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U.S.-China Trade War: What Are the Prospects for a Deal?

Question 1: What role did trade play in the 2016 election?

Answer: If we are going to understand the trade war, we have to go back to the election of 2016, and to do that we have to go back to the beginning of the Obama administration and the onset of the Global Financial Crisis of 2008-2009. This was a huge shock to the United States. Unemployment peaked at around 10 percent in early 2009, very shortly after President Obama came into office, and he thus had to confront this crisis which was felt particularly in the heartland of the country. Manufacturing jobs had been dropping since 2001—about the time that China entered the WTO. And as a result of that, you saw quite large swaths of distress in key battleground states in the election. So already before Trump was elected, it was going to be clear that trade policy was going to be a focal issue for both parties. Interestingly, Hillary Clinton played a role in designing, defining the Trans-Pacific Partnership (TPP), made the decision late in her campaign that she was going to withdraw from that agreement. And of course, Trump had been hammering on trade all throughout, as well as immigration. So, this is not just a Trump issue, is the main point I want to make. This is about gradual changes that were taking place within the party system of the United States, which saw the Trump wing of the Republican Party swing in a more protectionist direction. And Hillary Clinton representing a Democratic Party which was more institutionalist, internationalist than the Republicans, but was fighting a contest that was ultimately decided in states with larger manufacturing centers.

Question 2: What were the Trump administration's trade policy priorities?

Answer: It's difficult to understand the Trump administration's trade policy because it wasn't clear that there were any priorities. The president came into office shooting in all directions, you might say. He went after the NAFTA, he wanted that renegotiated. He wanted to renegotiate the U.S.-Korea Free Trade Agreement. He imposed tariffs on aluminum and steel for national security reasons. And it is interesting to point out that for the major steel exporters to the United States, China was actually relatively low on that list. So, he was taking actions against countries such as Canada, Mexico, Germany, Korea, Japan with the steel and aluminum actions. And of course, he was also bad-mouthing the WTO and promising trade actions against China. So, if we look at this history, it was not clear exactly where he was going to focus his attention. But gradually over the course of 2017 and 2018, it became clear that some of these other issues were getting resolved. We haven't ratified the revised NAFTA treaty, but essentially that has been renegotiated. The Korea-U.S. Free Trade Agreement has been negotiated. Settlements have been reached with a number of other parties. And we're even now entering into more sustained negotiations with both Japan and Europe on the possibility of striking trade deals with those two important trading partners. And essentially, over time, it became clear increasingly that China was going to be the central focus of the Trump administration's trade policy.

Question 3: How did China become the major focus of Trump's trade policy?

Answer: Well, as I've just said, obviously these other priorities were either fulfilled or passed away. But the real issue goes back to changes in China's approach to its own economic policy that date all the way back to the middle of the Hu Jintao period. Starting around 2005-2006, we see evidence that China is beginning to think about the development of an ambitious industrial policy. And this was a change because up until that point, the prior administrations going back to Jiang Zemin and the negotiation of entry into the WTO had really been focused quite centrally on the questions of reform and opening. But beginning in 2006 and again, after the Global Financial Crisis in China, you see a massive stimulus launched by the government to maintain growth rates. And a piece of that increasingly was state support not only for public investment, but for private investment as well. And then starting around 2010, you see a process of designating particular cutting-edge technologies and new industries for government attention. And all of this comes together in an extremely ambitious industrial policy proposal called "Made in China 2025," which is released in 2015. Now "Made in China 2025," there is a lot of debate about whether that really marks an integrated plan and so forth. But it's supported not only by detailed sectoral plans, but by provincial and municipal efforts and more significantly, by very large and aggressive public hedge funds. It might be seen as public investment funds or venture capital funds that are targeted at developing capacity—Chinese capacity—in a number of important sectors: electric vehicles, environmental technologies, biotech, semiconductors and so on. And the amounts of money involved in these in these efforts were huge in the over one-and-a-half trillion dollars of funds that were poured into these activities. Now, of course, all of this money hasn't been spent, but the U.S. was looking not only at trade practices in China with respect to tariffs and protection of intellectual property, but also the prospects that these large scale subsidies would have a disruptive effect on a number of industries in which the United States was also seeking to race towards the frontier.

Question 4: How is the trade war linked to Trump's wider foreign policy?

Answer: The trade war also has to be seen in the context of larger changes in U.S. foreign policy toward China. If you look at the Obama strategy, it always rested on a combination of checking China, deterring China, maintaining our traditional alliance relationships in the region. That piece of the foreign policy of the Obama administration was often identified as the pivot towards Asia, the shift towards Asia, rebalancing a number of terms that were employed. But at the same time, Obama era officials were very clear that they saw it important to develop a relationship with China and to continue to engage China on issues of mutual interest, whether it be on climate change, trade, the environment, a variety of areas where there is the potential for cooperation. And if we look at the approach that Trump took after coming to office, it didn't take him very long in his national security strategy to effectively outline an approach to China that saw it as a peer competitor, a strategic rival along with Russia. And China have, of course, was aware that this was the new strategic line that the Trump administration was pursuing. And this complicates the trade policy issue because if you have trade policy conflicts in the context of a broader strategy of engagement, it is very different than if you have trade policy conflicts in the context of a *stated intent* to see China as a peer competitor and to try to check and contain it in effect. And if we look at

