

The Future of China-U.S. Relation

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Introduction

- ◆ The China-U.S. relation is arguably the most important bilateral relation in the world today.
- ◆ The U.S. and China are respectively the largest and the second largest economy in the world today. They are also respectively the largest and the second largest trading nation in the world. They are also the largest trading partner of each other.
- ◆ If China and the U.S. work together, many things are possible. An example is the Paris Agreement on the prevention of climate change, reached unanimously by 196 states and other parties in December 2015. It was possible only because both President Barack Obama and President XI Jinping worked together to make it happen.
- ◆ However, it is far too early to speak of a “G-2”.

A Little History

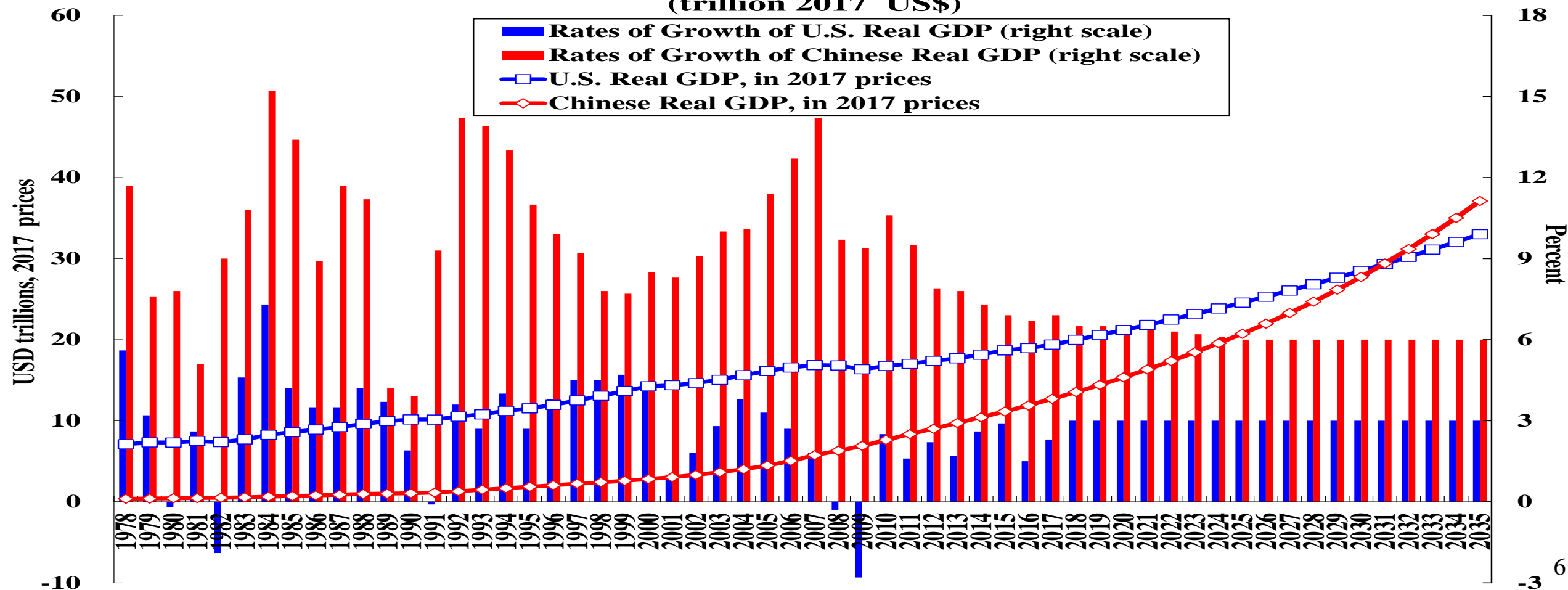
- ◆ The U.S. was the only major power without a colony, “concession” (leased territory), or sphere of influence in China in the 19th and the first half of the 20th Century.
- ◆ The predecessor of Tsinghua University, Tsinghua Xuetang, a preparatory school, was initially established with funds returned by the U.S. from its share of the Boxer Indemnity. The Peking Union Medical College (PUMC) was supported by the Rockefeller Foundation. The Flying Tigers of General Claire Chennault were volunteer American pilots supporting China in the Sino-Japanese War.
- ◆ The Korean War (1950-1953) made China and the U.S. enemies. However, the Sino-Soviet dispute which began in the late 1950s and early 1960s provided an opening. And the Kissinger-Nixon visits in the early 1970s made possible U.S.-China cooperation against the Soviet Union.
- ◆ The June 4, 1989 incident and the fall of the Berlin Wall in November 1989 and the subsequent dissolution of the Soviet Union in 1991 profoundly altered the geo-political situation of the world.
- ◆ China was finally able to accede to the World Trade Organisation (WTO) in 2001, after which its exports to the U.S. and the world expanded rapidly.

