DISCUSSION PAPER

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Introduction

The possibility of a full-scale trade war between the two biggest economies of the world is now considered the number one risk for the global economy. A tit-for-tat battle between Beijing and Washington is already creating a global economic slow-down and has the potential to turn into a perfect storm for the entire world economy. According to many, unless Xi and Trump can come to an agreement about trade arrangements between the two countries, we face the possibility of an economic cold war, which can create two mutually exclusive economic zones separated by an iron curtain. The tremendous level of integration between China and the US in terms of trade, capital movements, and technology transfers accomplished in recent decades makes the scenario of a complete decoupling of these two giant economies even scarier (Roubini, 2019b).

The conflict started with President Trump's decision to increase tariffs on $250 billion USD worth of Chinese imports as an attempt to reduce the ever-increasing US trade deficit with China. China retaliated with tariffs on US goods. In response, the US government banned American firms from trading with Chinese tech giants such as Huawei, which took the confrontation to a different level. After 11 rounds of talks, negotiations broke down last May and a trade stand-off between two countries continued until the G20 summit in Osaka, Japan. Now, the two governments are having another round of negotiations under the truce reached in G20 summit, but most experts agree that a final deal is not likely any time soon (Mashayekhi, 2019). Moreover, President Trump's threat to put further tariffs on the remainder of Chinese imports still stands.

President Trump believes that his country is in a disadvantaged position in global competition. He blames China for using the benefits of the international free-trade system under the terms of World Trade Organization without bothering to abide by its rules and restrictions. Specifically, the Trump administration claims that China tilts the level playing field by providing special advantages to Chinese firms through subsidies and protectionist measures, forcing American firms to make technology transfers, using monetary policy to cheapen Chinese products, and failing to enforce intellectual property rights. So, according to the US government, President Trump's attempt aims to protect American rights and force China to accept the principles of fair and free trade.

China, on the other hand, claims that Washington tries to derail Chinese development because they fear losing their status as world's hegemonic power and many undeserved privileges that come with it. According to the Chinese government, it is the US who is tilting the playing field through bullish methods such as banning Chinese firms from doing business with their American counterparts or imposing extra tariffs on Chinese products. From this perspective, the Trump administration is trying to undermine China from becoming a developed country with a viable economy by forcing its government to accept a subordinate position in the global economic hierarchy, because they want to avoid further economic and political competition at the global level.

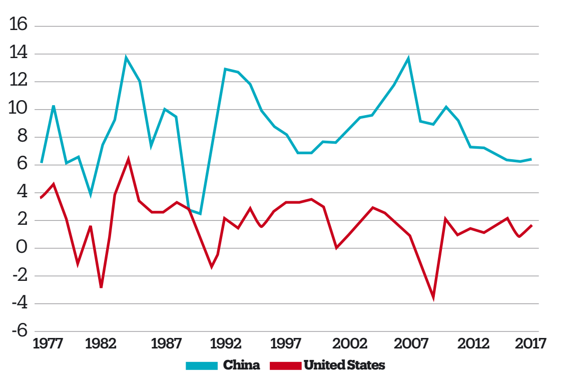
In this paper, I make the case that economic confrontation between the two economies is not an issue of agency but structure, in the sense that historical trends in global politics and economic relations drive the two countries to a conflict of some scale regardless of who is in power in either country. That's why the economic conflict between the two countries has a high probability of leading to a full-scale economic war with important global implications. This current trend has the potential to decide whether the 21st century will be another American century or dominated by China's vision for future. If the US can push China to submit to Washington's demands, like it did to Japan in 1980s, this may prolong American dominance in the global economy. However, given the size and dynamism of the Chinese economy, it is not easy that China's long march to global supremacy can be stopped.

1- Thucydides's Trap?

In his 2017 book 'Destined for War: Can America and China escape Thucydides's Trap?', eminent Harvard scholar Graham Allison argues that the US and China are at the brink of falling into what he calls Thucydides's Trap. Similar to Greek historian Thucydides's account of the military conflict between rising Athens and hegemonic Sparta, the US and China may be headed towards an inevitable war, regardless of if they actually want this outcome or not. According to Allison, as history has proven many times, when an emerging power threatens an established hierarchy, military conflict between the old hegemon and the rising power is very difficult to avoid. And, between China and the US, we are seeing the same dynamics at play.

