industrial Countries," *MERICS Papers on China*, December 2016; and U.S. Chamber of Commerce, "Made in China 2025: Global Ambitions Built on Local Protections," 2017.

at home.[23] The importance of both these programs is suggested by the regime's willingness to press ahead with them, despite their costs and risks, and notwithstanding the significant opposition that they have begun to generate in both advanced and developing countries.

Reducing vulnerability and increasing leverage. In addition to the obvious benefits, China's growth and its deepening integration into the global economy have created potential vulnerabilities in the form of heightened dependence on foreign technology, markets, resources, and capital. Thanks in part to China's long experience as the target of sanctions and embargos, the nation's leaders have always been highly sensitive to such vulnerabilities.[24] Even as it has engaged more deeply with the West, the CCP regime has taken steps to mitigate the potential risks associated with dependence and, to the extent possible, to turn the tables, putting China in position to exert leverage over its trading partners. These strategic concerns and ambitions are evident in virtually every facet of Beijing's economic policies.

Technology. The central thrust of China's current development plans is to reduce, if not eliminate altogether, reliance on imported technology across a range of leading-edge sectors. Chinese planners aim to close the remaining gap between their country's technological level and that of the most advanced industrial nations, to move from being a follower to a leader at the cutting edge of science and technology, and to become an innovation, as well as a manufacturing, powerhouse. These ambitious goals are supported by an array of plans and policy instruments, including increased R&D budgets, subsidies, and government-sponsored "megaprojects."[25] In the past decade, Beijing has also intensified its efforts to acquire, assimilate, absorb, and "re-innovate" foreign technology using methods that range from theft, to forced transfer from firms seeking access to the Chinese market, to direct investment in innovative companies in the United States and other advanced industrial countries.[26]

Projecting their own mercantilist attitudes and predilections, Chinese planners are convinced that the United States is trying to hold them back in both commercial and military competition. The only way to escape from a position of perpetual inferiority and potential vulnerability is to reduce reliance on imported technology. The recent experience of ZTE, the IT giant whose viability was threatened by a brief cutoff of high-end, U.S.-made semiconductors, served as a vivid reminder of the dangers of dependence. But Beijing's concerns in this regard are long-standing. Reviving a slogan from the Mao era, Xi has said that because Western "unilateralism and...protectionism"

---

[23] On the economic motivations behind the Belt and Road Initiative, see Nadège Rolland, *China's Eurasian Century? Political and Strategic Implications of the Belt and Road Initiative* (Seattle: NBR, 2017), 95–109.

[24] For two decades after the CCP's 1949 victory in China's civil war, Washington subjected China to a near-total economic embargo. As the Sino-Soviet split widened in the late 1950s and early 1960s, the Soviet Union suspended aid and technical assistance. Even after the United States resumed contact and established formal diplomatic relations with China, it continued to restrict the sale or transfer of potential dual-use high-tech items. The United States and other Western nations imposed sanctions in response to the regime's bloody crackdown at Tiananmen, including an embargo on arms sales that remains in place today. Throughout the 1990s, the United States sanctioned individual Chinese companies for a variety of offenses, including their alleged involvement in proliferation. See Shu Guang Zhang, *Economic Cold War: America's Embargo Against China and the Sino-Soviet Alliance, 1949–1973* (Stanford: Stanford University Press, 2001); Hugo Meijer, *Trading with the Enemy: The Making of U.S. Export Control Policy toward the People's Republic of China* (New York: Oxford University Press, 2016); and Dianne E. Rennack, "China: U.S. Economic Sanctions," Congressional Research Service, CRS Report for Congress, 1997.

[25] Beijing's objectives and the methods for achieving them have been spelled out in various plans, including the National Medium- and Long-Term Plan for the Development of Science and Technology (2006) and, more recently, Made in China 2025 (2015) and Internet Plus (2015). Regarding the origins, evolution, and relationship among these plans, see a report prepared for the U.S.-China Economic and Security Review Commission by Tai Ming Cheung et al., "Planning for Innovation: Understanding China's Plans for Technological, Energy, Industrial, and Defense Development," University of California, Institute on Global Conflict and Cooperation, July 28, 2016, 29–54. See also James McGregor, "China's Drive for 'Indigenous Innovation': A Web of Industrial Policies," U.S. Chamber of Commerce, 2010.

[26] These practices are detailed in Office of the USTR, "Findings of the Investigation into China's Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation under Section 301 of the Trade Act of 1974," March 22, 2018; and White House Office of Trade and Manufacturing Policy, "How China's Economic Aggression Threatens the Technologies and Intellectual Property of the United States and the World," June 2018.

have made “advanced technology and key technology...more and more difficult to obtain,” China must once again “travel the road of self-reliance.”[27]

If the regime can achieve its goals, in the future it may be in a position to exert similar leverage over foreign commercial rivals and governments, holding back critical technology in order to give an edge to China’s firms and armed forces. Meanwhile, although it may not originally have been sought for this purpose, the central position that China has acquired in global supply chains for an array of less advanced products (including certain electronic components, metals, and chemicals) already gives it the potential to disrupt the economies of other countries, including the United States. Sudden loss of access to some Chinese-made items, or their possible corruption or sabotage at the source, could complicate U.S. and allied efforts to ramp up production of weapons and other military systems in the event of a future crisis or conflict.[28]

Markets. In addition to fueling the desire for greater technological autonomy, the recent trade dispute with the United States will likely stimulate Chinese planners to try to further reduce their dependence on the U.S. market. Although its share of Chinese exports has declined since the turn of the century, the United States continues to be the single-biggest consumer of many Chinese-made products, including computers and consumer electronics, electrical equipment, and other machinery. By contrast, although U.S. exports to China have grown, they make up a considerably smaller share of total U.S. trade and, given the relatively smaller role of trade in the U.S. economy, of GDP.[29] Until recently, Chinese strategists were safe in assuming that, barring a major confrontation, Washington would not try to use this disparity as a source of leverage and that they therefore had time to diversify China’s export markets and reduce its dependence on a country they have long seen as an inevitable strategic rival. That task can only appear more urgent today than it did a few years ago.

Especially in the context of the Belt and Road Initiative, Chinese planners emphasize the importance of expanding markets in the developing world, including across Eurasia and into Southeast Asia, the Middle East, Africa, and Latin America. They evidently hope that investments in infrastructure will help China win preferred access to these emerging markets and to set technical standards for communications, transportation, and power-generation networks, thereby gaining an enduring advantage for Chinese companies at the expense of foreign competitors.[30] Emerging markets could be important not only as a driver of future growth in demand for China’s exports but as a source of large volumes of consumer data that could fuel the growth of the country’s emerging technology sectors, including artificial intelligence. If the United States

[27] Gabriel Wildau, “China’s Xi Jinping Revives Maoist Call for ‘Self-Reliance,’” *Financial Times*, November 11, 2018. On the long history of the CCP’s drive for technological leadership and autonomy, see Evan A. Feigenbaum, “The Deep Roots and Long Branches of Chinese Technonationalism,” MacroPolo, August 12, 2017, https://macropolo.org/deep-roots-long-branches-chinese-technonationalism.

[28] Regarding the possible implications of supply-chain vulnerabilities for national defense, see Chris Nissen et al., “Delivery Uncompromised: A Strategy for Supply Chain Security and Resilience in Response to the Changing Character of War,” MITRE Corporation, August 2018; and U.S. Department of Defense, “Assessing and Strengthening the Manufacturing and Defense Industrial Base and Supply Chain Resiliency of the United States,” September 2018.

[29] In 2017, China’s exports of goods and services to the United States amounted to just under 22% of its total exports, equal to roughly 4.3% of Chinese GDP. By comparison, U.S. exports of goods and services to China were 8% of its total exports, or slightly less than 1% of U.S. GDP. World Bank, DataBank, https://data.worldbank.org; and “U.S. Trade with Major Trading Partners,” Congressional Research Service, CRS Report for Congress, R45434, December 18, 2018, https://fas.org/sgp/crs/row/R45434.pdf.

[30] Andrew Polk, “China Is Quietly Setting Global Standards,” Bloomberg, May 6, 2018, https://www.bloomberg.com/opinion/articles/2018-05-06/china-is-quietly-setting-global-standards.

and China are truly engaged in an artificial intelligence "race," the developing world is one of the domains in which it will be run.[31]

The growth trajectories of the emerging market economies, the volume of demand for Chinese exports that they can be expected to generate, and the extent to which they could compensate for any decline in exports to the advanced industrial nations remain unclear. Nevertheless, Chinese analysts evidently see expanding engagement with developing countries as a way of reorienting the nation's economy away from excessive reliance on the advanced industrial countries, most of which are democracies aligned with the United States, thereby reducing China's vulnerability to future pressure through the imposition of tariffs or sanctions.