From Mentee to Potential Competitor

- ◆ Chinese economic growth has been rapid, especially after its accession to the WTO.
- ◆ In terms of aggregate GDP, China went from only 20 percent of the U.S. GDP in 2000 to two-thirds in 2017. It is only a matter of time that the Chinese GDP will catch up with the U.S. GDP, probably in the early 2030s (see my projections in the following charts).
- ◆ However, in terms of GDP per capita, China is still way behind, with US\$9,137 compared to almost US\$60,000 for the U.S. in 2017. My own projections suggest that it will probably take until the end of the Twenty-First Century before Chinese GDP per capita approaches the U.S. level.

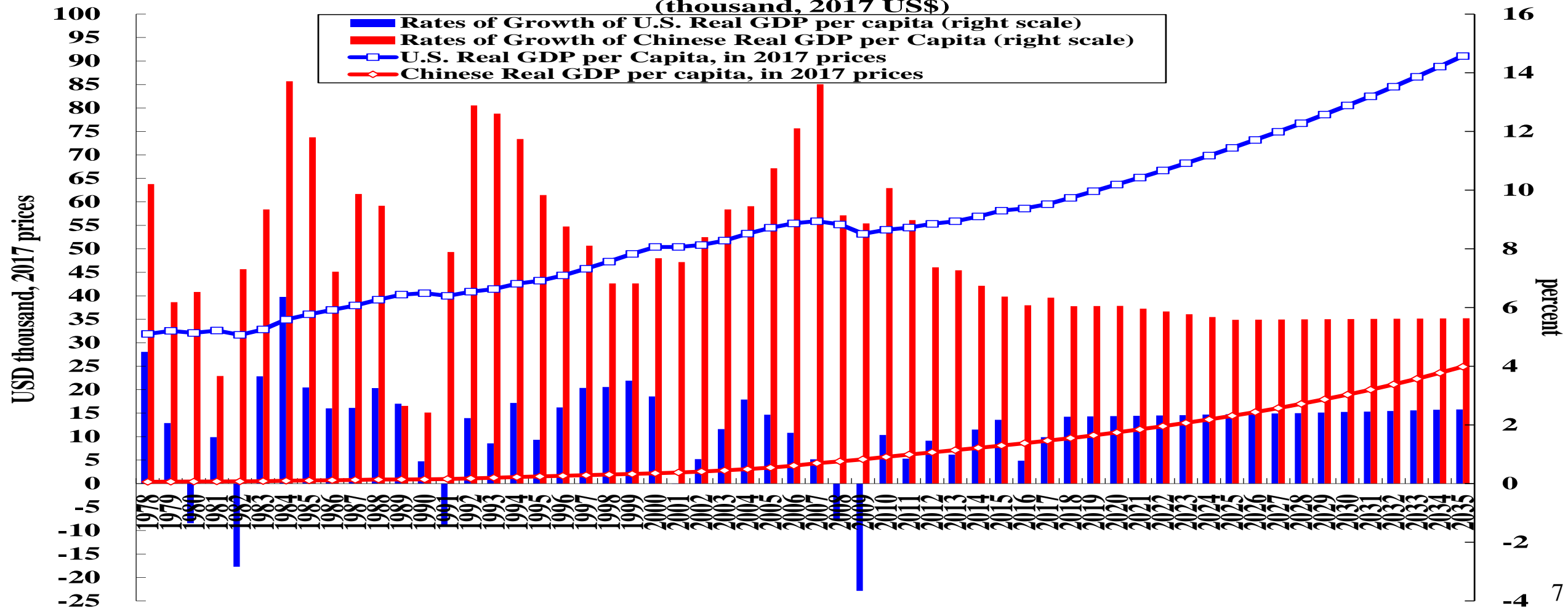
Actual and Projected Levels and Growth Rates of Chinese and U.S. Real GDP (2017 tril. US\$)