China is a rising power indeed. Over the last four decades, the Chinese economy has shown one of the fastest sustained expansions ever recorded in history and accomplished that without almost any sizable disruption. Thanks to an average annual GDP growth rate of nearly 10%, China has become an upper-middle income country and more than 850 million people moved out of poverty. Today, China is the second largest economy in the world after the US, having outranked Japan, Germany, and the UK, and the largest in purchasing price parity terms. It has become the workshop of global manufacturing thanks to its cheap labour force and world's largest economy in merchandise trade (World Bank, 2019). Furthermore, the country shows firm determination to overcome middle-income trap through aggressive investments in critical sectors such as energy, telecommunication, electronics.

Figure 1: GDP per capita growth
(annual %)



Source: World Bank

The turning point for China was 1978, when Deng Xiaoping came to power after Mao's death and initiated his reform program. Deng's vision was to gradually reform China from a Soviet-style communist economy to a dual-track system in which the authoritarian state effectively keeps control over key sectors, while allowing private enterprise and free markets to rule over other economic activities. In line with this 'eclectic' vision, China has been through a piecemeal transformation toward a hybrid economy. The state's share in production has drastically decreased and price controls have been dropped. Simultaneously, China has opened to foreign trade and become a magnet for foreign direct investments (Bramall, 2008). The Chinese model of 'market socialism' is rightfully pointed at as a third way between liberal free-market economies and centrally-planned socialist economies (Roemer, 1994).

Needless to say, China's tremendous growth record has significant implications for the US. Since Deng's reforms started in 1978, China has markedly outperformed the US in economic growth with the exception of 1989 (see figure 1). China is by far the top import origin and third export destination of the American economy after Mexico and Canada, with 22% and 11% share in total imports and exports respectively (UN comtrade, 2019). Furthermore, as it is fast moving towards high-tech sectors, the prospects of China replacing the US as the world's leading economy in innovation and technology are also very high. The fight over the Chinese technology giant Huawei is the perfect metaphor for this competition. Huawei, which was a small, low-cost, low-quality new-comer in electronics market 10 years ago, is now a multinational company selling its products to 170 countries and leads the sector in 5G technologies (Leonard, 2019).

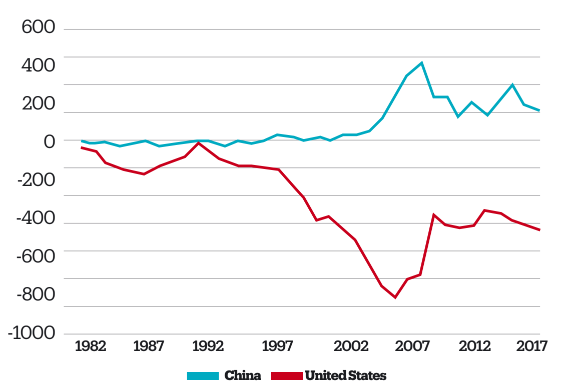
Therefore, there is a strong case for Allison's predictions for Chinese-American confrontation in near future. It is difficult to overlook the fact that China is threatening the US's leading position as world's economic powerhouse in terms of production, innovation, trade, and investment. Regardless of if China has the intension of politically challenging the US or not, Washington seems determined to eliminate even the possibility of China becoming a potential alternative to the US as the world's hegemonic power. China, on the other hand, will do its best to keep its economic growth on track and sustain its development. An unstoppable China and an immovable America may indeed be headed towards Thucydides's trap (Allison, 2017).

2- Is China Cheating?

The Chinese growth story is not as uncontentious as it may seem at first. The US administration claims that China has been abusing the liberal trade order for a long time at the expense of its trading partners and especially the US, the biggest buyer of Chinese products. According to Washington, while China extensively benefitted from free trade, unlimited movement of capital, and foreign direct investments, it did not comply with the rules of the system in many ways. Normally, the WTO imposes restrictions on tariffs and trade-related subsidies. But, China still has an authoritarian state with a heavy hand in the economy, which gives Chinese private sector a lot of special advantages and goes against the WTO regulations.