Even as China seeks to diversify and reduce its own potential exposure, Chinese strategists have also intensified efforts to use the country's large and growing market to exert leverage over foreign trading partners. This is being done in a tactical, transactional way to help propel China up the innovation ladder by compelling foreign firms to transfer cutting-edge technology in return for continued access to the Chinese market. But China is also using the gravitational pull of its massive market to achieve broader strategic aims, including punishing others for defying its wishes and seeking to drive wedges between the United States and its allies. To take one recent example, in 2017 Beijing imposed an array of undeclared sanctions on the Republic of Korea after its government agreed to permit the stationing of U.S. missile defense radars on South Korean soil.[32] Even where it has not yet taken action, Beijing has sometimes (as in its recent dealings with Australia and Canada) issued threats to governments contemplating what it regards as hostile actions.[33] And even when China has not overtly made such threats, the fear of losing access to the Chinese market is already shaping the behavior of some of the country's trading partners, causing them to be more cautious in criticizing its policies on trade and human rights, among other issues.[34]

Aside from whatever purely economic arguments can be made in their favor, one likely strategic rationale for many of the regional free trade agreements that Beijing has signed or is in the process of pursuing is precisely that they will increase the extent to which others rely on continued access to the Chinese market for their future prosperity.[35] Given the disparity in size, in virtually every case China will be far more important to its trading partners than they are to it; the more asymmetric the dependence, the greater the potential leverage.[36]

Resources. Over the past quarter century, China's growth has led to exploding demand for resources of all kinds and, because demand far outstrips domestic supply, to surging imports of

---

31 Regarding Chinese activity in Africa, see Amy Hawkins, "Beijing's Big Brother Tech Needs African Faces," *Foreign Policy*, July 24, 2018, https://foreignpolicy.com/2018/07/24/beijings-big-brother-tech-needs-african-faces; and Sheridan Prasso, "China's Digital Silk Road Is Looking More Like an Iron Curtain," Bloomberg, January 10, 2019.

32 See Jeongseok Lee, "Back to Normal? The End of the THAAD Dispute between China and South Korea," Jamestown Foundation, China Brief, November 22, 2017, https://jamestown.org/program/back-normal-end-thaad-dispute-china-south-korea.

33 See, for example, a recent statement by China's ambassador to Australia. Glenda Korporaal, "China Delivers Trade Warning amid Strain on Ties," *Australian*, April 30, 2018; and "Canada Counters China Threat of 'Repercussions' if Huawei Banned," Yahoo, January 18, 2019, https://sg.news.yahoo.com/canada-counters-china-threat-repercussions-huawei-banned-181236349.html.

34 Such concerns help explain the belated, cautious response of many Western governments to mounting evidence that China is engaged in widespread human rights abuses against its Uighur minority population. See Phillip Wen, Michael Martina, and Ben Blanchard, "Exclusive: In Rare Coordinated Move, Western Envoys Seek Meeting on Xinjiag Concerns," Reuters, November 15, 2018, https://www.reuters.com/article/us-china-xinjiang-exclusive/exclusive-in-rare-coordinated-move-western-envoys-seek-meeting-on-xinjiang-concerns-idUSKCN1NK0H0.

35 See Nargiza Salidjanova, "China's Trade Ambitions: Strategy and Objectives behind China's Pursuit of Free Trade Agreements," U.S.-Economic and Security Review Commission, Staff Research Report, May 28, 2015.

36 The classic treatment of the use of trade "as an instrument of national power" is Albert O. Hirschman, *National Power and the Structure of Foreign Trade* (Berkeley: University of California Press, 1945), 13–52.

energy, minerals, raw materials, and food. The vast majority of these imports reach China by sea, a domain still dominated by U.S. naval power. Well short of a direct confrontation with the United States, political upheaval or other unforeseen events in supplier countries could still disrupt resource supplies, threatening China's economic growth and perhaps its own political stability.

Chinese strategists are acutely aware of the dangers that accompany their country's growing dependence on imported resources. Though unable to eliminate these risks altogether, China has gone to considerable, often costly lengths to mitigate them. Among other measures, it has sought to ensure control over the physical means of production by purchasing mines, oil fields, and farm land in foreign countries. It has acquired key portions of the maritime transportation system through which resources are carried back to China by greatly enlarging its commercial fleet and buying, building, and expanding overseas port facilities. And under the "belt" portion of the Belt and Road Initiative, China has begun to invest heavily in overland roads, railways, and pipelines that could provide at least a portion of needed supplies in the event of a maritime blockade. While relying on freely functioning global markets to satisfy China's bourgeoning demand for resources would almost certainly be cheaper, all these investments represent a form of insurance, a hedge against strategic risk.[37]

As for exerting leverage of its own, China is not a major exporter of most raw materials, but since the early 2000s state economic planners have sought to develop and exploit a dominant position in the production of a number of materials, including rare earth minerals that are critical inputs to many high-tech manufacturing processes. Beijing has used output quotas and export tariffs to manipulate prices of these minerals on world markets.[38] In addition to increasing profits, these policies were intended to induce foreign firms to locate some manufacturing facilities in China, thereby easing access to desired technologies. Beijing has also experimented with the use of rare earth minerals for broader strategic purposes—for example, by cutting exports to signal its displeasure to Japan in 2010 during a dispute over maritime issues.[39] Absent adequate stockpiles or alternative sources of supply, an embargo on exports to the United States could impose significant costs and in a crisis might complicate efforts to boost production of items essential to national defense.[40]

Capital. During the first two decades of the reform period, China was a net debtor nation, heavily reliant on inflows of foreign capital to fund its development. To sustain high rates of growth, build industrial capacity, and increase national autonomy, the CCP regime practiced "financial repression," giving households little choice but to put their savings into very low-interest accounts in state-run banks, offering cheap loans to business, and channeling a sizable portion of the nation's increasing wealth into investment rather than consumption.[41]

---

[37] China's attempts to mitigate its dependence on imports of resources and raw materials are discussed in Friedberg, "Globalisation and Chinese Grand Strategy," 21–26.

[38] Shen Lei et al., "Overview on China's Rare Earth Industry Restructuring and Regulation Reforms," *Journal of Resources and Ecology* 8, no. 3 (2017): 213–22.

[39] Keith Bradsher, "Amid Tension, China Blocks Vital Exports to Japan," *New York Times*, September 22, 2010, https://www.nytimes.com/2010/09/23/business/global/23rare.html.

[40] For an overview, see Wayne M. Morrison and Rachel Tang, "China's Rare Earth Industry and Export Regime: Economic and Trade Implications for the United States," Congressional Research Service, CRS Report for Congress, R42510, April 30, 2012. For a skeptical assessment of China's ability to use rare earths as a strategic weapon, see Eugene Gholz, "Rare Earth Elements and National Security," Council on Foreign Relations, October 2014.

[41] Matthew C. Klein, "Tariffs Are the Wrong Response to China," *Barron's*, June 22, 2018, https://www.barrons.com/articles/tariffs-are-the-wrong-response-to-china-1529670600.

In support of its plans for building up the nation's manufacturing base, Beijing also sought to promote exports by various means, including intervening in currency markets to buy dollars, thereby holding down the value of the renminbi. Especially after it entered the WTO, China began to run large trade surpluses with the United States and to accumulate vast quantities of dollar-denominated assets. While the country continued to receive substantial quantities of foreign investment, China's overall position shifted rapidly and it moved from being a net debtor nation to one of the world's largest creditors.[42]

In the past decade, the CCP regime has begun to use the country's position as a capital exporter to advance toward its closely interwoven economic and broader strategic objectives.[43] The provision of government-to-government aid and loans through various mechanisms enhances China's international profile and prestige and can increase its presence in, and leverage over, other countries, especially in the developing world. In some cases where the recipients have been unable to repay their loans, Beijing has taken valuable national assets as collateral, including ports and natural resources. This has led to allegations that it is engaging in "debt-trap diplomacy."[44] The CCP regime has also encouraged and enabled more overseas direct investment by Chinese firms, steering much of it in ways intended to support national strategy, including the purchase of foreign companies at the cutting edge of technological development.[45] Finally, Beijing's deep pockets have helped fund increasingly intense and ambitious propaganda campaigns and political influence operations, including those targeted at wealthy advanced industrial countries. In addition to shaping the perceptions and policies of foreign elites and governments, these operations are sometimes aimed at enhancing the access and advancing the interests of large Chinese companies, which are themselves instruments of CCP policy.[46]

Although it continues to hold large quantities of U.S. debt, to date China has made no explicit effort to translate its position as a creditor into diplomatic leverage. Selling off assets denominated in dollars and refusing to buy more would do damage to the U.S. economy, driving up U.S. interest rates, weakening the dollar, and increasing the cost of imports. But these actions would also hurt China, reducing its exports to the United States and diminishing the value of its remaining dollar holdings.[47] Beijing thus continues to be constrained by its reliance on the dollar as a medium of international exchange, a condition that it hopes eventually to remedy. Because it would require the regime to loosen control over financial flows, however, the full internationalization of the renminbi is unlikely in the foreseeable future.[48] Despite this, China

---

42 Between 1999 and 2007, China went from being a net debtor, to the tune of roughly 9% of its GDP, to the position of a net creditor at over 30% of GDP. Guonan Ma and Haiwen Zhou, "China's Increasing External Wealth," in *China's New Place in a World in Crisis*, ed. Ross Garnaut, Ligang Song, and Wing Thye Woo (Canberra: Australian National University Press, 2009), 59.

43 For an early survey of the possibilities, see Gregory Chin and Eric Helleiner, "China as a Creditor: A Rising Financial Power?" *Journal of International Affairs* 6, no. 1 (2008): 87–102.