Actual and Projected Chinese and U.S. Real GDPs and Their Rates of Growth (trillion 2017 US\$)



Actual and Projected Chinese and U.S. Levels and Growth Rates of Real GDP/Capita (1000 2017 US\$)

Actual and Projected Chinese and U.S. Real GDP per Capita and Their Rates of Growth
(thousand, 2017 US\$)



From Mentee to Potential Competitor

- ◆ It is because of the rapid economic growth of China that it is now viewed by the U.S. as a competitor.
- ◆ The current China-U.S. trade war is a reflection of the underlying China-U.S. competition for economic and technological dominance as well as the rise of populism, isolationism and protectionism in the U.S. but also almost everywhere in the world.
- ◆ This competition, whether explicit or implicit, and whether intentional or not, will not go away soon. It did not begin with President Donald Trump. Both the “Pivot to Asia” and the “Trans-Pacific Partnership” were measures initiated by President Barack Obama with the objective of containing the expansion of China. The China-U.S. competition will not go away even after President Trump leaves office.

From Mentee to Potential Competitor

- ◆ However, competition can potentially lead to constructive and positive as well as destructive and negative outcomes. For example, the competition on creating the fastest super-computer has already resulted in both countries producing better and faster super-computers. The champion in 2018 is the IBM Summit, a U.S. super-computer, which beat the Sunway TaihuLight, the champion in 2016 and 2017, a Chinese super-computer that was built entirely with indigenously designed chips.
- ◆ In terms of the number of nuclear-armed warheads, the U.S. is way ahead by at least an order of magnitude in total, and even more in per capita terms. This is not a competition that China should wish to join.
- ◆ However, a race to find an effective cure for cancer or Alzheimer's disease would be worthwhile for both countries and in fact for the entire world.
- ◆ Other areas of potential beneficial cooperation between China and the U.S. include the prevention of climate change, R&D on nuclear fusion, and space exploration.

New Major Power Relation

- ◆ Prof. Graham Allison of the Kennedy School at Harvard University has written about the inevitability of a China-U.S. war. As a rising power challenges the dominance of an established power, the established power is likely to respond with force. He refers to this “inevitability” as the “Thucydides Trap”, drawing on Thucydides’s History of the Peloponnesian War.
- ◆ I do not believe that war between China and the U.S. is inevitable. Such a war will probably result in China being completely devastated and a couple of cities in the U.S. destroyed. There will be no real winners. It would just be pure “madness”.
- ◆ However, whether China and the U.S. will become friends or foes in the future depends on the expectations on both sides, which can be self-fulfilling. If they both believe that they will be friends, and act accordingly, they will be friends; if they both believe that they will be foes, and act accordingly, they will become foes. Thus, expectations must be carefully managed by the leaders on both sides.

New Major Power Relation

- ◆ Moreover, both China and the U.S. suffer from the same problem—neither of them have had any experience of treating a friendly nation as an equal.
- ◆ Historically, China either treated all other countries as vassal states, or it was subservient to the more powerful Western nations (between 1840 and 1949).
- ◆ The U.S. was a savior to the U.K., France and other countries in Western Europe in the two World Wars. It was a victor to (and one-time occupier of) Germany, Italy and Japan. It defended Western Europe from Soviet expansionism between 1945 and 1989. And the U.S. certainly has no equal in both North and South America. The U.S. considers none of these countries as its equal. It did consider the former Soviet Union as an equal; but it was not a friend, it was an adversary.
- ◆ Both China and the U.S. have to learn to treat each other as an equal friend and respect each other's differences. In particular, they have to respect each other's core interests. 11