First, Chinese government is known to be heavily subsidizing domestic producers, which, according to the US, gives Chinese firms an unfair advantage in international trade. Having support from their government, Chinese producers are able to sell their products at much lower prices even though they may not be as efficient and productive as their foreign competitors. This, in turn, suppresses American firms' share in global trade. Second, China protects its market through tariff and non-tariff measures in order to limit foreign firms' penetration in the Chinese market to specific sectors. The Chinese government has repeatedly promised to open more financial and service sectors to foreign direct investment and make it easier for foreign companies to compete in China, but this has never materialized (Martina & Lawder, 2019).

Figure 2: Current Account Surplus (current USD)



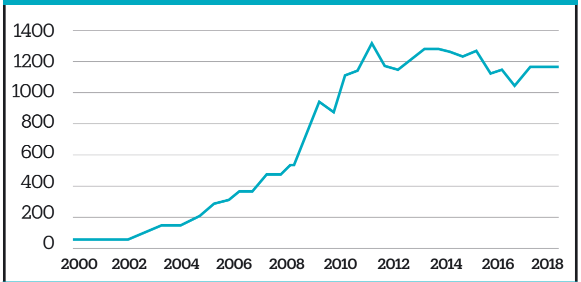
Source: World Bank

Also, the US administration has repeatedly accused China of weaponizing its monetary policy to gain trade advantages, which also violates WTO regulations. The Chinese Central Bank has historically undervalued the Chinese currency, Renminbi, so as to undermine Chinese consumers' purchasing power and supresses imports while giving Chinese firms a competitive price advantage in international trade by cheapening Chinese products (Bernanke, 2010). This is often cited as one of the reasons China has been able to sustain such high levels of trade surplus for such a long time and is put forth as another justification for US trade sanctions against China. Actually, contrary to the US administration's claims, China's currency had appreciated 33% against the U.S. dollar since 2005, and IMF declared several times since 2015 that the Renminbi is no more undervalued as its value is in line with fundamentals (IMF, 2015). However, President Trump still believes that the Chinese renminbi remains undervalued.

In one way or another, the American economy has been running a huge trade deficit with China for a very long time which the Trump administration considers as very problematic. China says the surplus is much smaller than it appears once the trade in services and the value extracted by U.S. companies are considered. However, the correlation between the current account balances of the two countries seem very obvious (see figure 2). This pattern becomes apparent especially after China joined the WTO in 2001. Whether this is due to China's violations of WTO rules or because the US lags behind in trade competition is open to discussion. According to Chinese academic and the former World Bank Chief Economist Justin Lin, American economy's trade deficit is mainly Americans' own doing and caused by high consumption beyond the economy's capacity (Tillett, 2019).

China's trade surplus turned into reserve assets, mostly in the form of US treasury bonds, and made China the largest foreign holder of US treasury bonds. With its $1.1 trillion USD holdings of US treasuries, China currently holds 5.6% of the entire US treasury bond market. This obviously has serious implications for the fiscal and financial stability of the American economy (Morrison, 2019). The possibility of China abruptly liquidating its treasury debt portfolio as an economic war weapon is an unlikely scenario as this would harm China more than it would the US. Still, the US administration is deeply uncomfortable with the fact that the US depends on Chinese finance to fund the federal debt and keep U.S. interest rates low. In the unlikely event that this extreme scenario materializes, other foreign buyers, comprising 40% of the market, would easily follow, skyrocketing US interest rates and federal debt burden.

Figure 3: China's holdings of the US Treasury Securities



Source: US Department of the Treasury

A persistent trade deficit is not the only concern of the US administration. President Trump has explicitly and repeatedly stated both during his presidential campaign and his time in office that he aims to 'bring back American jobs' from China. Since the globalization era started in 1980s, trade agreements have usually taken the form of reduced regulations and more freedom for multinational corporations producing across the world. Given the free-trade arrangements between China and the US, many American companies have moved their production lines to China and other East-Asian economies to reap the benefits of a cheap labour force. This, in turn, cost millions of American workers their jobs. Furthermore, many argue that China's cheap labour force comes at the expense of workers' rights and security suppressed by the authoritarian government of China. It is a fact that China lacks basic labour rights such as right to strike or organize outside the government approved ACFTU (Pringle, 2011).