44 See John Pomfret, "China's Debt Traps around the World Are a Trademark of Its Imperialist Ambitions," *Washington Post*, August 27, 2018, https://www.washingtonpost.com/news/global-opinions/wp/2018/08/27/chinas-debt-traps-around-the-world-are-a-trademark-of-its-imperialist-ambitions.

45 Regarding recent efforts by the regime to impose strategic direction on overseas investment, see Covington, "China's State Council Publishes New Guidance on Regulation of Outbound Investment," September 8, 2017, https://www.cov.com/-/media/files/corporate/publications/2017/09/chinas_state_council_publishes_new_guidance_on_regulation_of_outbound_investment.pdf.

46 See Jichang Lulu and Martin Hála, "A New Front Opens in Huwaei's Battle for Central Europe," Sinopsis, January 12, 2019, https://sinopsis.cz/en/a-new-front-opens-for-huaweis-battle-for-central-europe.

47 The possibility that Beijing might try to use its position as a creditor to exert leverage over the United States has been discussed repeatedly since before the 2008–9 global financial crisis and has emerged again in the context of the current trade dispute. See Daniel W. Drezner, "Bad Debts: Assessing China's Financial Influence in Great Power Politics," *International Security* 34, no. 2 (2009): 7–45. For a recent assessment of this scenario, see Brad W. Setser, "What Would Happen if China Started Selling Off Its Treasury Portfolio?" Council on Foreign Relations, June 21, 2018, https://www.cfr.org/blog/what-would-happen-if-china-started-selling-its-treasury-portfolio.

48 Eswar S. Prasad, *Gaining Currency: The Rise of the Renminbi* (New York: Oxford University Press, 2017), 245–48.

has taken steps to increase the use of its currency in international transactions, including through the use of swap agreements. Being able to conduct business in this way provides a number of strategic benefits to China and its counterparties, including reducing their exposure to U.S. surveillance and possible financial sanctions.[49]

Goals

Far from being a happy realm in which nations engage in "win-win cooperation" for "the benefit of all mankind," trade and commerce, as seen from Beijing, are yet another domain in the ongoing struggle for power with the United States and its democratic allies. Economic policy is only one instrument, albeit a critically important one, with which the CCP seeks to achieve its grand strategic objectives. First and foremost, the party strives to preserve its monopoly on domestic political power. Second, it seeks to achieve the "great rejuvenation of the Chinese nation," restoring China to its historic position as the preponderant power in eastern Eurasia and, in the long run, displacing the United States from its perch as the richest, strongest, and most influential nation in the world.

Xi Jinping and his colleagues present themselves as the advocates of "globalization 2.0" and, especially in contrast with the current U.S. administration, as the defenders of continued "openness" and "global free trade."[50] China's leaders are no doubt sincere in their desire to preserve some elements of the existing economic order at least for the time being. Despite their claims to the contrary, however, what they appear to have in mind is not a level playing field, but one that tilts ever more heavily in China's favor. What the CCP regime evidently seeks is the perpetuation and reinforcement of the situation that has evolved since the turn of the century—one in which other countries remain open to China, absorbing its exports and allowing it unrestricted access to their technology, resources, educational institutions, and other services, while Beijing closely regulates, and in many cases further constricts, the inward flow of foreign goods, investment, people, and ideas.

While Beijing is generally cautious in discussing such matters, its vision for the economic future likely includes the following elements:

- Thanks in part to China's success in acquiring technology and securing new export markets, the country's overall growth will be sustained at moderately high levels. This will create enough new jobs to avoid mass unemployment and provide the resources necessary to fund a continuing military buildup and the pursuit of expanded international influence, as well as strengthening domestic security. China will emerge as the world's largest economy, and as its productivity converges with the levels achieved by the advanced industrial countries, its total output will grow to be several times that of the United States.[51]

---

49 Washington's recent use of financial sanctions against Iran and other "rogue regimes" has evidently fueled China's interest in internationalizing its currency. See Cameron Rotblat, "Weaponizing the Plumbing: Dollar Diplomacy, Yuan Internationalization and the Future of Financial Sanctions," *UCLA Journal of Foreign Affairs* 21, no. 2 (2017): 311–60. The Cross-Border Interbank Payment System (CIPS), which allows countries to bypass the dollar and the U.S. banking system and conduct business directly in renminbi, has been hailed by some observers (including in Zimbabwe, a target of U.S. sanctions) as striking a blow against American "financial tyranny." Lloyd Gumbo, "CIPS: Liberating the World from U.S. Financial Tyranny," *Herald*, October 14, 2015.

50 See, for example, Xi Jinping, "Jointly Shoulder Responsibility of Our Times, Promote Global Growth" (keynote speech at World Economic Forum, Davos, January 17, 2017), http://www.xinhuanet.com//english/2017-01/18/c_135991184.htm.

51 Regarding this prospect, see Lawrence H. Summers, "Can Anything Hold Back China's Economy?" *Washington Post*, December 3, 2018, https://www.washingtonpost.com/opinions/can-anything-hold-back-chinas-economy/2018/12/03/9140fc06-f726-11e8-8c9a-860ce2a8148f_story.html.

- State-directed industrial policies will enable China to establish itself as the leader and dominant global player across a range of high-tech sectors. Chinese firms will control all portions of the supply chains for many products. China will be able to acquire foreign technology as needed, but its overall dependence on imported technology will diminish. For its part, Beijing will carefully control foreign investment and technology exports so as to preserve its growing commercial and military advantages.
- China will be at the heart of what two Beijing academics have described as "a Chinese-centered radial network"—a vast and increasingly integrated Eurasian regional economic system, extending east into parts of maritime East Asia and Oceania, west across Central Asia to include some Central and Western European nations, south to incorporate most of Southeast Asia and parts of the Middle East, and north to include Russia.[52] These countries, many ruled by authoritarian regimes, will compose what Xi has labeled a "community of common destiny."[53] They will be linked to China by free trade agreements, financial institutions, and Chinese-built communications and transportation infrastructure and will use the renminbi to conduct much of their trade. This strengthened position overland and along key maritime trade routes will help alleviate, even if it does not entirely eliminate, China's vulnerability to naval blockades and supply disruptions.
- Beyond the Eurasian landmass, China will have developed a substantial and growing presence, especially in the emerging market economies of Africa and Latin America. As in other parts of the developing world, Beijing will use infrastructure investments to gain political influence and set technical standards in ways that give an advantage to Chinese firms at the expense of foreign competitors. In addition to exporting manufactured goods and services and importing resources and raw materials, China will seek preferential access to the vast volume of data generated by billions of consumers using Chinese-built phones, computers, and cars.
- In dealing with the advanced industrial democracies of Europe, North America, and East Asia, Beijing will continue for as long as possible to sell into their markets and to tap them for technology, while deflecting their demands for reciprocity and reform with superficial concessions and dividing these countries from one another with the offer of differential deals. Over time, China will seek, in the words of one Chinese analyst, to "change the current situation in which we seriously depend on the United States in the aspects of foreign reserves, export need, and technical importation."[54] More generally, it will attempt to "increase market share in the European Union, Asia-Pacific region, Africa, Latin America, and the Middle East," while "appropriately reducing dependency on the market in the United States and Japan."[55] These two implacable foes will be consigned increasingly to the role of isolated islands off the coasts of Eurasia, while, for their part, the more pliant European countries are drawn ever more tightly into China's emerging transcontinental trading bloc.
- As regards international economic institutions, Beijing will continue to make use of those that serve its purposes (such as the WTO) while building new ones (such as the China Development Bank and the Cross-Border Interbank Payments System) that will enhance its own autonomy and influence.

[52] Xinquan Tu and Yue Lyu, "Contesting Visions of East Asia's Regional Economic Order: A Chinese Perspective," *Asia Policy* 13, no. 2 (2018): 30.

[53] See Nadège Rolland, "Beijing's Vision for a Reshaped Order," Jamestown Foundation, February 26, 2018, https://jamestown.org/program/beijings-vision-reshaped-international-order.

[54] Jin Canrong of Renmin University, quoted in Deng Yuan and Xiong Zhengyan, "Zhong-Mei xinx-ing daguo guanxi: Guang you gainian yuanyuan bu gou" [China-U.S. New Type of Great-Power Relationship: A Mere Concept Is Not Enough], *Guoji Xianqu Daobao*, September 30, 2014.

[55] Huang Zhiling, "Zhongguo yi jinzao tiaozheng duiwai jingji zhanlüe" [China Should Adjust Its Foreign Economic Strategy as Soon as Possible], *Jingji Cankao Bao*, February 24, 2014.

The fact that the CCP regime has ambitious goals does not mean that it will be able to achieve them. China's leaders face serious obstacles to sustaining growth, including the burdens imposed by past policies that have saddled the country with a rapidly aging population, a badly contaminated natural environment, and a mountain of debt. Massive subsidies and top-down programs designed to force technological innovation will likely prove wasteful, at least to some degree, and could wind up diverting resources into costly dead ends.[56] The aggressiveness of many of Beijing's present policies may provoke effective counters from other countries, nullifying the gains they were intended to achieve and perhaps leaving China worse off than it would have been if its leaders had chosen a more accommodating course. In the long run, it may well prove to be the case that rigid political control and economic vitality are incompatible. Like the Soviet Union before it, CCP-ruled China could spiral down into stagnation, leading ultimately to irresistible pressures for liberalizing reform, whether from inside the party or from society at large. At least for the moment, however, no such transition appears imminent.

