PIIE PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

POLICY BRIEF

18-21 China and the United States: Trade Conflict and Systemic Competition

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The current trade war between the United States and China is a central dimension of the emerging Cold War between the two superpowers. The conflict also highlights and threatens to aggravate the contest for global economic leadership between the two countries, which ranges far beyond their disputes over trade balances and level playing fields. This Policy Brief analyzes the links between the immediate clash and the far more important systemic confrontation and offers three suggestions for new policy directions that could address the two problems simultaneously.

First, China should join the current initiatives of the United States and the European Union, and of those two with Japan, to reform the rules of the World Trade Organization (WTO) to effectively address the systemic issues central to the present trade conflict: role of governments in economic policy as they affect issues such as trade and investment protection, subsidies, state-owned enterprises, technology transfer, intellectual property rights, and currency manipulation. Second, China should indicate an interest in joining the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP); such a step probably would induce the United States to rejoin the arrangement and provide another venue to open markets and write new rules. Third, though not directly related to trade, the United States and China should work together to reform the International Monetary Fund (IMF) to shore up its financial resources and amend its governance structure to provide a much larger role for China (and other emerging-market economies such as India and Brazil).These steps would provide a comprehensive new framework to address the most critical problems that have triggered the current trade war, and the economic component of the new Cold War that surrounds it, as well as the even more fundamental crisis of the global economic order.