recent developments in both Taiwan and Hong Kong, you can see how these issues are increasingly linked. The U.S. is undertaking a very large arms sale to Taiwan. At the same time, it is trying to reach an agreement on trade. It has now made comments that the trade war could possibly be linked to developments in Hong Kong, when China obviously sees the Taiwan issue and the Hong Kong issue as questions of internal political affairs that are not the subject of any external involvement or meddling. And so, it is not impossible that we can get to a trade deal—and I will talk about that in a moment. But it is a context where the fact that the U.S. sees China as a pure competitor, the fact that the Trump administration has been playing in the Taiwan and Hong Kong yards—so to speak—that all makes it more difficult for the administration to reach an agreement if those issues are seen as linked.

Question 5: What are the prospects for a deal?

Answer: Well, the prospect for a deal? That is obviously the most significant question. And sadly, like an academic, I have to say, ‘Well, who knows?’ On the one hand, the president is under a fair amount of pressure to reach a deal with China because of the drag that the trade war is starting to present to the economy more broadly conceived in the last several weeks—this is being recorded in late August. We have seen the markets swoon over bad trade war news and we have seen increasing discussion of the prospects that the American economy. And in fact, the world economy could slide into either a period of slowing growth or outright recession. Germany is very near to recession. And there's the prospect that the United States could see a slowdown over the course of 2019 and 2020. On the other hand. And that those forces would press the president to move away from the trade policy actions he has taken and try to lift some of the tariffs that have been used for these strategic purposes. But at the same time, because Trump has made China so central to his broader foreign policy and because the promises of a grand deal are so big, there is a concern that he may not want to strike a deal in advance of the election which is seen as weak and therefore, vulnerable to criticism by the Democrats as well as more hawkish Republicans. Just to give you an example, the whole question of how to handle Huawei—this very significant Chinese manufacturer of internet and telecommunications equipment—has been one that is seen as a security issue. And the president has both sought to reduce sales of American companies to Huawei, but then has tacked back and forth on whether Huawei would or would not be part of a deal. And in the course of that tacking, Democrats, including Senate Minority Leader (Chuck) Schumer, have come out and said that this is a bad policy for Trump to reverse himself. In a recent tweet, (Senate Minority Leader Schumer) even told the president to stay strong. So, I think there are very conflicting forces at this juncture. And it is increasingly possible that you could actually, simply have a delay—a long delay in the negotiations—where this drags out into 2020, or even past the election because of a concern on the part of the president that a weak deal would be to his disadvantage.

Question 6: What would a deal look like? And what if there is no deal?

Answer: One of the difficulties of solving trade tensions is that it is really difficult to figure out what a deal would actually look like. The standard kind of trade deal is what you might call a list-like deal in which the two parties agree to a whole set of commitments, there is general good faith, there is a belief that those propositions would ultimately be enforced by

the two sides, and the question of the credibility of the commitments on the two parties would not really be in fundamental play. So, for example, while there are obviously possibilities for cheating, no one would think that the Korea-U.S. Free Trade Agreement or NAFTA would be subject to large scale evasion on the part of Korea, Canada or Mexico. The problem with China is that its legal and policy system is incredibly opaque, and the government maintains significant discretion in the way that it can use economic instruments to make it difficult for companies to trade with China and particularly to invest in China. Recall that some of the key issues that the administration has been going at do not actually have to do with Chinese tariffs, but they have to do, ironically, with the treatment of American firms who are domiciled in China or are seeking to invest in China. And it is very easy for the Chinese administration to tweak regulations and to exercise discretion in ways that make it difficult for those companies to operate.

What this means is that the confidence in the willingness of the Chinese government to actually implement an agreement are thin because of concerns about their failure to implement their WTO commitments. And as a result, one of the biggest negotiating issues in the trade negotiations is precisely on how the agreement would be enforced. The Trump administration has gone so far as to argue to the Chinese that the United States should be given the right and the discretion to respond to perceived violations of the trade agreement effectively in any way they want, including by a return to the imposition of tariffs. And I cannot see China really agreeing to that. Another possibility, though, that should be mentioned, or two other possibilities that should be mentioned and could come up in a Democratic administration, is the idea of trying to use the WTO more effectively as an instrument for going after Chinese trade policy practices. So, rather than acting unilaterally by the imposition of tariffs, the United States, perhaps joined by other allies—maybe even including Korea and Japan—would bilaterally submit a very large case to the WTO which would seek to go after all of the outstanding complaints against the country. But I want to close on a somewhat pessimistic note which is that there is a possibility that the United States and China are headed for what some in Washington are now calling a “decoupling.” And the idea of decoupling is that China and the United States pose mutual risks to one another and certainly the U.S. dependence on China—financial, economic in terms of trade and investment—are that those risk really need to be reduced by pulling the two countries away from each other at the margin. I personally think that this is not really a feasible strategy for two economies that are so deeply entwined. But the fact that the language about decoupling is on the agenda, both among Republicans and Democrats, means that this issue is going to continue well after the elections of 2020.

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