CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE

公益財団法人 日本国際フォーラム
The Japan Forum on International Relations, Inc.

ALLIANCE POLICY COORDINATION BRIEF

OCTOBER 2019

Avoiding Friendly Fire Amid Economic Tensions With China

James L. Schoff and Asei Ito

Avoiding Friendly Fire Amid Economic Tensions With China

James L. Schoff and Asei Ito

For your convenience, this document contains hyperlinked source notes as indicated by teal-colored text.

Carnegie Endowment for International Peace
Publications Department
1779 Massachusetts Avenue NW
Washington, DC 20036
P: +1 202 483 7600
F: +1 202 483 1840
CarnegieEndowment.org

This publication can be downloaded at no cost at CarnegieEndowment.org

CONTENTS

China Risk and China Opportunity for the U.S.-Japan Alliance	i
Papers in this Series	ii
Issue Background	1
The Stakes	2
Recent Developments	3
Potential Risks	5
Potential Opportunities	7
Next Steps	8
About the Authors	9
Notes	9

China Risk and China Opportunity for the U.S.-Japan Alliance

How should the risks and opportunities presented by a continually rising, increasingly self-assertive China be addressed? This is a pressing issue for the international community, particularly for the United States and Japan, whose alliance has proactively helped form and maintain the liberal, rules-based international order for the past several decades.

To enhance mutual understanding and encourage effective policymaking, the Japan Forum on International Relations (JFIR) and the Carnegie Endowment for International Peace have convened a small group of U.S. and Japanese scholars to examine the risks and opportunities accompanying China's ascendance. This group includes China specialists, alliance experts, and authorities on trade and security issues in the Asia Pacific.

Led by Matake Kamiya and James L. Schoff, the group has conducted research and facilitated dialogue since April 2017 through private roundtables and public symposia that seek to further U.S.-Japan cooperation and coordination on China policy. The project examines different perspectives between the alliance members and discusses ways in which Washington and Tokyo can effectively respond to China's rise. An accompanying series of policy briefs explores various China-related risks and opportunities for the U.S.-Japan alliance in the areas of regional and international order, trade and technology, security, and foreign relations. To learn more about the project, click here.

JFIR, together with the project's U.S. team members, wish to thank the Japanese Ministry of Foreign Affairs and the Japan Foundation Center for Global Partnership respectively for their generous support, without which this project would not have been possible.

—Matake Kamiya and James L. Schoff, Project Leaders and Co-editors

Policy Brief Series:

- "Managing Risks and Opportunities for the U.S.-Japan Alliance Through Coordinated China Policy"
  Shin Kawashima, Matake Kamiya, and James L. Schoff

- "Responding to China's Complicated Views on International Order"
  Mira Rapp-Hooper, Michael S. Chase, Matake Kamiya, Shin Kawashima, and Yuichi Hosoya

- "Working Toward a Free and Open Indo-Pacific"
  Nicholas Szechenyi and Yuichi Hosoya

- "Bridging the Belt and Road Divide"
  Carla P. Freeman and Mie Ōba

- "Avoiding Friendly Fire Amid Economic Tensions With China"
  James L. Schoff and Asei Ito

- "Competing With China on Technology and Innovation"
  James L. Schoff and Asei Ito

- "Bolstering the Alliance Amid China's Military Resurgence"
  Michael S. Chase, Satoru Mori, and Masafumi Iida

- "Staying in Sync on North Korea's Nuclear Program"
  Evans J.R. Revere and Matake Kamiya

- "Remaining Aligned on the Challenges Facing Taiwan"
  Michael Swaine and Ryo Sahashi

Issue Background

Like many countries around the world, Japan and the United States share concerns about how China conducts its economic statecraft. For well over a decade, U.S. policymakers have criticized China's economic management and trade practices, worried about the potential damage being inflicted on the U.S. economy and workforce. In early 2006, U.S. Senator Chuck Schumer said, "China's refusal to play by international economic rules cripples our ability to compete on a level playing field." Among U.S. grievances were unfair subsidies to state owned enterprises (SOEs), currency manipulation, restricted markets, and theft of intellectual property (IP). Congress proposed various coercive measures to push China to change its ways, but the U.S. government only had taken modest targeted actions until recently.