Last but not least, the US accuses the Chinese government of forcing foreign companies to make technology transfers in return for access to the Chinese market and turning a blind eye to intellectual property theft committed by Chinese firms. China denies these allegations. However, President Xi is known for his ambitious 'Made in China 2025' policy scheme, which aims to make China dominant in global high-tech manufacturing by surpassing cutting-edge Western companies. It is also no secret that government has mobilized state subsidies and state-owned enterprises to pursue intellectual property acquisitions in critical technologies such as 5G and artificial intelligence (McBride & Chatzky, 2019). For the United States, these tactics go against international trade rules and pose a security risk for other economies. Washington also argues that the policy relies on cyber espionage, which was cited as the reason for President Trump's ban on American suppliers to engage in business relations with Huawei and other Chinese tech firms.

3- Is the US "Kicking away the Ladder" for China?

While the US points at Chinese trade policies and state interventions in the economy as unfair practices, many economists actually lauded the Chinese government for taking the initiative in economic development by improving the productive capacity of its economy beyond what unfettered market forces would generate. According to them, protecting and supporting critical sectors, facilitating technological transfers, improving productivity and innovative capacity of the overall economy are the actual duties of the government in developing countries, not illegitimate activities. From this perspective, by forcing China to drop such policies, the US is actually preventing Chinese government from doing its job and derailing Chinese economic growth which literally saved millions of lives.

China is not the only country which has used such policies. Since post-WW2 era, only a handful of countries were able to increase their income levels enough to escape poverty and be labelled as high-income countries. Most of these were so-called East-Asian tigers, including Japan, S. Korea, Taiwan, and Singapore, and it is no secret that all these countries utilized protectionist and interventionist industrial policies very similar to what China has been trying to do since the 1980s (Amsden, 2001). These countries managed to transform their economies from primitive sectors to sophisticated, high-tech sectors thanks to strong government initiative. Now, Beijing believes that it is unfair that China is banned from using the same policies that are proven to be working in catching-up with developed countries.

Xi Jinping, President of People's Republic of China. (Murat Kaynak - Anadolu Agency)

As a matter of fact, most of today's developed countries, including Britain, the US, and Germany, have also used direct state interventions in order to lift their economies to higher stages of economic development. German economist Friedrich List claimed that countries that benefit from trade protectionism later promote free trade policies in order to prevent other countries from following the same path (List, 1841). List called this "kicking away the ladder", whereby rich countries deny other countries the policy tools that they used during their own development process. Of course, at the time, he was referring to the British government's imposition of open trade policies on other countries, and especially on the US.

It is very well-known that, despite strong British pressure to open its markets to free trade, the US protected its private sector from being crushed by Britain in 19th century. US president Ulysses S. Grant (1869-77) once famously said:

> *"For centuries England has relied on protection, has carried it to extremes and has obtained satisfactory results from it. There is no doubt that it is to this system that it owes its present strength. After two centuries, England has found it convenient to adopt free trade because it thinks that protection can no longer offer it anything. Very well then, Gentlemen, my knowledge of our country leads me to believe that within 200 years, when America has gotten out of protection all that it can offer, it too will adopt free trade"* (cited in A.G. Frank, 1967, p.164).

Furthermore, it was Alexander Hamilton, the first secretary of the treasury of the US, who argued for the first time that developing countries should protect their 'infant industries' from competition coming from more advanced capitalist countries so that they may have the opportunity to build their own capacity (Hamilton, 1791). China today subscribes to the very policy paradigm President Grant and Hamilton were referring to and faces the very same challenge the US faced at the time; pressure from a hegemonic power to open its markets. The great irony is that China's challenge comes from the US.