A New U.S. Strategy

Objectives

The United States now finds itself engaged in an intensifying geopolitical and ideological rivalry with an adversary to which it is closely joined economically. The two countries are linked not only via traditional imports and exports of goods and capital but also through complex supply chains, data flows, and movements of people, including large numbers of tourists, students, and business executives. These are new and unfamiliar circumstances, very different from those that prevailed during the Cold War struggle against the Soviet Union. Over the course of the past decade, the United States has sought to respond to the growth of Chinese power by enhancing its own military capabilities in Asia and strengthening its alliances and quasi-alliance ties to others in the region. Until very recently, however, U.S. economic policies toward China were essentially unchanged. One way or another, this incongruity is now coming to an end.

What should be the objectives of the economic dimension of a new, comprehensive strategy for dealing with China?

Accelerating sustainable economic growth. First and most important, U.S. policymakers should aim, over time, to achieve the highest sustainable rate of national economic growth and to ensure that its benefits are distributed more equitably than has been the case in recent decades. In addition to adjustments in its own fiscal, monetary, and regulatory policies, as well as appropriate investments in education, basic scientific research, and national transportation and communications infrastructure, the federal government must take measures to protect the U.S. economy against the potential harmful effects of China's predatory economic policies. Especially troubling are its ongoing theft or extortion of technology and intellectual property, which diminish the value of investments in R&D; use of subsidies to undercut U.S. and other foreign competitors; deployment of a wide array of protective measures that constrict or deny others access to the Chinese market; and efforts to secure preferential access to emerging economies across Eurasia and beyond.

[56] For a recent, measured assessment of the economic prospects, see Martin Wolf, "The Future Might Not Belong to China," *Financial Times*, January 1, 2019.

Addressing these challenges is necessary not only to guarantee the nation's future prosperity but also to preserve its security. Without healthy and more equitable growth, the United States will find it increasingly difficult, both politically and economically, to sustain the measures necessary to wage a successful long-term strategic competition with China.

Strengthening technological advantage. The United States, working in conjunction with its most advanced allies and trading partners, should seek to preserve an edge over China in the development and application of technologies critical to future commercial and military competition. This will require that the United States and its allies take steps to maintain and enhance their own capacities for innovation while at the same time working to slow the pace at which select technologies (including hardware, software, and tacit knowledge) diffuse to China. Because technological competition is dynamic and ongoing, it would be unrealistic to expect to be able to maintain a constant margin in all areas. The object of the exercise should be not to derail China's technological development but rather to stay ahead where it matters most, moving forward even as China advances.

Preserving a favorable balance of economic power. Other things being equal, a nation (or coalition) with a larger economic base will have an advantage in generating additional increments of military power, political influence, and diplomatic leverage over a nation (or coalition) with a smaller one. Together with its allies and strategic partners, the United States should therefore seek to maintain a substantial "GDP gap" in relation to China, even as the latter continues to grow. What this means in practice is not only that the United States should pursue policies that enhance its own prospects for long-term economic growth, but that it should seek to do so in ways that enhance the prospects of its friends, allies, and strategic partners. Whether or not they seek actively to slow China's progress (a course of action that at least for now appears unlikely), U.S. policymakers should prefer policies, such as free trade agreements, that contribute to the growth of countries that share with the United States an interest in balancing Chinese power.

Building the largest possible zone of rule-abiding market economies. Whatever the future course of its relationship with China, the United States should be seeking to build a coalition of like-minded, rule-abiding market states, joined together by high-standard trade and investment agreements. Such agreements can promote shared prosperity, improve the security of supply chains and global value chains, and help ensure that the balance of economic power remains favorable to the advanced industrial democracies. The Trans-Pacific Partnership and the Transatlantic Trade and Investment Partnership represented one multilateral approach to creating and strengthening these kinds of linkages, but there may be others that deserve consideration.

While it works to achieve greater connectivity with its like-minded partners, the United States should also be leading an effort to reform and strengthen existing rules and institutions so that they are better able to deal with China's exploitative and distorting behavior. The United States played the key role in creating these institutions and would sacrifice a source of leverage and legitimacy if it is seen to be the party damaging or abandoning them. For tactical reasons, but also as a matter of principle, Washington should not foreclose the possibility that if Beijing chooses to modify its approach, China can eventually be incorporated fully into a truly fair and open global trading system.

Minimizing vulnerability. Given the CCP regime's objectives, its ability to influence or control the decisions even of nominally private Chinese actors, and its mercantilist approach to trade and investment, other nations have no choice but to defend themselves against the possibility that China might use economic instruments to sabotage, spy on, or seek to exert leverage over them. Because of the nature of the Chinese political system, it would be imprudent to treat China as if it were just another market-oriented, liberal democratic trading partner. While not every instance of reliance on Chinese-made equipment, China-centered supply chains, Chinese capital, or the Chinese market represents a strategic liability, some clearly do. The challenge for U.S. and allied policymakers will be identifying those that may present a problem and mitigating the accompanying risks, preferably at the lowest possible cost.

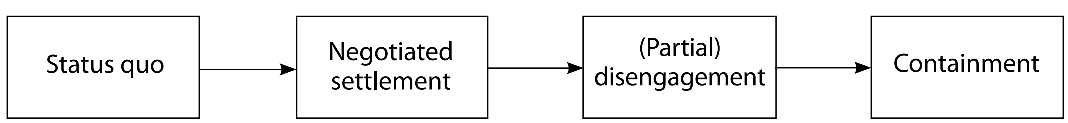
Moreover, if it wishes to offset the gravitational pull of the Chinese economy, the United States needs to ensure that its own markets are as open as possible to its friends and allies. Similarly, if they want to help developing countries avoid excessive and unhealthy entanglement, the advanced industrial nations need to provide alternative sources of investment, as well as opportunities for training and education competitive with those offered by Beijing.

Maintaining leverage. Even as they act to minimize their own exposure, the United States and its allies should consider ways in which they can preserve their ability to exert leverage over China. Under some circumstances, Chinese dependence on the dollar, as well as on imports of U.S. food, energy, and technology, and the continuing desire of Chinese elites to have access to U.S. real estate, financial markets, and educational systems could act as a restraint on Beijing's aggressive impulses. If deterrence fails, the breaking of these links would enable the United States to impose significant costs on China, perhaps encouraging it to change course. As there will inevitably be a measure of dependence and vulnerability in the bilateral relationship, it should at least be mutual and preferably tilted in Washington's favor.

Alternatives

With these overarching objectives in mind, it is possible to envision four broad alternative approaches to managing economic relations with China over the near to medium term (i.e., the next one to five years). These are displayed in **Figure 1**.

FIGURE 1 Four approaches to managing economic relations with China



At one extreme, it is conceivable that the best available choice would be essentially to continue with the same policies that have been in place for most of the past quarter century. Advocates of this position might argue that China's mercantilist policies do not pose as great a threat as is sometimes claimed and will eventually fail of their own accord. Even if these policies prove to be sustainable, the costs of the proposed counters to them would exceed the benefits, damaging American welfare while not contributing appreciably to the nation's security.

At the other end of the spectrum of possibilities is a strategy of containment. Under this approach, the United States would revert to a posture toward China more closely resembling the one it adopted during the first two decades of the Cold War: sharply reducing trade, investment, people-to-people contact, and technology transfer. As during the period from the late 1940s to the early 1970s, the goal here would be to slow China's technological progress, hobbling its growth and, if possible, undermining and weakening the CCP regime. In addition, in contrast with the first Cold War, U.S. policy would have significant defensive aims: shielding the domestic economy from penetration and exploitation and ensuring that China could not destabilize growth or interfere with defense mobilization.

While these alternatives exist as theoretical possibilities, neither appears feasible or desirable at this point. Even most of those who basically favor a continuation of engagement acknowledge that China is pursuing some market-distorting policies that deserve to be addressed. Conversely, even among the harshest critics of the status quo, few have yet gone so far as to openly advocate an all but complete severing of ties with China.

As a practical matter, this leaves two possibilities. On the one hand, through a combination of pressures, inducements, and a potentially protracted process of negotiation, the United States, perhaps acting in concert with other nations, may be able to persuade Beijing to abandon or significantly modify its most problematic practices. The goal here would be to induce or impel China back onto the path of economic liberalization that it was assumed to be following at the turn of the century when it entered the WTO. Abandoning subsidies, shrinking the role of state-owned enterprises, lifting tariffs and non-tariff barriers, and opening the Chinese market fully to imports and investments would finally create a level playing field on which foreign firms could fairly compete. Yet, as will be discussed more fully below, although reciprocity is appealing in principle, even if it can be achieved, mutual openness may not be adequate to protect long-term U.S. strategic interests.