The Current Trade War

- ◆ The proximate cause of the China-U.S. trade war is the persistent U.S.-China trade deficit in goods and services. There exist significant differences in the official Chinese and U.S. estimates of the trade deficit. However, the trade deficit, as measured in value-added terms, may be estimated at approximately US\$150 billion in 2017 (see Lawrence J. Lau (2018)). This contrasts with the U.S. figure for the trade deficit in goods only of US\$375 billion in gross value terms. The U.S. has a surplus in trade in services between the two countries.
- ◆ While the immediate direct impacts of the China-U.S. trade war on the Chinese economy are certainly negative, they are small in real terms, affecting less than 0.5 percent of Chinese GDP, and quite manageable for China. Even after taking into account the indirect second-, third-, and higher-round effects, the total reduction in Chinese GDP may be estimated to be approximately 1.12%. There is no need to panic.

The Current Trade War

- ◆ However, President Donald Trump has threatened to impose tariffs on another US\$267 billion of Chinese imports. This will essentially cover all the U.S. imports from China, including the Apple i-phones where are finally assembled in China. It will result in a significant increase in Apple i-phones in the U.S. market.
- ◆ Such an escalation will lead to a decline in Chinese GDP of approximately 2.25%, which is tolerable.
- ◆ the trade war is not likely to end soon, at least not before the U.S. mid-term elections.
- ◆ The concern is that the trade war itself may do damage to the longer-term relation between China and the U.S.

The Current Trade War

- ◆ The immediate direct impacts on the U.S. economy are even smaller. Suppose half of U.S. exports of goods to China is halted by the Chinese tariffs, it would amount to a loss of U.S. GDP of 0.17%. This is not significant for the U.S. economy as a whole.
- ◆ Even after taking into account the indirect second-, third-, and higher-round effects, the total reduction in U.S. GDP may be estimated at approximately 0.30%. It is not likely that all the U.S. exports to China will be halted. Even if it were done, the effect will be around 0.60%, tolerable for the U.S.
- ◆ President Donald Trump's primary objective is to run and win re-election in 2020. In the interim, he would need to have the Republican Party retain a majority in both the House of Representatives and the Senate of the U.S. Congress in the mid-term elections to be held on 6 November 2019.
- ◆ President Trump did promise to be tough on China during his presidential campaign in 2016. He will use China as a villain and bash China in the mid-term elections. It will be a popular theme with his base.
- ◆ Thus, the current trade war is unlikely to end before the U.S. mid-term elections.

The Longer-Term Developments

- ◆ U.S. grievances against China include intellectual property rights protection, forced transfer of technology and cyber-theft. (Note that none of these grievances have much to do with trade per se.)
- ◆ Intellectual property right protection in China has actually been vastly improved since special intellectual property courts were set up in Beijing, Shanghai and Guangzhou in 2014. Economically meaningful fines have begun to be levied on violators of intellectual property rights in China.
- ◆ Both Japan and Taiwan in their early stages of economic development did not do much to protect intellectual property rights either. But as they changed from being a user and imitator to a creator of intellectual property, they began to enforce intellectual property rights vigorously.
- ◆ Intellectual property right protection in China should become even better over time.

The Longer-Term Developments

- ◆ Forced technology transfer has to do with the Chinese requirements for foreign direct investors in certain industries to take Chinese enterprises as equal joint-venture partners.
- ◆ However, the sharing of technology in a joint venture is a voluntary one. The foreign direct investor will have to weigh the benefits of having a local joint-venture partner versus the costs. In any case, the technology used in the current manufacturing process is probably already on the way to becoming obsolete. What is more valuable is the next-generation technology that has yet to be implemented. This is what the foreign direct investor can still maintain as its own in its home factories and laboratories.
- ◆ The issue of forced transfer of technology is fast becoming moot because of recent Chinese liberalisation measures. For example, in the automobile manufacturing industry, Tesla has been able to establish a wholly-owned subsidiary in Shanghai to manufacture electric cars; and even though it is now possible for General Motors to buy out its Chinese joint-venture partner, it has indicated that it does not intend to do so.