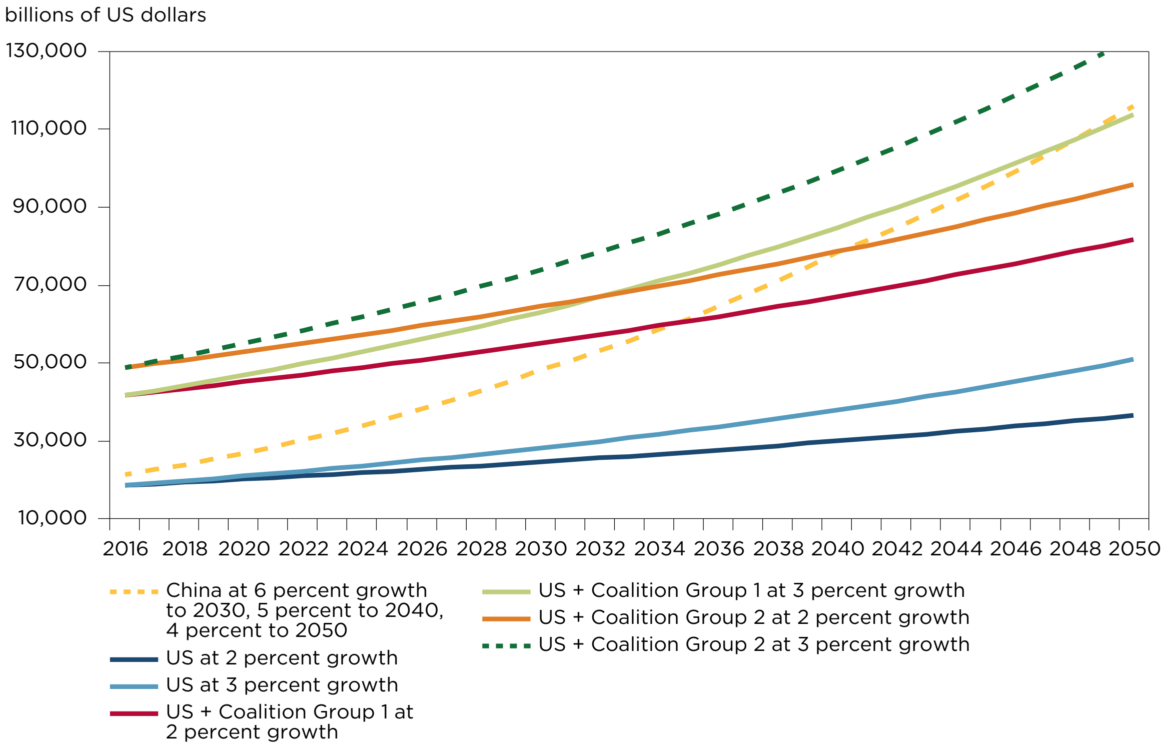
RISE OF CHINA

China's rise to global economic superpower status, with its distinct national characteristics, poses a challenge to the international economic order and its incumbent leader, the United States. History suggests the real possibility of inevitable conflict between rising and incumbent powers, the so-called Thucydides trap (Allison 2017). Germany's challenge to Great Britain in the late 19th century was associated with the end of the first era of globalization and the descent toward the First World War. The confrontation between rising Japan and the newly powerful United States in the 1930s contributed importantly to the onset of the Second World War. Some in the United States clearly want to arrest the rise of China to whatever extent possible. A new Cold War, or worse, could be at hand.

Transition periods in global leadership also lead to major economic disruption. Economic historian Charles Kindleberger (1973) blamed the Great Depression largely on the unwillingness of the newly powerful United States to replace the traditional but faltering leader, the United Kingdom, in providing the global public goods that were essential to head off the spread of that calamity: open markets for trade, adequate lending to debtor countries, and provision of needed liquidity in the face of financial crises. Such a "Kindleberger trap" could occur today if the United States were no longer willing or able to exercise such leadership and if China were not yet able or willing to do so.

China has been a larger economy than the United States in purchasing power parity (PPP) terms since 2010 (figure 1). Its trade is now slightly larger than that of the United States (figure 2). Its GDP at market exchange rates will exceed that of the United States, on likely growth pro-

Figure 1 GDP growth at PPP exchange rates, 2016–50



PPP = purchasing power parity

Coalition Group 1: United States, European Union, Canada, Australia, and New Zealand
Coalition Group 2: Group 1 plus Japan and South Korea

Source: IMF *World Economic Outlook* Database, October 2017; author's calculations.

jections, in about a decade (figure 3a). China is likely to outdistance the United States substantially on all these metrics over the coming decades.

A very different picture emerges, however, when the economic weight of America's traditional allies is added to that of the United States itself. The "hegemonic coalition" as a whole, whether limited to the core group of Europe-Canada-Australia-New Zealand (Coalition Group 1) or also including Japan and Korea (Coalition Group 2), more than doubles the size of the leadership alliance and prolongs its numerical superiority over China for at least two more decades (figures 1, 2, 3b, and 3c). The inevitable systemic competition between the United States and China has thus been largely viewed, in both countries and around the world, as a gradual and long-term process that would play out over many years and probably decades.

THREE NEW SHOCKS

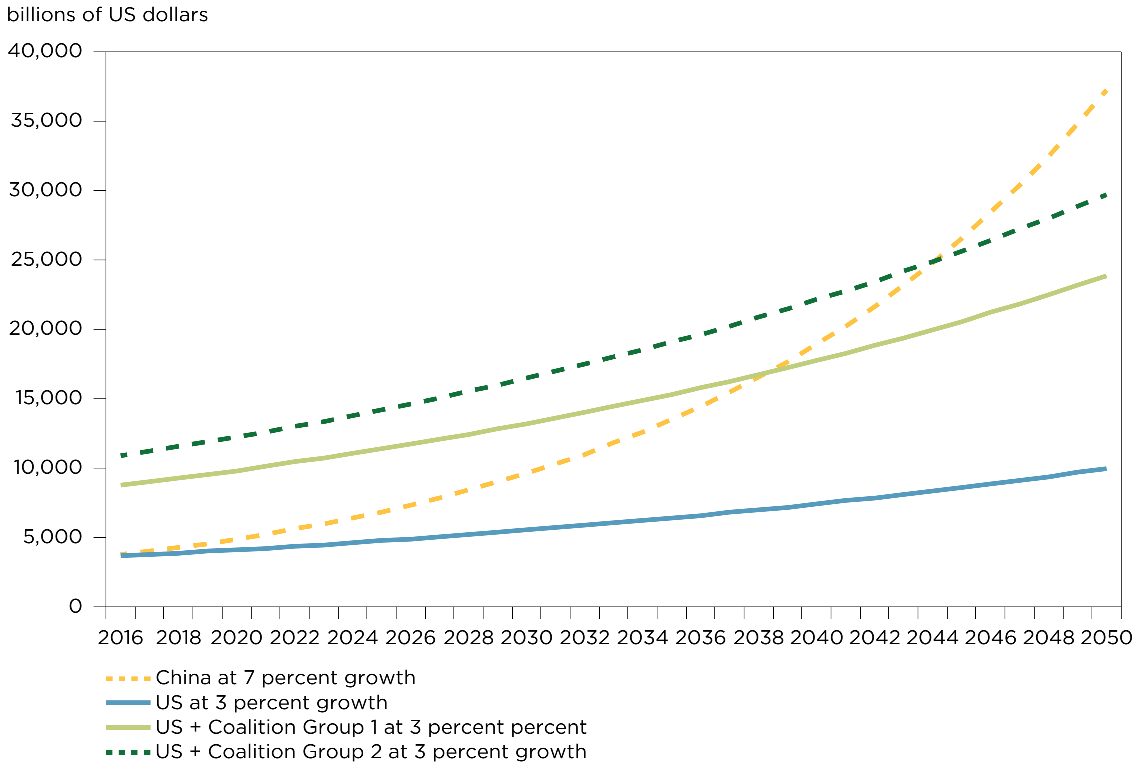
Three shocks surrounding the current US-China conflict now threaten to sharply accelerate the timetable, however, and greatly heighten the salience of the systemic issues for the resolution of that confrontation (and vice versa).