Tokyo shares many of these misgivings about Beijing's economic policymaking, particularly in the areas of IP theft, subsidies to SOEs, and market access. Japan joined a U.S. complaint regarding China's alleged IP theft filed at the World Trade Organization (WTO) in 2018, and it has been consulting with U.S. and European Union (EU) officials about how to promote Chinese state-sector reform and rein in overcapacity and the dumping of steel and other products in international markets. In fact, both Japan and the EU would prefer it if U.S. President Donald Trump's administration utilized the WTO system more and invested in WTO reforms, rather than taking unilateral trade actions against China that at times are applied to U.S. allies as well. In addition, Tokyo is wary of Washington's focus on currency manipulation, in part because Trump and members of Congress have made similar complaints of Japan in the past.

Still, for both countries, many of these economic concerns have come to overshadow the benefits that economic engagement with China has offered for more than two decades. Until the last few years, many U.S. analysts downplayed the danger of the country's rising trade deficit with China, noting the benefit to U.S. consumers of cheap Chinese imports that were arguably just replacing imports from other Asian countries, which had shifted final assembly of such goods to China. Moreover, China's rising middle class was becoming an important market for U.S. goods and commodities, and there was reason to expect that the Chinese economy would increasingly resemble that of other industrialized countries as it matured. Japan's economy also benefited greatly from China's growth. Amid the economic stagnation of the 1990s, one bright spot for Japan was expanded trade with China. Japanese exports to China grew four-fold by 2000 before surging by another factor of four over the next seventeen years; this growth has made Japan China's second largest trading partner and one of its largest sources of investment.

But, even as China's economy has grown to become among the world's largest and most influential, its unbalanced trade has continued amid allegations of IP theft, mercantilism, and a drive to dominate the most consequential technological fields of the twenty-first century. The U.S. trade deficit in goods with China grew to more than $400 billion in 2018, or nearly half of the U.S. deficit with the entire world. Japan's deficit with China is much smaller, but Tokyo is keenly aware of

China's efforts to replace its high value-added exports with its own indigenous products. China's economic and technological power has morphed mere trade complaints into a broader sense of strategic rivalry with significant national security risks and some commercial opportunities for both Japan and the United States. How closely Tokyo and Washington can coordinate their policy responses to Beijing's heightened economic influence remains to be seen.

The Stakes

Japan and the United States could hardly have more at stake, a reality that a growing number of citizens and policymakers have been coming to terms with in the years since China joined the WTO. Ultimately, the economic health and growth of the two countries, the prosperity of their private firms (as well as U.S. farmers), their technological leadership, their military competitiveness, and their allied foreign policy influence all hang in the balance.

This is true regardless of which direction the Chinese economy takes, as there are both potentially positive and negative impacts that would result whether China's economy grows or deteriorates for the foreseeable future. China's macroeconomic performance and that of some of the country's largest companies can have a significant impact on allied interests in both the short and long term. This is evident from the influence China's economic behavior and prospects have on the stock prices and performances of major U.S. corporations, as expressed in letters and testimony by U.S. business leaders presented to U.S. policymakers regarding U.S.-China trade frictions. The worst development for the United States would be strong Chinese economic growth and technological innovation at the expense of the United States and U.S. firms. Such an outcome has the greatest potential to expose the U.S. economy to mostly negative aspects of Chinese growth over the long term. (That said, relevant data generally reveals a mixed picture, suggesting that some of China's gains have been at the expense of certain U.S. firms and workers, while other U.S. sectors and regions have benefited from China's economic success.) While U.S. concerns about China's economic behavior tend to focus on such zero-sum competition, Japanese citizens often worry about other vulnerabilities and risks, such as quality control related to food imports or other product safety issues.

If a firm policy response could encourage Beijing to make at least some changes to its economic behavior, a more open and rules-based form of Chinese capitalism could benefit all three countries. This could include boosting Chinese foreign direct investment (FDI) in Japan and the United States, although heightened competition would still create problems for some U.S. and Japanese businesses. Competition in harnessing dual-use technologies and writing rules of the road for new technologies (and rules on data usage/privacy) will continue to be contentious.