The Longer-Term Developments

- ◆ These latest policy measures on the part of China and the new, much shortened negative list on foreign direct investment should go a long way towards eliminating the issue of forced technology transfer.
- ◆ Commercial cyber-thefts should be vigorously prosecuted, with the collaboration of both governments.
- ◆ If Huawei is perceived as a national security risk by the U.S., will the Apple iPhone be considered a national security risk by China eventually?

The Longer-Term Developments

- ◆ The rise of populist, isolationist and protectionist sentiments in the U.S. and elsewhere in the world will also have significant impacts on international trade and investment (and migration). Even though these sentiments were not created by President Donald Trump, he has been able to tap into them and exploited them very effectively.
- ◆ Economic globalisation and innovation benefit every country in the aggregate. However, they also create winners and losers in every country. The free market cannot compensate the losers. It is up to the government of each country to take care of its domestic losers, who naturally oppose economic globalisation and free trade.
- ◆ In addition, it is also natural and instinctive for any individual to entertain the feeling of “us” versus “them”. And most people believe that all deals are zero-sum, that is, “more for them is less for us, and vice versa”. It is therefore a revelation to many that voluntary trade between two countries benefits both, that is, it is in fact win-win.

The Longer-Term Developments

- ◆ Unfortunately, it will take a while before the people at large realise that protectionism is a lose-lose proposition.
- ◆ The eventual solution has to be some form of redistribution within each country—taxing the winners to compensate the losers so that everyone wins.
- ◆ President Donald Trump also believes that every deal is zero sum--one country's gain must be another country's loss. Moreover, he would like to modify the existing distribution of gains from trade between the U.S. and its trading-partner countries. He believes that the U.S. can achieve much better trade deals by negotiating bilaterally with every single country, taking full advantage of the market size and bargaining power of the U.S. This would work best for the U.S. in a bilateral rather than multilateral context.

Enhancing Mutual Economic Interdependence

- ◆ To reduce the probability of an armed conflict between China and the U.S. down the road, both countries should promote greater mutual economic interdependence, to make their relation win-win; so that a war between them would be unthinkable, just as another war between France and Germany, which fought three wars between them (1870, 1914 and 1939) in less than 80 years, is not possible today.
- ◆ China and the U.S. should exploit their mutual economic complementarities.

Enhancing Mutual Economic Interdependence

- ◆ The problem with a trade war as an instrument for reducing a bilateral trade deficit is that while it may reduce the bilateral trade surplus/deficit, there are no real winners—both countries lose because the feasible choices open to each of them are reduced. Exporters in both countries will be hurt because of the reduction in their exports, and importers in both countries will see their businesses decline. And the consumers and producers who rely on imported goods and inputs in both countries will have to pay higher prices.
- ◆ A better way to narrow the U.S. trade deficit with China is for the U.S. to increase its exports of goods and services to China, especially newly created goods and services, for example, by producing and exporting meat (beef, pork and poultry) instead of feed grains (corn and soybeans) to China, and exporting the newly developed liquefied natural gas from Alaska and shale oil from the continental U.S.

Enhancing Mutual Economic Interdependence

- ◆ However, it is important that the trade in food and energy be put on a long-term basis, at pre-determined price formulae and with credible enforcement provisions. Only then will new long-term supply and demand emerge. And only then will there be long-term mutual economic interdependence.
- ◆ A further area of significant potential win-win collaboration is the deployment of the excess Chinese savings in the U.S. for the financing of the renovation and upgrading of U.S. basic infrastructure as well as the augmentation of the equity capital of U.S. corporations.