Cambridge economist Ha-Joon Chang, updating List's arguments to the contemporary context, claims that because they are in a more advantageous position in terms of technological sophistication and productivity, developed countries such as the US promote and impose open market policies on less developed countries. According to Chang, it is natural that developing countries such as China may want to enforce industrial policy and coordinate private initiative with public efforts to improve productivity, and most importantly protect and support their companies in international competition, so that they can develop their own capacity in high-productivity sectors themselves without being crushed by developed countries' established companies. However, just like Britain did in the second half of the 19th century, today the US and other industrialized Western economies are forcing developing countries to drop such policies and adopt open market policies (Chang, 2002).

This is not the first time the US did something like this either. In 1980s, the US had a huge trade deficit with Japan which was rising to be an economic superpower and threatening US global hegemony. In 1985, threatened with widespread tariffs, Japan agreed to appreciate the Japanese Yen and imposed voluntary export restrictions on its own industries so as to reduce its trade surplus with the US (Tai, 2018). History will tell if China surrenders like Japan did. But, from a historical point of view, there seems to be nothing really surprising. It is just that history repeats itself with different actors. However, one central difference of China is that it has a giant domestic market with a lot of influence on the global economy. China has the power of closing its markets to foreign companies, which gives China a leverage in its confrontation with the US and a superior position compared to Japan. Furthermore, China has an authoritarian government without any electoral pressure. So, it is not easy to pressure Chinese government through the threat of economic sanctions because Chinese decision-makers have much less to lose compared to their counterparts in democratic countries.

4- Trump's Legacy: Global Chaos or a New American Century

There seems to be a near-consensus regarding the view that aggressive policies of the current US administration towards China are a consequence of the change in agency, embodied in the Trump Presidency. According to this interpretation, economic war between China and the US is the result of President Trump's 'reckless' foreign policy understanding. Actually, there is a strong case for the idea that the current paradigm in US policy-making is a direct result of the change in structure, rather than agency, in the global economic order. In this latter interpretation, the US administration is not disrupting the established American order, instead reacting to the fact that it is already crumbling. But, whether it will be successful in maintaining and reviving global hegemony of the US remains to be seen.

The Trump administration believes that under the current institutional arrangements of the global order, while China continues to grow, the US will continue to decline in power. The pattern is painfully visible in the US-China trade balance, China's catching-up with the US in economic size, and it's challenging the American economy in critical technologies. While it is still in a position to set the terms, Washington wants to leverage US financial and political power to its greatest extent in order to reform and restructure the institutions of the global governance which have been proven not to be working in best American interests anymore, before it is too late. However, in order to restructure them, it first needs to let go of them; hence the Trump administration's criticism of international organizations such as NATO and WTO, or previous trade arrangements such as NAFTA and TFF (Leonard, 2019).

Therefore, regardless of whether it will give the intended results or not, there is a rationale behind this aggressive policy approach, which is why it is way more difficult to reverse it. In that respect, China is not the only target of the US. The Trump administration has directly challenged not only rivals like Russia and Iran but also allies in Europe over contributions to NATO military spending or Canada and Mexico over trade relations. For the time being, this plays out through Washington forcing other countries into one-to-one confrontations while disregarding America's previous commitments and agreements. In Trump's vision, this is what it takes to extend American hegemony to 21st century and to 'make America great again'.

However, this aggressive policy stance comes with the risk of 'killing Pax-Americana' altogether while trying to prolong its life. After all, all restructuring comes with a certain extent of destruction. According to Paul Krugman, a Nobel laurate in economics, by disrespecting previous multilateral agreements and acting unilaterally, the US risks destroying what is left of the post-WW2 international order that was erected by the US in the first place (Krugman, 2019). Commercial links are actually a crucial aspect and, in a sense, a guarantee of the fragile peace established between powerful nations in the aftermath of WW2. Now that its economic dominance in that system is being eroded, the US is trying to go back in time and restore its hegemony. According to Krugman, this is playing with fire.