Although competitiveness is certainly important to Tokyo in microeconomic terms, the Japanese government has a particularly vital interest in finding a productive balance between deep engagement to benefit from China's dynamic markets, while avoiding the risk of becoming overreliant on Beijing for economic growth and vulnerable to economic coercion. China's importance as a trading partner for Japan is clear, but security concerns in Tokyo have made the central role of the U.S.-Japan alliance even more important than before. This drives a broad consensus-based commitment among Japanese policymakers to the long-term maintenance of the alliance.

Recent Developments

China's remarkable post–Cold War economic growth is slowing, as the country's gross domestic product (GDP) reportedly expanded by only 6.6 percent in 2018 and grew by merely 6.2 percent in the first half of 2019. The 2018 figure is China's lowest level of annual growth since 1990, though this is still a relatively healthy rate for the world's second-largest economy. Mainland China's economy is now roughly thirty-five times larger than it was when the Soviet Union collapsed in 1991. Policymakers in Beijing are trying to adapt from a track record of unbalanced growth (investment-led and concentrated along the coast) to the realities of a maturing economy characterized by moderating growth rates, rising wages, growing public expectations, and higher levels of debt. The government has sought to stimulate more consumption-led growth and is considering additional reforms. The private sector features a wide mix of global players including some stagnant SOEs and highly innovative and profitable private firms such as the telecom giant Huawei, which posted record profits of $8.8 billion in 2018.

Washington's response to economic concerns about China has been far more forceful to date than Japan's response. Given ongoing concerns over IP theft, forced technology transfer, and other examples of perceived unfair Chinese practices, Trump and his administration launched a multipronged attack to help protect U.S. industries and apply pressure on Beijing to fundamentally change its economic behavior.

1) **Steel and aluminum tariffs**: The Trump administration moved quickly to protect some U.S. industries from Chinese competition, first in April 2017 by initiating Section 232 investigations by the Commerce Department into the national security implications of imported steel and aluminum. As a result, a year later, the administration respectively applied 25 percent and 10 percent tariffs on steel and aluminum imports from several countries including China.

2) **Tariffs to protect U.S. intellectual property**: Trump next launched a Section 301 investigation of Chinese economic practices that could be "harming American intellectual property rights, innovation or technology development," an investigation that resulted in four rounds of U.S. tariffs on certain imports from China starting in September 2018. Trump raised the tariff rate on the largest block of Chinese goods (with a value of about $200 billion) from 10 percent to 25 percent in June 2019, and another $300 billion worth of Chinese goods are

targeted for a 25 percent tariff if trade talks are unsuccessful. The Trump team's goal is to pressure China to end IP theft and forced technology transfers. The two sides have been negotiating to find a mutually acceptable level of Chinese policy and legal changes that protect U.S. technology.

3) **Restrictions on U.S.-China private-sector engagement**: On a related note, the Trump administration is working to limit the U.S. private sector's interactions with certain Chinese companies that Washington believes pose technological security risks. For example, Congress approved new restrictions on inward FDI in 2018 by expanding the jurisdiction of the Committee on Foreign Investment in the United States (CFIUS), which can prohibit outside investments in U.S. firms if it believes they will harm national security. The committee also banned the U.S. government from using Chinese telecom equipment, and it started a process by which specific emerging technologies could have tougher export licensing requirements if sold to China.

4) **Export ban on a Chinese tech giant**: The export restrictions related to Chinese national high-tech champion Huawei are particularly severe. Most notably, the U.S. Commerce Department in May 2019 added Huawei group companies to the department's so-called Entity List, which means that U.S. firms are prohibited from selling any goods or services to the Chinese telecommunications giant without explicit U.S. government approval. The Trump administration softened the blow somewhat by issuing a temporary general license for many transactions, but Huawei is nonetheless forecasting a $30 billion drop in revenue over two years due in large part to the U.S. moves.