A final possibility, which could either accompany an ongoing search for a negotiated settlement or follow from its failure, would see the United States constricting its economic engagement with China, at least to some degree, and perhaps encouraging others to take similar measures. Tighter regulation of FDI, coupled with new export-control regulations and restrictions on joint research and educational exchange, could make it more difficult for Chinese entities to obtain cutting-edge technologies from the United States, and possibly from other advanced industrial economies as well. Permanent tariffs on some imports, combined with new regulations prohibiting the use of certain Chinese-made parts, sub-assemblies, equipment, and other materials in items procured by the Department of Defense or other government agencies, could result in the restructuring of supply chains. As a result, production could shift either back to the United States or toward friendly countries. The aim of this approach would be to slow the diffusion of technologies critical to future commercial or military competition while minimizing the vulnerability of the United States and other Western countries to surveillance or disruption.

Such policies might well enhance U.S. security and could be justifiable on those grounds. Yet they also would likely carry significant costs. The remainder of this report will explore the preconditions, terms, and probability of an acceptable negotiated settlement to the current trade standoff.

Is a Satisfactory Negotiated Settlement Possible?

State of Play

The United States and China are now locked in a standoff over the terms of their bilateral economic relationship. Over the course of the past year, the Trump administration has imposed three sets of tariffs on a variety of imported products. The first two measures targeted imports of solar panels and washing machines (January 2018) and steel and aluminum (March 2018) coming not only from China but from a number of other countries as well, including U.S. allies. These initial steps were justified on the grounds that low-cost foreign goods were injuring domestic manufacturers. In the case of steel and aluminum, it was further alleged that a loss of domestic capacity could endanger national security. The third set of tariffs was aimed more specifically at China and followed an investigation by the Office of the U.S. Trade Representative into whether Chinese laws and policies discriminated against U.S. companies or harmed their intellectual property rights and innovative capacities. These tariffs, in turn, were imposed in three tranches in July, August, and September and now cover several thousand product categories, comprising an estimated $250 billion worth of Chinese manufactured goods.[57]

In addition to levying taxes on imports, the U.S. Congress has taken a number of steps to respond to what it sees as unfair or inappropriate Chinese efforts to gain access to U.S. technology. Included among these measures are new laws enabling closer scrutiny of attempted Chinese investments in U.S. companies and broader use of export controls, as well as criminal prosecutions against Chinese individuals and entities accused of commercial espionage to steal intellectual property.[58] The Trump administration is also reportedly considering an executive order that would invoke national security concerns to bar U.S. companies from purchasing equipment manufactured by telecommunications giants Huawei and ZTE and to impose new restrictions on Chinese students seeking to study in the United States.[59]

While many of these measures are presumably intended to be permanent, several could be loosened or lifted, along with some or all of the recently imposed tariffs, if Beijing accepts U.S. terms. These, in turn, comprise a long list of demands that can be broken down into three categories: first, promises to cut the bilateral trade deficit by buying more U.S. goods; second, pledges to improve U.S. access to the Chinese market, relaxing restrictions on investment by U.S. firms, including in the service sector, and lowering tariff and non-tariff barriers on imports of U.S. products; and, third, commitments by Beijing to modify its basic approach to promoting industrial development by cutting subsidies and other government support for industries targeted by the Made in China 2025 plan, stopping state-sponsored cybertheft, abandoning the forced extraction of foreign technology, and strengthening protection of intellectual property.[60]

---

57 See Chad P. Bown and Melina Kolb, "Trump's Trade War Timeline: An Up-to-Date Guide," Peterson Institute for International Economics, December 1, 2018, https://piie.com/system/files/documents/trump-trade-war-timeline.pdf.

58 See Alexandra Yoon-Hendricks, "Congress Strengthens Review of Chinese and Other Foreign Investments," *New York Times*, August 1, 2018, https://www.nytimes.com/2018/08/01/business/foreign-investment-united-states.html; Scott R. Anderson, Sarah Tate Chambers, and Molly E. Reynolds, "What's in the New NDAA," Lawfare, August 14, 2018, https://www.lawfareblog.com/whats-new-ndaa; and Katie Benner, "Chinese Intelligence Officers Accused of Stealing Aerospace Secrets," *New York Times*, October 30, 2018, https://www.nytimes.com/2018/10/30/us/politics/justice-department-china-espionage.html.

59 David Shepardson and Diane Bartz, "Exclusive: White House Mulls New Year Executive Order to Bar Huawei, ZTE Purchases," Reuters, December 27, 2018, https://www.reuters.com/article/us-usa-china-huawei-tech-exclusive/exclusive-white-house-mulls-new-year-executive-order-to-bar-huawei-zte-purchases-idUSKCN1OQ09P; and Patricia Zengerle and Matt Spetalnick, "Exclusive: Fearing Espionage, U.S. Weighs Tighter Rules on Chinese Students," Reuters, November 29, 2018, https://www.reuters.com/article/us-usa-china-students-exclusive/exclusive-fearing-espionage-us-weighs-tighter-rules-on-chinese-students-idUSKCN1NY1HE.

60 Enda Curran and Keith Zhai, "Here's What the U.S., China Demanded of Each Other on Trade," Bloomberg, May 4, 2018, https://www.bloomberg.com/news/articles/2018-05-04/here-s-what-u-s-demanded-of-china-at-the-start-of-trade-talks.

For its part, Beijing has placed tariffs on $110 billion worth of imported U.S. goods. While it has evidently been circumspect to date, the CCP regime is reportedly preparing to use so-called qualitative measures to impose further costs and burdens on U.S. companies. These might include more stringent customs inspections, enhanced regulatory oversight of U.S. firms operating inside China, delayed approval for permits and licenses, and unofficial consumer boycotts of U.S. products.[61] The CCP regime could also take steps to offset the impact of U.S. tariffs, holding down the cost of its exports by encouraging the further devaluation of the renminbi in relation to the dollar.[62]

Even as they respond to U.S. restrictions by imposing tariffs of their own, the Chinese authorities have also signaled their willingness to reach a deal, promising to buy more U.S. products (including soybeans and liquefied natural gas),[63] reducing tariffs on U.S. automobiles to where they were before the current dispute began,[64] circulating a draft law that would supposedly ban forced technology transfer from foreign companies and strengthen protection of intellectual property rights,[65] and downplaying public discussion of the controversial Made in China 2025 plan.[66] In terms of its own demands, Beijing is reportedly insisting that the United States lift tariffs on Chinese exports, permit Chinese high-tech manufacturers to bid on U.S. government procurement contracts, open the U.S. e-payment market to Chinese companies, and refrain from discriminating against potential Chinese investors on national security grounds.[67]

Correlation of Forces

As with any bargaining situation, the outcome of the present standoff will be determined by the relative strength and resolve of the two sides, as well as by the shape of their respective "win sets" and the extent to which these overlap. After a few months of escalating confrontation, and with the costs of the trade dispute only beginning to be felt, it is difficult at this point to assess the ability of the parties to absorb economic punishment, nor is it obvious exactly what each would be willing to settle for.

Statements by some U.S. officials, including President Trump, suggest that they believe that China holds a relatively weak hand and will soon be forced to fold. Even if it is not due primarily to the recent trade dispute, the continuing slowdown in China's economic growth must be a cause of intense concern to Chinese policymakers.[68] The prospect of a sustained, and possibly accelerating, falloff in exports to the United States likely adds to the sense of urgency and anxiety in Beijing,

---

61 Enda Curran, "China Has Arsenal of Non-tariff Weapons to Hit Back at Trump," Bloomberg, July 10, 2018, https://www.bloomberg.com/news/articles/2018-07-11/china-has-arsenal-of-non-tariff-weapons-to-hit-back-at-trump.

62 Bryan Borzykowski, "4 Powerful Weapons China Has in Its Arsenal to Win the U.S.-China Trade War," CNBC, July 20, 2018, https://www.cnbc.com/2018/07/19/4-lethal-weapons-china-has-to-help-win-the-us-china-trade-war.html.

63 "China Is Preparing to Buy U.S. LNG and Soybeans Again, Sources Say," Bloomberg, December 5, 2018, https://www.bloomberg.com/news/articles/2018-12-05/china-is-said-to-be-preparing-to-buy-u-s-lng-and-soybeans-again.

64 Jethro Mullen, "China Is Temporarily Slashing Tariffs on U.S. Auto Imports," CNN, December 14, 2018.

65 Yawen Chen and Adam Jourdan, "China's Draft Foreign Investment Law Bans Forced Tech Transfer, Emphasizes Reciprocity," Reuters, December 27, 2018, https://www.reuters.com/article/us-china-economy-foreign-investment/chinas-draft-foreign-investment-law-bans-forced-tech-transfer-emphasizes-reciprocity-idUSKCN1OQ07T.

66 Sidney Leng and Zheng Yangpeng, "Beijing Tries to Play Down 'Made in China 2025' as Donald Trump Escalates Trade Hostilities," *South China Morning Post*, June 26, 2018, https://www.scmp.com/news/china/policies-politics/article/2152422/beijing-tries-play-down-made-china-2025-donald-trump.