First, President Donald Trump's abdication of America's traditional international role, and especially his threatening of the alliances that underpin America's hegemonic coalition, could create a global leadership vacuum reminiscent of the 1930s. This could tempt China to make a dash for dominance rather than bide its time per the traditional mantra of Deng Xiaoping. A systemic clash could become much more imminent.

President Trump is of course not alone in endorsing US withdrawal from global responsibility. Many Democrats take credit for withdrawing from the Trans-Pacific Partnership (TPP) before he did and most of them also opposed the North American Free Trade Agreement (NAFTA). Both parties criticized globalization sharply during the 2016 campaigns. There is now substantial domestic pushback against Trump's abdication and protectionism, and a future administration from either party would probably be less extreme and much less confrontational. It is unclear, however, whether the United States will regain the will to re-assume global economic leadership at anything like the traditional level in the foreseeable future.

A dash for dominance by China is especially plausible because of the second new shock: the ambitious agenda of President Xi Jinping to realize "the China Dream" sooner

Figure 2 Trade growth, 2016–50



Coalition Group 1: United States, European Union, Canada, Australia, and New Zealand
Coalition Group 2: Group 1 plus Japan and South Korea

Source: IMF *Direction of Trade Statistics*; author's calculations.

rather than later (though there are some indications that the rhetoric to that end is now being dialed down). The "Made in China 2025" program explicitly endorses this goal. Xi's assumption of political power for an indefinite period enables him to pursue such an effort. It reflects a widespread Chinese view that US responsibility for the global financial crisis in 2008–09 severely, perhaps fatally, discredited the American economic model and the ability of the United States to provide credible global leadership.

The third shock emphasizes the importance of the possible acceleration of the global transition timetable: the apparent reversal of China's economic policy strategy. As my colleague Nicholas Lardy (2019) lays out brilliantly in a forthcoming book, the emphasis on marketization, which drove Chinese economic policy for 30 years after the opening up reforms of the late 1970s, has given way to a renewed focus on state enterprises, governmental intervention, and central control—political as well as economic. This reversal significantly affects China's foreign economic policy and could carry profound implications for other countries.