Enhancing Mutual Economic Interdependence

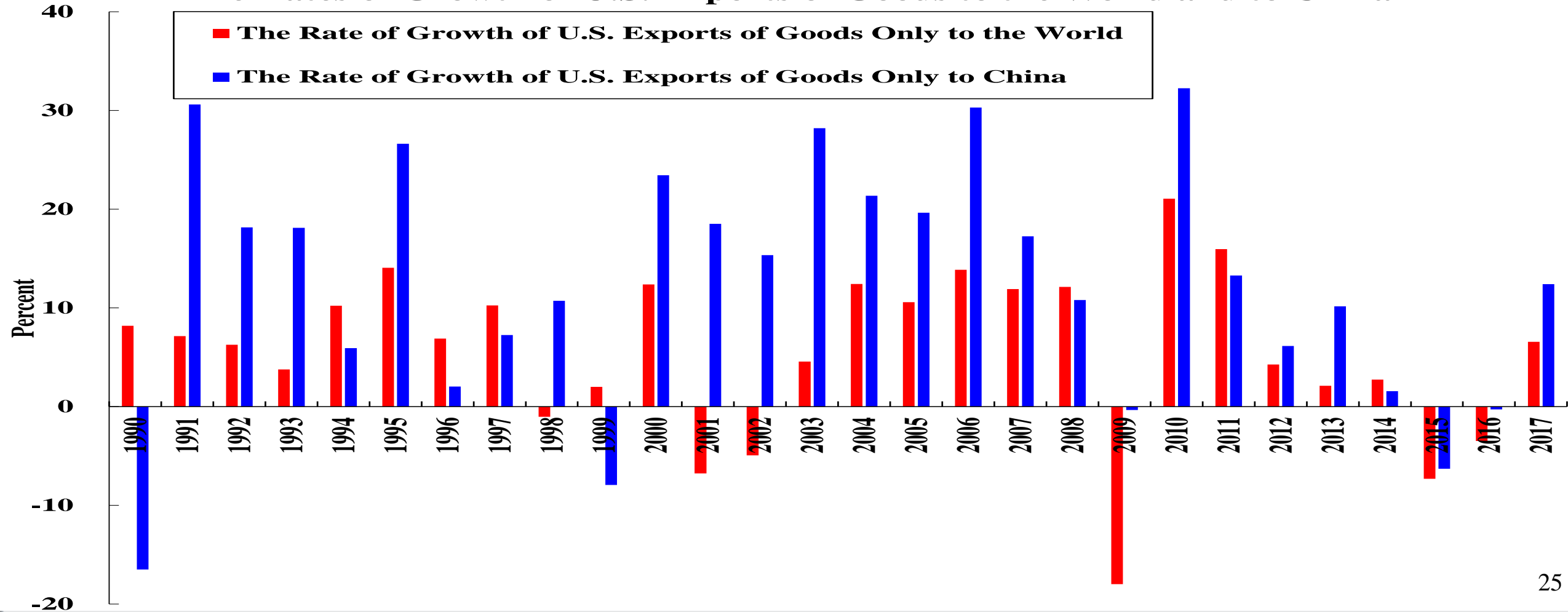
- ◆ It is difficult to assess which country has benefitted more from their economic relations. China has been able to lift 600 million of its citizens out of poverty, initially through the vast expansion of export-oriented jobs in China that result from China's opening up and accession to the World Trade Organisation (WTO).
- ◆ However, the U.S. consumers have benefitted from two decades of low prices for their consumer goods. Had U.S. imports from China stayed at 1994 levels, the U.S. Consumer Price Index would have been 27 percent higher in 2017, or approximately 1 percentage point higher annually.
- ◆ Additional benefits for the U.S. include the profits of U.S. corporations earned by their operations within China, such as General Motors and Walmart, as well as the sales of Apple iPhones, which since they are finally assembled within China, are not considered U.S. exports to China.
- ◆ This also does not include the benefits that the U.S. has derived from seigniorage, that is, from being the provider of the international medium of exchange, which can be worth as much as US\$350 billion a year.