67 Curran and Zhai, "Here's What the U.S., China Demanded of Each Other on Trade."

68 The slowdown in growth preceded the escalation of the trade dispute. It appears to be the product of a mix of secular factors (specifically the ongoing maturation of the Chinese economy) and recent government attempts to "deleverage" in order to reduce the nation's vast burden of debt, much of it accumulated in counteracting the effects of the global financial crisis. See Alexandra Stevenson, "China's Growth Hits Slowest Pace in a Decade," *New York Times*, October 18, 2018, https://www.nytimes.com/2018/10/18/business/china-economy-third-quarter.html.

and the sharp drop in China's stock market over the past year suggests that these worries may be widespread.[69] In recent months, there have also been a number of unusual instances of open criticism by academics of Xi Jinping's policies on a variety of issues, including his handling of relations with the United States.[70] The past year has also seen more frequent rumors of increasing "disharmony" within the CCP elite.[71]

Despite all of this, Xi, who was previously assumed to have concentrated power in his own hands to a virtually unprecedented degree, has thus far shown no evidence of wavering or weakness. To the contrary, in an apparent response to grumbling over the escalating trade dispute, he informed a recent meeting of party bureaucrats that the regime's handling of "propaganda work" had in fact been "absolutely correct."[72] A few months later, at a year-end meeting of the Politburo, top CCP officials were reportedly required to engage in "criticism, self-criticism," a practice from the Maoist era intended to impose discipline and uniformity.[73] On a more practical level, Beijing has responded to the recent economic slowdown with a mix of tax cuts, monetary stimulus, and yet more infrastructure spending designed to sustain growth and cushion the effects of a drop in exports to the United States.[74] While Xi may yet be compelled to give ground, or choose to do so for tactical reasons, his assertions of personal authority and frequent calls for "self-reliance" do not suggest a fundamental softening in his stance, either at home or abroad.

Meanwhile, on the other side of the Pacific, U.S. resolve could turn out to be more fragile than a simple assessment of objective factors might suggest. It is true that, as President Trump has pointed out, the United States imports far more from China than it exports in return. U.S. exports to China also account for a considerably smaller share of total U.S. output than China's exports to the United States contribute to its own GDP.[75] Notwithstanding this disparity, Chinese tariffs (most notably those on agricultural products, and especially soybeans, the largest single item targeted) have been shrewdly crafted to impose pain on the small towns and rural areas of the country that voted disproportionately for the president in 2016, and on whose support he will presumably need to rely if he chooses to run for re-election in 2020.[76]

Because the first rounds of U.S. tariffs were aimed primarily at so-called capital and intermediate goods mainly used by business, and because those that hit consumer products were relatively low, their impact on ordinary consumers was limited and indirect. If negotiations fail and the administration follows through on its threat to raise tariff levels and to tax virtually

---

69 "China Has the World's Worst Stock Market with $2.4 Trillion Loss," Bloomberg, December 27, 2018, https://www.bloomberg.com/news/articles/2018-12-27/china-has-the-world-s-worst-stock-market-with-2-3-trillion-loss.

70 Chris Buckley, "As China's Woes Mount, Xi Jinping Faces Rare Rebuke at Home," *New York Times*, July 31, 2018, https://www.nytimes.com/2018/07/31/world/asia/xi-jinping-internal-dissent.html.

71 Geremie R. Barmé, "Deathwatch for a Chairman: Watching China Watching (XXXI)," China Heritage, July 17, 2018.

72 "China's Xi Says Ideology Work 'Absolutely Correct' amid Trade Row Criticism," Reuters, August 22, 2018, https://www.reuters.com/article/us-china-politics/chinas-xi-says-internet-must-be-clean-and-righteous-idUSKCN1L71CG.

73 Ryan Drillsma, "Xi Forces Top Chinese Officials to Conduct Self-Criticisms," *Taiwan News*, December 28, 2018, https://www.taiwannews.com.tw/en/news/3606243.

74 Tom Hancock, "China Steps Up Fiscal Spending as It Approves $125bn of Rail Projects," *Financial Times*, January 7, 2018, https://www.ft.com/content/c272c1fc-0fee-11e9-a3aa-118c761d2745; Gabriel Wildau, "China's Response to Its Slowing Economy and the Trade War—In Charts," *Financial Times*, November 14, 2018, https://www.ft.com/content/6267c992-e726-11e8-8a85-04b8afea6ea3; and Barry Naughton, "Economic Policy under Trade War Conditions: Can China Move Beyond Tit for Tat?" Hoover Institution, China Leadership Monitor, no. 57, Fall 2018, https://www.hoover.org/sites/default/files/research/docs/clm57-bn-final.pdf.

75 See World Bank, DataBank; and "U.S. Trade with Major Trading Partners."

76 Joseph Parilla and Max Bouchet, "Which U.S. Communities Are Most Affected by Chinese, EU, and NAFTA Retaliatory Tariffs?" Brookings Institution, October 2018, https://www.brookings.edu/research/which-us-communities-are-most-affected-by-chinese-eu-and-nafta-retaliatory-tariffs; and Binyamin Appelbaum, "Their Soybeans Piling Up, Farmers Hope Trade War Ends before Beans Rot," *New York Times*, November 5, 2018, https://www.nytimes.com/2018/11/05/business/soybeans-farmers-trade-war.html.

all remaining Chinese imports, the effects will include moderately higher prices for an array of consumer products.[77] Finally, whatever the actual linkages to the trade dispute, further turbulence in the U.S. stock market, more announcements of worse-than-expected performance by large U.S. companies like Apple, and/or a slowdown in overall growth will contribute to pressure on the Trump administration to reach some kind of compromise with Beijing. These pressures seem certain to increase as the 2020 election draws closer. Taking a tougher stand on trade with China is not controversial at this point; indeed, to the contrary, there is a striking convergence of opinion on the necessity of doing so among both Democrats and Republicans. But this consensus will probably fray and could break down as the costs mount and the campaign season begins.

Potential Outcomes

Notwithstanding the relative strength of the overall U.S. economic position, and the pressure that tariffs appear to be putting on China, it is possible that, for political reasons, the Trump administration may decide to settle for some version of what the Chinese side is offering: essentially a mix of promises to modify or abandon its industrial policies, open its market, and buy more American products. The difficulty with any such agreement is that, far from yielding meaningful, lasting change, it would likely end up simply codifying the *status quo ante*. Beijing has a long history of making solemn commitments to reform, both in its own planning documents and in its undertakings to international institutions, and then bending or breaking them as it sees fit. As for its pledges to narrow the trade imbalance by increasing imports from the United States, these too will likely be of little lasting value. Although China lacks the capacity to buy from the United States as much as it sells, within certain limits Beijing can dial imports up to placate Washington. But it can just as easily dial them down.

There are at least two additional reasons that it would be a mistake for U.S. negotiators to place excessive emphasis on shrinking the trade deficit with China. First, as most economists agree, a nation's bilateral balance with any single trading partner is virtually irrelevant as a measure of its overall well-being.[78] Moreover, even if it could be achieved, a more balanced bilateral account would not necessarily be indicative of an economic relationship that serves long-term U.S. national interests. As Stephen Ezell points out, the United States could reduce its trade deficit with China by exporting yet more agricultural goods and raw materials, even as it imports increasing volumes of high-tech, value-added products. In such a scenario, however, the United States would face the growing risk of losing its position as a global technology leader, with troubling implications for its future prosperity and security.[79]

Instead of trying to legislate a particular result in bilateral trade, the ultimate aim of U.S. policy in the current standoff should be to alter the entire process through which China interacts economically not only with the United States but with the rest of the world as well. In other words,

---

[77] Chad P. Bown, Euijin Jung, and Zhiyao (Lucy) Lu, "Trump and China Formalize Tariffs on $260 Billion of Imports and Look Ahead to Next Phase," Peterson Institute for International Economics, Policy Watch, September 20, 2018, https://piie.com/blogs/trade-investment-policy-watch/trump-and-china-formalize-tariffs-260-billion-imports-and-look. At this point, however, the aggregate impact of the tariffs imposed on Chinese imports is miniscule. As Martin Feldstein points out, in a $20 trillion economy a 25% tax on $200 billion in imports amounts to 0.25% of total sales, "hardly noticeable in the overall cost of living." See Martin Feldstein, "Tariffs Should Target Chinese Lawlessness, Not the Trade Deficit," *Wall Street Journal*, December 27, 2018, https://www.wsj.com/articles/tariffs-should-target-chinese-lawlessness-not-the-trade-deficit-11545955628.

[78] See, for example, Martin Feldstein, "Inconvenient Truths about the U.S. Trade Deficit," *Wall Street Journal*, April 25, 2017, https://www.project-syndicate.org/commentary/america-trade-deficit-inconvenient-truth-by-martin-feldstein-2017-04.

[79] At the extreme, the United States could be headed back to becoming a nation of "hewers of wood and drawers of water." Stephen Ezell, "Trump Must Fight for the Jobs of Tomorrow in Meetings with China," *Hill*, April 7, 2017, https://thehill.com/blogs/pundits-blog/economy-budget/327770-trump-must-fight-for-the-jobs-of-tomorrow-in-meetings-with.

through the application of strong pressure, Washington should be seeking an outcome that decades of gentle cajoling have thus far failed to attain: convincing Beijing to play by the rules of the global trading system as these have generally been understood in Washington and other Western capitals. This would require the CCP regime to bring its economic policies into conformity with those of the advanced industrial nations and finally fulfill its promises to permit market forces rather than state intervention to play the dominant role at home and in international trade.

