FOREIGN AFFAIRS
27-6-19

How China Really Sees the Trade War

Xi Still Believes He Has the Upper Hand

By Andrew J. Nathan

When Presidents Xi Jinping and Donald Trump meet on the margins of the G-20 summit in Osaka later this week to seek a trade deal, Xi is likely to soften the customary formality of Chinese diplomacy by calling the U.S. president “my friend.” Beneath the cordial surface, however, Xi will yield nothing. Trump must then decide whether to accept the Chinese offer that has been on the table ever since early 2017 and end the trade war or to allow the U.S. and Chinese economies to drift further toward decoupling.

“We’re going to win either way,” Trump likes to say. But according to two Chinese colleagues who contributed to this article but cannot attach their names, Beijing policymakers believe he is either misinformed or bluffing.

CHINA'S BOTTOM LINE

The basic Chinese position on the trade war has not changed since 2017. Under its proposal, China would buy more U.S. products in an effort to narrow the trade deficit, and it would reaffirm its long-standing commitment to the legal protection of intellectual property rights. But if foreign firms voluntarily decide to share trade secrets with Chinese firms in order to gain access to the Chinese market—a practice the United States characterizes as “coercive transfer”—China would do nothing to interfere. China would continue on its established trajectory of opening its market to foreign banks and businesses, but it would not accelerate the pace of opening. Its currency would remain pegged to a basket of foreign currencies, and Beijing would not artificially deflate it, since China sees no benefit to a currency war. The Chinese government has already lowered the volume of propaganda about its Made in China 2025 program, which pushes for Chinese dominance of modern technologies such as robotics and artificial intelligence. But it is not willing to ramp down the research and development projects that form the substance of that program. In short, China has offered to change nothing structural in its development model, but it is willing to grant Trump a nominal victory he could use in the 2020 presidential campaign.

At the start of negotiations, the Chinese side believed that Trump was likely to accept their offer, following the advice of administration figures such as Treasury Secretary Steven Mnuchin and Trump whisperers such as gambling magnate Steve Wynn. But then the Chinese watched as hard-liners such as trade adviser Peter Navarro and U.S. Trade Representative Robert Lighthizer got the president’s ear. The two men persuaded Trump that only fundamental changes to the Chinese economic model would enable the United States to maintain its position as the world’s leading economy. The strong U.S. economy and stock market also emboldened Trump to take a tougher position. In April, the American negotiators therefore submitted a draft agreement demanding that China stop giving special support to its state-owned enterprises, allow U.S. firms to serve the Chinese market without sharing industrial technology with Chinese partners, amend Chinese laws that were inconsistent with the U.S. demands, and allow Washington to establish an office in Beijing to monitor China’s compliance. The Trump team offered to lift U.S. tariffs step by step upon proof that China had met the terms of the agreement. The Chinese side balked and struck many of the U.S. demands from the draft accord. The Americans accused them of going back on the deal.

In a little-noticed interview with Chinese media on May 10, the day that trade talks broke off, the chief Chinese negotiator, Vice Premier Liu He, acknowledged that the Chinese side had crossed out many of the provisions the Americans had added. It was reasonable to do so, he said. "Nothing is final before a deal is closed. So we don't agree with the U.S. characterization that we 'reneged.'"

Liu also spelled out the three issues that, in China's view, had stymied the talks. First, China wanted all punitive tariffs lifted before the agreement was finalized, not in stages during its implementation. China would not compromise with a stick held over its head. Second, the Americans had tried to reinterpret—and make more generous—an offer to increase imports that Xi had made in 2018. But the offer, Liu said, "could not be changed lightly." Finally, China wanted the text of the agreement to be "balanced," as "all countries have their dignity."

China would not give up control over its economy. All Chinese leaders negotiate under the shadow of the "unequal treaties," lopsided agreements China was coerced into signing with Western powers in the nineteenth century. Decades of rapid economic development have not healed the wounds of what are known in China as the "hundred years of humiliation." Xi will only sign an agreement that is based on the principles of equality and reciprocity. In a subsequent and more hawkish white paper published at the beginning of June, Beijing reiterated that "China will not compromise on major issues of principle" and blamed the United States for the collapse of the talks, accusing it of changing its position three times since early 2018.