Furthermore, the chances of the US winning this war are also debatable. American economist and Nobel laureate, Joseph Stiglitz, for instance, argues that it is not really an option for the US economy to restore its previous 'glory' in global trade relations. This is because the US is no longer able to control and influence the world economic order, as was the case in the post-WW2 period when one-third of today's independent countries were mere colonies and Europe was in ruins. Today, there is very little room left for the US to move unilaterally. However much globalization may be hurting the American economy, a retreat from international trade, he believes, will do more harm than good (Stiglitz, 2018).

Professor Lin also claims that the success of Trump's policies will be minimal. "The world has just changed too radically for tariffs to work like Trump expects. It's like trying to fight World War III with muzzle loaded guns.", he said. According to Lin, considering the level of economic integration around the world and how intertwined supply chains are, it is impossible to create any substantial effect on trade volumes in your preferred way or shape a technological divide between the West and other economies. So, the likely outcome of Trump's hawkish policies will be nothing but disruption in global economic relations. Yet, he still considers it as a valid concern especially for developing countries because the current trade tensions, even without leading to a full-scale economic war, will drive costs up, increase prices around the world, and reduce global growth (Tillett, 2019).

Conclusion

The US president's decision to impose protectionist tariffs on imports opened a new era in global trade relations. The new policy is intended to reduce the current account deficit of the US economy, which the US administration believes results from unfair practices by trading partners and costs American workers their jobs. China immediately responded by imposing restrictions on imports from the US and declared that it is prepared for a full-fledged economic war in case the US decides to expand its protectionist measures. According to the Chinese government, the US is trying to derail Chinese economic growth in order to eliminate China from global competition.

It is not clear if such protectionist policies will give the intended results, which President Trump promised, but it will surely lead to very important changes in the global economy. The US risks the complete breakdown of the system which it created in the aftermath of World War II. The international trade system provides a ground on which goods and services are exchanged at the global scale. The breakdown of this system may lead to devastating consequences in some poor economies due to rising prices, especially of food and oil, as well as a serious reduction in welfare in rich parts of the world. Furthermore, in our extremely digitalised world, an economic disintegration of China and the US may lead to the creation of two mutually exclusive worlds of digital technologies. Not to mention, the consequences of such a division will also be very significant. So, it is fair to say that the US risks global chaos in an attempt to maintain American hegemony in the 21st century.

China, on the other hand, is trying to find its way to prosperity and power. Even though China has been through a deep and extensive economic transformation in recent decades, it is still a middle income country with high levels of poverty. Thus, it needs to maintain its impressive growth performance for a little longer that it already has. The conundrum is that for the most populous country of the world, getting rich also means becoming the world's most powerful country, which the US does not like so much. Although it is declining in comparative power, The American economy continues to be the centre of finance, businesses, and technological innovation, so if the US government decides to continue on its current track, this will likely lead to a serious deviation in China's economic trajectory with significant consequences for the political stability. How much of this will be reversible is unknown. So, there is a lot in stake on the part of China as well.

In the meantime, other economies will have to brace themselves for this storm. However, this need not be all bad. In fact, some developing countries that can navigate their way through this chaotic situation may even be able to turn this into an advantage. As a consequence of trade war, global supply chains will be disturbed, production costs will rise, and long-established trade links will be disrupted around the world. Under these conditions, high-profile companies of advanced economies may lose their competitive muscle in the international trade which may provide an advantage for newly developing companies of emerging economies. Furthermore, developing countries can use the political atmosphere of the trade war as an opportunity for implementing their own protectionist policies. Then, in the absence of harsh competition coming from global companies of industrialized countries, these economies may find the opportunity to expand their production, improve their productive capacity, and find new markets for their products.

Time will tell if China and the US will be able to settle at a new global order, which potentially gives more influence to rising China without curtailing American hegemony, or choose to turn their competition into a full-scale economic war. One way or another, a new global economic order is in making. Arguably, an economic war between China and the US is the expected outcome of political and economic dynamics that is in play right now. So, contrary to common perception, this is not really a problem of agency but of structure and there is not much that can be done to prevent an ultimate China-US confrontation. Therefore, it is not really a question of if, but rather of at what scale and on what grounds, China and the US will continue to confront each other.

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