The second and third categories of U.S. demands (for China to improve market access and abandon its market-distorting industrial and technology policies) are targeted at achieving this result. If it wants to continue to enjoy the same degree of access to the markets of other countries, Beijing must drop its use of tariffs, regulations, administrative procedures, and other, informal techniques to limit not only the United States' but other foreign firms' access to the Chinese market or to restrict their ability to compete effectively against local counterparts. In addition to opening its own market, China must cease its excessive use of subsidies, both explicit and disguised, to support Chinese firms. This long-standing practice enables them to build excess capacity, undercutting and potentially even destroying foreign competitors on global markets. Most important of all, Beijing must abandon its relentless and ongoing efforts to acquire foreign technology and intellectual property using methods that contravene international agreements or national laws, including cybertheft and other forms of industrial espionage, as well as forced transfer via compulsory joint ventures for firms seeking market access. Again, if it is to create a truly level global playing field, this prohibition would need to extend to China's activities targeting all other countries and not just the United States.[80]

For reasons that have already been suggested, any new commitments that Beijing might make to resolve these issues will be of limited value unless they are accompanied by robust provisions for verification and enforcement. These must include some mechanism or procedure for assessing China's performance, adjudicating any disputes that might arise over implementation, and imposing penalties for noncompliance. Given the level of mistrust on the U.S. side, in order to be truly credible a future agreement might have to look more like an arms control treaty than a traditional trade deal.

According to press accounts, the Trump administration has proposed that the two sides set specific targets and meet periodically to review them. But it has also insisted that the U.S. government would reserve the right to reach its own conclusions and to impose punishments in the form of renewed tariffs or other restrictions if China has failed to live up to its commitments. The administration reportedly also has demanded that, should this happen, Beijing must agree in advance not to retaliate.[81]

---

[80] While there are variations in emphasis, most observers, including non-Americans, cite similar lists of concerns. For a formal statement of U.S. complaints, see a paper presented to the WTO by U.S. ambassador Dennis Shea. Dennis Shea "China's Trade-Disruptive Economic Model: Communication from the United States," July 11, 2018. See also Robert D. Atkinson, "China Might Be Looking to End the Trade War. Don't Let It Off Easy," *Washington Post*, November 29, 2018, https://www.washingtonpost.com/opinions/china-might-be-looking-to-end-the-trade-war-dont-let-it-off-easy/2018/11/29/6a8c1a82-f348-11e8-bc79-68604ed88993_story.html; Jean-Maurice Ripert and Clemens von Goetze, "'Will Shanghai Become Milestone for China's Opening-Up?' Ask French, German Ambassadors," Caixin, November 1, 2018, https://www.caixinglobal.com/2018-11-01/opinion-will-shanghai-become-milestone-for-chinas-opening-up-101341138.html; and Office of the USTR, "Joint Statement on Trilateral Meeting of the Trade Ministers of the United States, Japan and the European Union," September 25, 2018, https://ustr.gov/about-us/policy-offices/press-office/press-releases/2018/september/joint-statement-trilateral.

[81] Curran and Zhai, "Here's What the U.S., China Demanded of Each Other on Trade."

Obstacles and Caveats

While it is certainly worthwhile to try, there are a number of reasons for believing that an agreement along the lines just described will be extremely difficult to reach. As regards enforcement, it stretches credulity to imagine that a sovereign nation, still less one that sees itself as a rising global superpower, would agree to permit its greatest rival to act as judge, jury, and executioner in any disputes between them. Unilateral U.S. demands for such an arrangement will be seen by the CCP leadership as an intrusive affront to Chinese sovereignty. On the other hand, from a U.S. perspective, a mechanism in which disagreements are submitted to supposedly impartial arbitration before existing international bodies will appear as a formula for endless litigation and yet more delay.

The problem of enforcement aside, the objections that the United States and other foreign powers have raised to China's trade and economic policies highlight fundamental features of its mercantilist-Leninist system rather than mere "bugs." As discussed in the opening sections of this report, the CCP leadership believes that its ability to exert control over the direction of the economy is essential to retaining the party's grip on political power and eventually achieving its grand strategic objectives. Existing policies also enjoy strong support from the interest groups and individuals who benefit from them. What is more, while recognizing certain problems and challenges, the CCP appears to believe that its preferred approach is working and that changing course would be dangerous as well as difficult. Indeed, some commentators have suggested that U.S. pressure is a direct response to China's success, part of an elaborate scheme to lure Beijing into a trap, forcing it to adopt policies that undermine Chinese progress, much as Washington allegedly did to Japan in the mid-1980s.[82] Xi Jinping's extensive power may give him the leeway to make tactical concessions if he deems them necessary. Conversely, the apparent scope of his authority and his personal association with existing initiatives may make it difficult for him to change direction in any substantial way without appearing weak.

Matched against these powerful sources of resistance, the United States acting alone may simply lack sufficient leverage to compel China to accede to Washington's most important demands. Given the perceived stakes, combined with uncertainty in Beijing about the strength of the United States' resolve (and its willingness or ability to make common cause with the other advanced industrial countries), the CCP regime is highly unlikely to make meaningful concessions quickly and without exhausting every possible expedient.

One final issue that has not yet received the attention it deserves: while an agreement that makes progress in rolling back some of China's mercantilist policies might be desirable from a purely economic standpoint by promoting the fortunes of some U.S. companies, it would not be sufficient to address important concerns about U.S. national security. For as long as China remains a military and geopolitical rival of the United States, there will continue to be reasons to restrict its access to certain critical technologies and to exercise caution in integrating China-based companies into sensitive supply chains. Given the character of the CCP regime and the nature of its objectives, Washington was unwise to regard China as simply another "normal" U.S. trading partner. Pending far-reaching changes, it would be imprudent in the extreme to go back to trying to treat China as one, even if Beijing does modify some of its more egregious economic policies.

---

82 See "Chinese State Media Cites Japan's 'Lost Decade' When Warning of Risks of Giving in to U.S. Demands," *South China Morning Post*, August 17, 2018, https://www.scmp.com/news/china/diplomacy-defence/article/2160196/chinese-state-media-cites-japans-lost-decade-when; and Zhang Wang, "China Won't Repeat Japan's Plaza Accord Mistake," *Global Times*, March 28, 2018, http://www.globaltimes.cn/content/1095660.shtml.

Next Steps

The Trump administration deserves considerable credit for challenging China on trade and beginning a process that may yet yield substantial benefits. To date, however, the administration appears to have chosen an approach that emphasizes the application of unilateral pressure in pursuit of near-term results. Given the magnitude and complexity of the problem, and the intensity of the resistance to change on the Chinese side, the likelihood that such tactics will yield truly meaningful results is limited. Any agreement reached under these conditions is likely to be an unstable one, and the gains, transient. Even with more time and greater collective pressure it may prove impossible to persuade Beijing to undertake deep and far-reaching structural reforms; but a more deliberate and coordinated approach would certainly improve the odds of success.

The details of a more comprehensive, long-term strategy for addressing the economic dimension of the challenge posed by China will be discussed in a subsequent report. In the coming weeks and months, U.S. policy for managing the current standoff over trade should combine the following interrelated elements.

Keep up the pressure. The tariffs imposed in the past year are an imperfect tool, at best; while the costs to date have been limited, they distort markets and impose a tax on American consumers and producers. Still, in contrast with the milder methods employed in the past, these retaliatory protective measures have clearly commanded the attention of Chinese policymakers, compelling them to come to the table with greater seriousness and creating at least the possibility of eventual change. Lifting tariffs prematurely would mean abandoning one of the few effective tools for punishing Chinese mercantilism. Worse, it would likely confirm the assessments of those in Beijing who believe that market democracies like the United States lack the capacity and the resolve to stand firm in the face of potentially painful pressure tactics.

The Trump administration should therefore resist demands that it lift tariffs in return for anything less than significant, verifiable progress on structural issues. An agreement in which both sides ratchet back duties on each other's imports, even if accompanied by Chinese promises to buy more U.S. goods and services, would not achieve this end. If talks appear to be producing real results, Washington might agree to extend the current 90-day ceasefire, forgoing the application of additional tariffs for a specified period. If acceptable agreements can be reached regarding Beijing's policies in particular sectors, then the U.S. side might agree to at least a partial lifting of tariffs in those areas. But it should not fritter away the leverage it has now through misguided gestures of goodwill or in response to offers that would not address the profound problems that have led to the current confrontation.

Extend time horizons and mobilize public support. Rather than treating it as an intense, all-or-nothing effort to achieve immediate gains, Washington needs to recalibrate the U.S. approach to the current standoff, making clear that this is only the first skirmish in what seems certain to be a protracted and difficult campaign. This is in part a matter of public education. Instead of holding out the empty promise of a quick, easy, "incredible" deal, administration officials need to do more to explain to the American people why it has become necessary to respond forcefully to China's exploitative behavior, even at some short-term cost to particular domestic interests and to the nation as a whole. Given the growing weight of the Chinese economy, and the clear intent behind Beijing's technology promotion and industrial development policies, failure to act now will lead to even greater and more enduring costs in the future.