XI'S CONFIDENCE

Although U.S. officials claim that China needs a deal more than the United States does, Xi believes that China has the stronger negotiating position. U.S. tariffs have hurt the Chinese economy much less than the Trump administration seems to believe. Even though the tariffs are forcing retailers to charge American consumers more for Chinese goods, importers cannot find other sources for many of the products Americans want to buy. Chinese exports to the United States fell by just 4.8 percent in the first five months of 2019. Over the same period, Chinese exports to the European Union—China's number one trading partner—rose by 14.2 percent and imports from the EU went up by 8.3 percent, while the Association of Southeast Asian Nations replaced the United States as China's second-largest export market. The EU-China Bilateral Investment Agreement, which comes into force in 2020, will further strengthen China's trading relationship with Europe. In Asia, China and 15 other Pacific nations are set to sign a new trade deal, the *Regional Comprehensive Economic Partnership,* in late 2019 or early 2020. China's trillion-dollar *Belt and Road Initiative* is opening up markets for Chinese exports throughout Asia, Africa, and the Middle East.

At the same time, the trade war is doing more damage to the U.S. economy than the Trump administration seems to realize. While raising tariffs on U.S. goods, China has reduced them on imports from other trading partners. U.S. exports to China dropped by more than 26 percent in the first five months of 2019. In many sectors, such as agriculture, the damage is probably permanent, as China has quickly found new suppliers, such as Argentina and Brazil. The Chinese market has become crucial for many large U.S. companies. General Motors, for instance, now sells more cars in China than in the United States. Because some of these cars are made in China, their sales are not captured as U.S. exports, but their profits come back to Detroit. In 2017, according to Chinese statistics, U.S. companies generated some $700 billion of revenue in China, with net profits of more than $50 billion. Many U.S. companies are already reporting or projecting lower earnings as a result of the trade war.

China has many ways besides tariffs to inflict pain on the U.S. economy. These include tightening audit requirements for U.S. companies in China, toughening up quarantine and safety inspections for U.S. imports, and intensifying the regulation of U.S. financial institutions operating in China. China has already limited the export of rare earth minerals, essential in the production of high-tech electronics, to the United States. And it has drawn up a preliminary list of large U.S. companies to be deemed "nonreliable," although what sanctions those on the list will face is not yet clear. At the same time, China has made life easier for British, French, German, and Japanese companies. The People's Bank of China has steadily reduced its holdings of U.S. Treasury bonds, thus gradually constraining Washington's ability to finance its deficit at low interest rates. Even North Korea has come into the picture: Xi's visit to Pyongyang last week was timed to remind the U.S. side that China can help or hurt the United States not only economically but strategically as well.

Beijing believes that democracy makes the United States far more vulnerable to the political effects of the trade war than authoritarian China. Workers will be harder hit by tariffs in the United States, where the social safety net will do little to cushion the blow, than in China, where the state-dominated economy can create new jobs for laid-off workers. Farm and manufacturing states are crucial to Trump's chances of winning a second term in next year's election, whereas Xi has no such worry. As the Chinese point out, two years of U.S. pressure and 11 rounds of negotiations have failed to change the Chinese bottom line. Xi may wind up making Trump an offer in Osaka that is actually less generous than his offer two years ago.

DECOUPLING BEGINS

Despite their assessment of U.S. weakness, the Chinese do not necessarily expect Trump to accept their offer. He certainly could do so and proclaim victory. But he may feel backed into a corner by the hard-line negotiating position to which he has committed himself. Beijing also knows that Trump faces conflicting pressures from his advisers, and whom he may listen to at any particular time is hard to predict. The Chinese believe that Navarro and perhaps Lighthizer see economic decoupling not as a risk of the trade war but as its goal.

For their part, the Chinese see no benefit—and some downside—to decoupling. Huawei and other Chinese tech giants depend on U.S. manufacturers for high-end chips and other components that power their 5G network gear; the United States is proposing to cut off China's access. In response, Xi has ordered Huawei and other firms to speed up research and development on crucial technologies such as core chips, operating systems, high-performance computing, mobile communication equipment, quantum communication equipment, and AI sensors.

Like the trade hard-liners in the Trump administration, Xi takes a long view of the trade war. Sources in China quote him as saying that as China rises, it must expect 30 years of "containment and provocation" from the United States, lasting until 2049—the hundredth anniversary of the establishment of the People's Republic of China—when he expects China to surpass the United States in economic and military strength. In the service of that goal, China has long tried to diversify its markets, sources of energy and raw materials, and investment targets, as it works toward self-sufficiency in advanced technology and manufacturing. Trade war or no trade war, decoupling or no decoupling, China is on the path to economic independence from the United States.