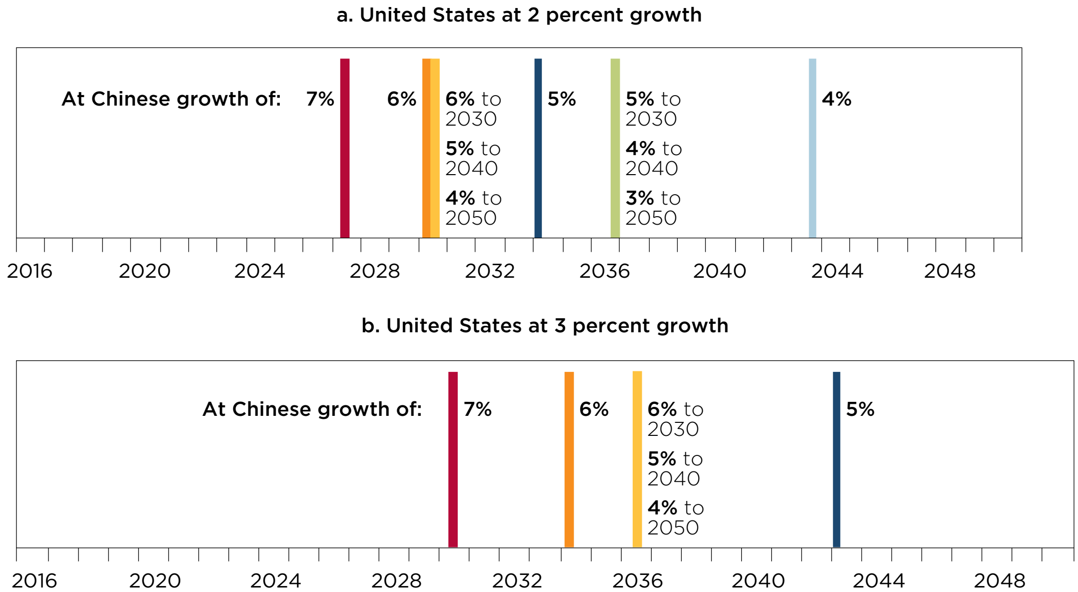
THREE SYSTEMIC POSSIBILITIES

In this new global environment, three systemic outcomes are possible. The first, and perhaps most likely, is a **G-0** world without any effective national leadership at all. The United States is arguably still able but no longer willing to lead. China may not yet be either able or willing. The result could be an unstable G-0 (G-0u), a replication of the "Kindleberger trap" of the 1930s: a systemic vacuum with no provider of public goods to counter another, perhaps even worse, global trade and/or financial crisis.

On the other hand, a leaderless world could turn out to be stable (G-0s) even without its traditional leader. The rest of the world has responded admirably to Trump's abdication so far by keeping the system intact, and indeed moving ahead, on many fronts, for example, the Paris agreement on climate change, the CPTPP, and new free trade agreements (most notably EU-Japan). The Federal Reserve, as an independent institution, can continue to support the monetary system as it did so critically during the financial crisis in 2008–09.

Will the rest of the world be able to proceed successfully without the "indispensable nation," especially when the next crisis hits? Will the institutions that have been built up

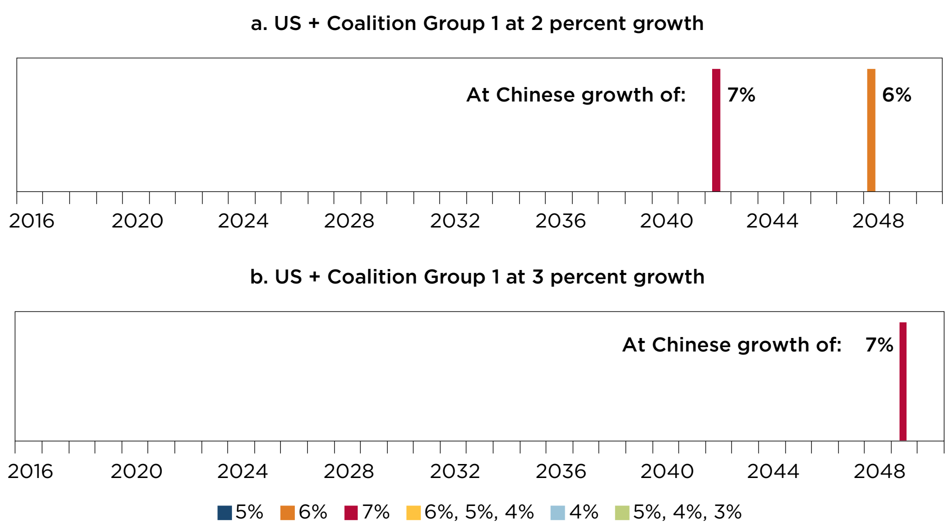
Figure 3a When does China exceed US GDP at market exchange rates?