U.S. officials also need to make clear that what is unfolding is not merely a dispute over intellectual property rights, subsidies, and state-owned enterprises. It is certainly true that, at the direction and with the assistance of their government, Chinese companies are "cheating," "stealing," and "not playing by the rules." But the deeper difficulty arises from the oppressive, authoritarian character of the CCP regime and the fact that it is using a portion of the increasing wealth at its disposal to pursue aims that are threatening to the interests and inimical to the values of the United States and other democratic countries. Today's controversies over trade, investment, and technology are only one part of a much larger rivalry between competing systems and worldviews. Without a full accounting of the stakes, the American people cannot be expected to support the economic policies necessary to wage this struggle.

Build maximum aggregate leverage. The intensifying competition between the United States and China is not occurring in isolation from the relations that these two giants have with other countries. The world's two largest economies and most powerful states, despite their divergent values, economic systems, cultures, historical legacies, and views of governance, are both deeply integrated into the economies of other nations through trade, investment, and complex supply chains. This has resulted in a rapidly changing and potentially unstable balance of economic power.

To build maximum pressure for reform on the CCP leadership, the United States will need to assemble a coalition of states that share its concerns about China's predatory policies and unfair trading practices. With this end in view, it would be desirable for Washington to reach prompt and mutually acceptable resolutions to the outstanding disputes that currently divide the United States from some of its traditional allies and most important trading partners in both Europe and Asia. Whatever the merits of the arguments on either side of these disagreements, their significance pales in comparison to the common challenge that all parties now face from China.

If the United States persists in pursuing purely bilateral agreements with China, it risks creating outcomes that could increase the burdens on others—for example, by deflecting some surplus production from the U.S. market to those of its trading partners in Europe and Asia. In addition to depriving the United States of the full support of its friends, proceeding in this way gives Beijing reason to hope that, with enough patience and guile, it can drive wedges between the advanced industrial democracies and outwait U.S. pressure. Shared values aside, from a purely power-political standpoint, it would make more sense for the United States to join forces with these countries rather than being embroiled in conflict on all sides simultaneously.

As a first step toward forging a common position, the Trump administration should consider organizing a summit meeting of advanced industrial nations that seeks to build on the joint statement issued by U.S., EU, and Japanese trade officials in September 2018.[83] Among the tactical questions that will need to be addressed is whether to pursue negotiations directly in an expanded, multinational version of the administration's current approach or through existing institutional channels.[84]

While working to develop a common negotiating position toward China with its friends and allies, the United States should also be laying the groundwork for reconstituting, over the longer

---

83 Office of the USTR, "Joint Statement on Trilateral Meeting of the Trade Ministers of the United States, Japan and the European Union."

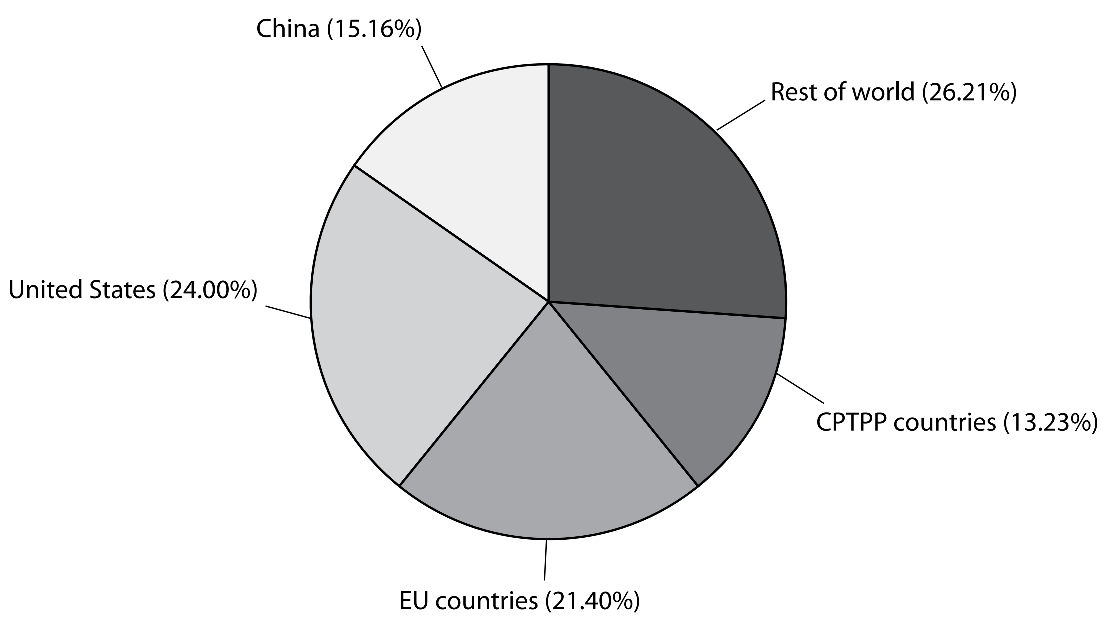
84 One way of doing this would be to bring a "big, bold multilateral" case against China at the WTO. See Jennifer Hillman, "The Best Way to Address China's Unfair Policies and Practices Is through a Big, Bold Multilateral Case at the WTO," testimony before the U.S.-China Economic and Security Review Commission, Washington, D.C., June 8, 2018, https://www.uscc.gov/sites/default/files/Hillman%20 Testimony%20US%20China%20Comm%20w%20Appendix%20A.pdf.

term, a stronger and more closely integrated grouping of market-oriented liberal democracies. This will require hammering out trade and investment agreements that adhere to high standards and create the widest possible zone of unencumbered trade and investment among countries that agree on basic principles and adhere to shared rules.

Toward this end, consideration should be given to assembling a coalition of advanced market economies, based on the model used for the Trade in Services Agreement and digital trade (e-commerce) negotiations, to begin discussions of possible high-standard approaches to a range of trade issues. This initiative could be used either to build momentum for WTO reform or to lay the foundation for an alternative "WTO plus" approach, under which the advanced market economies would develop rules of engagement for dealing with non-market economies. In addition, having completed the U.S.-Mexico-Canada Agreement (USMCA), Washington should use bilateral trade talks with Japan to explore a renegotiated pathway into the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). Changes would be required for the United States' accession, but this outcome would be quicker to achieve and more effective than a bilateral agreement and would be politically easier for Prime Minister Shinzo Abe, who is facing local and upper chamber parliamentary elections later this year. Finally, the United States should not abandon the possibility of achieving some kind of "zero tariff" trans-Atlantic free trade agreement with EU nations.[85]

As illustrated in **Figure 2**, taken together, the economies in the CPTPP, EU, and the United States command roughly 59% of global GDP, giving them more than enough leverage to counterbalance China's growing strength and increasingly aggressive and exploitative behavior.

FIGURE 2 Shares of global GDP



SOURCE: World Bank, "GDP (Current US$)," https://data.worldbank.org/indicator/NY.GDP.MKTP.CD.

[85] David Smith and Dominic Rushe, "Trump and EU Officials Agree to Work Toward 'Zero Tariff' Deal," *Guardian*, July 25, 2018.

Intensify defensive measures. Whatever the outcome of current negotiations with China, the U.S. government should intensify its own efforts and coordinate more closely with friends and allies to protect against Chinese penetration and exploitation of their national economies. This will require strengthening collective defenses against illicit Chinese attempts to acquire cutting-edge technologies through cybertheft, concealed investments, and industrial espionage and working together to prevent the transfer by any means of products or knowledge that could improve China's military capabilities or enhance its ability to surveil and repress its own population.

To achieve these objectives, the United States should cooperate with its friends and allies to improve the efficient use of export controls and to expand and institutionalize mechanisms for information sharing and policy coordination in the area of investment screening. In addition to these more traditional policy instruments, the U.S. government, in collaboration with the private sector, should be exploring innovative new tools and techniques to guard against the risks to intellectual property and the integrity of supply chains in a highly integrated global economy. One possibility would be to establish a dynamic scoring mechanism, similar to that used to assess individual credit risk. Such a system could provide public and private actors in the United States and abroad with real-time information about the reliability of Chinese companies with which they are contemplating doing business.

The effect of all these defensive measures, some of which are already in train, will be to impose a degree of separation between China's economy and the economies of many of its advanced industrial trading partners. How far and how fast this process of disengagement proceeds will depend in large part on whether Beijing proves capable of changing its ways.

TASKFORCE MEMBERS

Charles W. Boustany Jr. (co-chair and principal investigator)
Aaron L. Friedberg (co-chair and principal investigator)

George Davidson
Jacqueline Deal
Ashley Dutta (ex officio)
Richard J. Ellings (ex officio)
Stephen Ezell
Roy D. Kamphausen (ex officio)
Claire Reade
Nadège Rolland
Julian Snelder
Ashley J. Tellis

NBR THE NATIONAL BUREAU *of* ASIAN RESEARCH

Seattle and Washington, D.C.

1414 NE 42ND STREET, SUITE 300
SEATTLE, WASHINGTON 98105 USA
PHONE 206-632-7370, FAX 206-632-7487

1819 L STREET NW, NINTH FLOOR
WASHINGTON, D.C. 20036 USA
PHONE 202-347-9767, FAX 202-347-9766

NBR@NBR.ORG, WWW.NBR.ORG