Enhancing Mutual Economic Interdependence

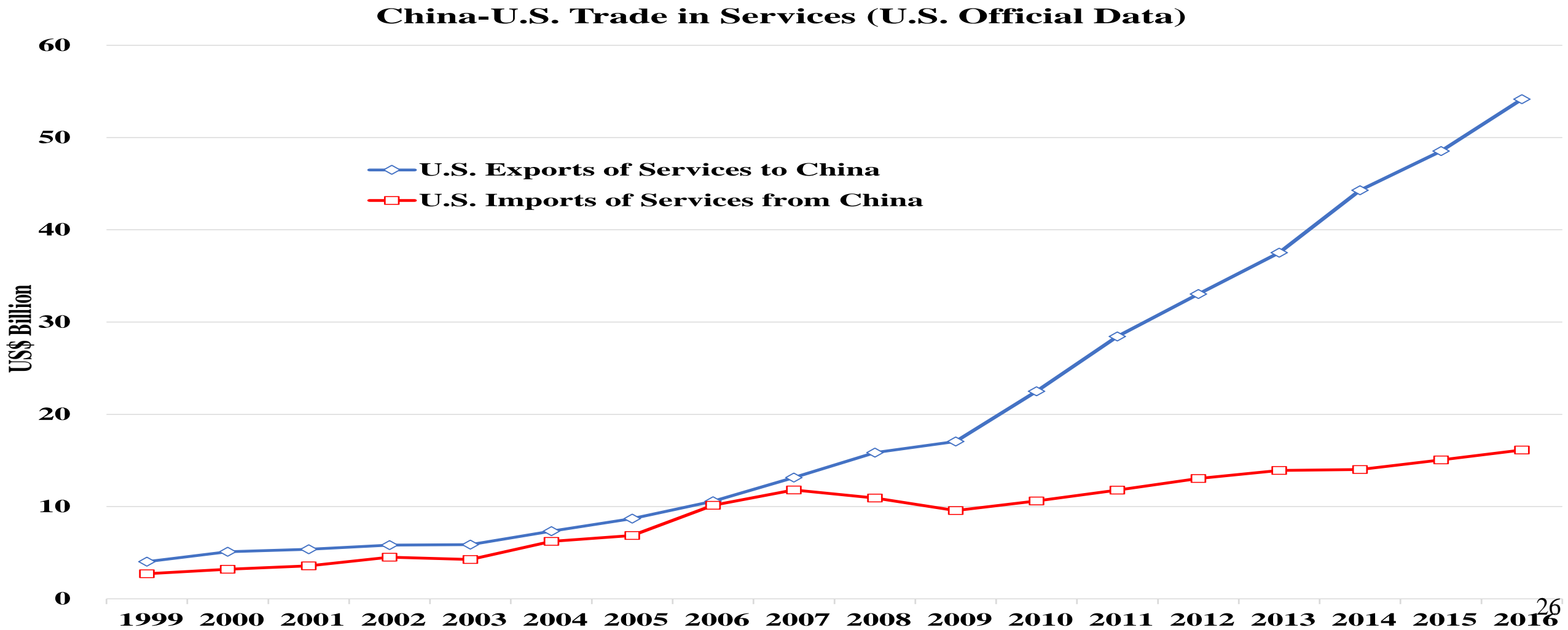
- ◆ This is also an inopportune time for the U.S. to have a trade war with China. The rate of growth of U.S. exports to China has been much higher than the rate of growth of U.S. exports to the world. This means that the huge and growing Chinese market can be a major growth point for U.S. exports.
- ◆ In addition, the U.S. has been running a significant and increasing surplus vis-a-vis China in trade in services, especially in the area of education and tourism. The expenditures of Chinese students (currently totaling 350,000) and tourists in the U.S. have been rising rapidly. Moreover, their presence in the U.S. can enhance understanding between the Chinese and American peoples and improve long-term ties. U.S. students and tourists in China can also play the same role.

The Annual Rates of Growth of U.S. Exports of Goods to the World and to China

The Rates of Growth of U.S. Exports of Goods to the World and to China



China-U.S. Trade in Services (U.S. Official Data)



Estimates of U.S.-China Trade Surplus in Services



Concluding Remarks

- ◆ The competition between China and the U.S., whether friendly or unfriendly, can be assumed to be an ongoing and long-term one. The trade dispute is only a symptom of the potential possible conflicts between the two countries.
- ◆ China-U.S. relation must be carefully managed going forward.

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