Note: Light blue and green lines not shown in panel b because if Chinese GDP grows at those rates, it will not exceed US GDP (assuming 3 percent growth) by 2050.

Source: IMF *World Economic Outlook* Database, October 2017; author's calculations.

Figure 3b When does China exceed US + Coalition Group 1 GDP at market exchange rates?



Coalition Group 1: United States, European Union, Canada, Australia, and New Zealand

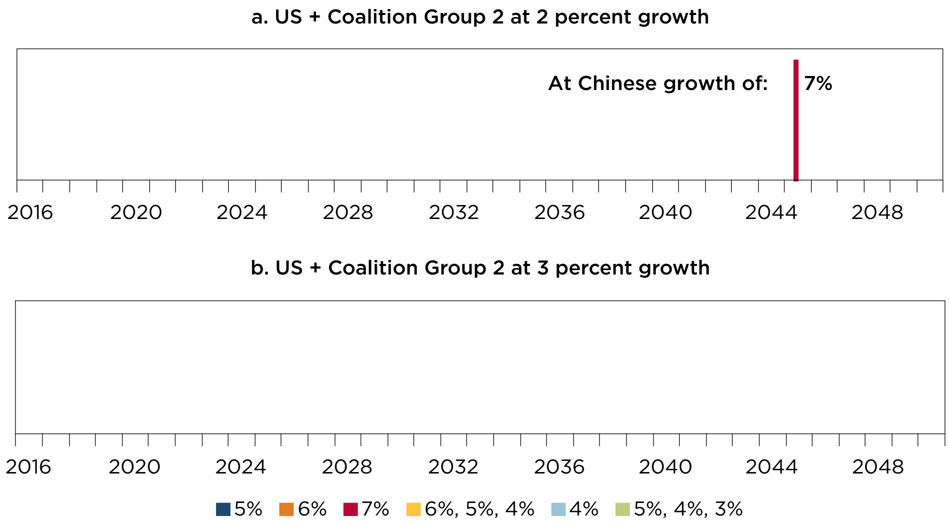
Note: Other lines not shown because if Chinese GDP grows at those rates, it will not exceed US + Coalition Group 1 GDP by 2050.

Source: IMF *World Economic Outlook* Database, October 2017; author's calculations.

so painstakingly over the last 70 years hold? The European Union and especially the eurozone and the European Central Bank on monetary issues will be key determinants of the G-0 outcome, stable or unstable. So will China, if it chooses (as it has on several occasions in the past) to shore up the current system, from which it has gained so much—but from whose rules it has been quite willing to deviate when it believes it gains from doing so.

If the G-0 proves to be unstable, and the United States remains in withdrawal mode from the world and attack

Figure 3c When does China exceed US + Coalition Group 2 GDP at market exchange rates?



Coalition Group 2: Group 1 plus Japan and South Korea

Note: Other lines not shown because if Chinese GDP grows at those rates, it will not exceed US + Coalition Group 2 GDP by 2050.

Source: IMF *World Economic Outlook* Database, October 2017; author's calculations.

mode on its erstwhile allies, and especially if China decides to make a dash for dominance rather than support the current regime, a **G-1** led by China is a plausible alternative. The rest of the world might welcome, and even seek, such a result to fill the void. China's domestic politics would presumably support, and even exult in, such a dash.

An international economic order with Chinese characteristics could differ significantly from its predecessors (led by the United Kingdom and then the United States). There would be less emphasis on the market and more scope for governmental intervention, especially on international transactions (managed trade) but also in domestic policies. There would be less rule of law and institutionalized dispute settlement and more voluntary arrangements and negotiated resolutions, preferring the United Nations institutions to those of Bretton Woods. There would be less democracy and more centralized authority.

All this would presumably evolve over time, as modifications to the existing order, rather than emerge full-blown through a "new Bretton Woods" agreement. It would clearly be uncomfortable for the United States and most other members of the hegemonic coalition, although, as otherwise opposites Thomas Friedman[1] and George Will[2] have both noted recently, Trump has moved considerably in China's direction on such issues and attitudes as absolute sovereignty, trade protection, the rule or nonrule of law, disregard for truth, and sycophancy.

This prospect vividly illustrates the link to the current US-China disputes. Those disputes center on some of these very issues, including the apparent inability of current international rules and enforcement mechanisms to prevent objectionable Chinese practices (intellectual property theft, forced technology transfer) but also objectionable US practices (abuse of "national security" protection, blocking of the dispute settlement system). Differences persist over the role of the state (e.g., regarding state-owned enterprises and support for national champions), international governance (e.g., regarding subsidies and China's demand to be accorded "market economy status" in the WTO), and decision-making procedures. Different outcomes of the current debates will push the system in different directions, and different systemic reforms would lead to different resolutions of such issues in the future.

The third systemic option is thus the most desirable: a **G-2** in which the United States and China, under the looming threat of trade wars and major economic and political disruption, work together to resolve their current conflicts and begin to address the structural issues to head off either a Thucydides trap or a Kindleberger trap. Such a strategy would provide essential leadership within the existing institutions, both formal (WTO, IMF) and informal

1. Thomas Friedman, "Are we becoming too like China?," *New York Times,* May 9, 2018, A25.

2. George Will, "The Socialist States of America," *Washington Post,* July 8, 2018, A17.

(G-20, APEC), for carrying out their mandates to achieve and maintain prosperity and stability.

AN ACTION AGENDA

In addition to resolving some of the immediate issues, the action agenda could have three major components:

1. China should join the new US-EU and US-EU-Japan initiatives to reform the rules of the WTO (including those on subsidies, intellectual property rights, state-owned enterprises, investment, technology transfer, and maybe cybersecurity) in a plurilateral and thus less charged political context. This step by China would both provide an effective substantive response to the most pressing (as well as long-term) problems and multilateralize the means for doing so, which is the best way to obtain cooperation from China.
2. China should indicate interest in joining the CPTPP, which would probably induce the United States to rejoin so both could then use the negotiation to reduce barriers and write new regional rules in some of these areas. The United States has been hostile toward the CPTPP, but most of the other members would welcome Chinese participation and the United States would find it very difficult to stay out if China entered.
3. Both China and the United States should support major reform of the IMF, as already scheduled for the next two years, to provide it with adequate financial resources and modify its governance to better reflect the evolving balance of international economic power for China and a few others such as India and Brazil. This action item does not relate directly to the trade issues but is an essential component of constructively engaging China into global economic leadership.

Channeling the current confrontation partly toward such multilateral rule-making negotiations, based on prior agreements between, and steered by, the United States and China themselves, would represent by far the most constructive path toward its resolution. One way to get there would be for the United States and China to work out their own differences first, through a new bilateral arrangement or even a free trade agreement, and then transmit their agreements to the broader regional and global contexts. Whatever the chosen strategy, the goal would be to link the immediate conflicts and long-term systemic considerations (in addition to agreeing on more immediate deliverables to help overcome the current confrontation).

The United States disrupted the global economic order once before in the postwar period with the "Nixon shocks" of floating the dollar and imposing an across-the-board import surcharge in 1971. The immediate result was several years of financial instability, trade uncertainty, and high diplomatic tension. But the system held. Moreover, the long-term results were highly constructive: Most of the world moved to floating from fixed exchange rates, and the Tokyo Round of multilateral trade negotiations under the General Agreement on Tariffs and Trade (GATT) reduced trade barriers substantially and significantly improved the GATT (e.g., negotiation of the Subsidies Code and the Government Procurement Agreement, among others). A similar outcome can be achieved on this occasion but only if the rest of the world, including China, keeps the regime afloat during the G-0 period of US abdication and if the United States and China themselves resolve their current confrontation and agree to cooperate to modify the system so that it is sustainable in the long run.

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