The U.S. business community and many members of Congress generally oppose Trump's tariff approach, but many agree that stronger measures were necessary to induce China to make substantial changes. One example is the new House Ways and Means Committee Chairman Richard Neal, who said, "As controversial as the China tariffs have been, this Administration does currently have the attention of China's economic policy makers. . . [creating] a unique opportunity . . . to secure meaningful and significant changes from China in the way China competes"; he further argued against reaching "a quick and easy deal" that does not secure "a fundamental reset of the U.S.-China trade relationship."

Trump seems to hope a trade deal with China will bolster the U.S. economy and spark a stock market rally that would give him political momentum going into an election year in 2020. Politicians from states that export agricultural products such as Iowa, Kansas, and Nebraska—places that have been hurt by Chinese retaliatory tariffs—also recommend a more flexible U.S. approach to reach a deal and end the uncertainty. The U.S. Chamber of Commerce is sympathetic to this position as well.

But U.S. Trade Representative Robert Lighthizer and other White House aides are pushing Trump to hold firm and demand that China reform its economic behavior in fundamental ways, primarily to protect U.S. jobs and the country's economic future. They want new and enforceable rules that would prohibit undesired technology transfer to Chinese actors and open new markets in fields like biotechnology and electronic payments. Lighthizer and other like-minded individuals have support from domestic U.S. manufacturers, whose trade association criticized Trump for record-high trade deficits and demanded "dramatic structural changes in Beijing's state-led economy" in any trade deal. Maximalist demands of this sort seem to have pushed China's leadership in 2019 to reduce its flexibility in negotiations, and the resulting impasse threatens to carry over into the U.S. election year.

Despite its shared concerns, Tokyo has taken a more measured approach to economic relations with Beijing than Washington has. Improved relations between Japan and China—compared to earlier in this decade—has helped drive a rebound in Japanese exports and investment to China, rising faster in 2018 than comparable Chinese trade and investment with the United States. At the same time, Prime Minister Shinzo Abe and his administration have taken steps to restrict government purchases of certain Chinese telecom equipment over security concerns. Furthermore, there are signs that Japanese exports and FDI to China are dropping off in early 2019, as the Chinese economy slows and U.S. tariffs prompt some Japanese companies to consider making adjustments to their supply chains.

Potential Risks

The ongoing trade disputes between China and its trading partners pose risks to all parties involved directly and indirectly, including Japan and the United States. Some of the most prominent factors to consider include:

- **The adverse domestic effects of a Chinese economic slowdown**: A sharp drop in China's near-term economic growth in China would adversely affect the U.S. and Japanese economies (especially the U.S. agricultural sector and certain firms). Apple, for example, earns about 20 percent of its revenue from Greater China (including Hong Kong and Taiwan), and the company's net sales there have dropped by 10 percent over the last three quarters—compared to the same period a year earlier. This shift is due primarily to lower iPhone sales in China. In addition, an economically weakened China will be less able to finance the U.S. government's deficit spending over the longer term. As for Japan, already in 2019, the country has seen a decline in machinery and other goods exported to China, and there has been a corresponding drop in demand for investment in China's domestic market.

- **The global institutional fallout of illiberal trade practices**: The International Monetary Fund (IMF) has been revising its global growth estimates downward, due in part to "the negative effects of tariff increases enacted in the United States and China" in 2018. There is a risk that the tit-for-tat duty hikes and the imposition of nontariff barriers will weaken the rules-based trading system, which has been centered on the WTO. Guarding against this risk was a high priority for Japan when it hosted the 2019 G20 meetings.

- **Costly disruptions to globe-spanning supply chains**: Each volley of tariffs in the U.S.-China trade war heightens the uncertainty and inefficiency associated with adjustments to the global manufacturing supply chains that crisscross Asia. In some cases, the costs are borne by Japanese businesses like the telecom firm Softbank. This company reportedly replaced upward of $100 million worth of Huawei equipment in its wireless network due to security concerns (and fears of lost business involving the United States). Further segregation of supply chains in Asia could lead to even greater, costlier adjustments.

- **The uncertain outcome of U.S.-China trade talks**: Whether strong or weak, a potential U.S.-China trade truce understandably would not affect Washington and Tokyo the same way. A less demanding U.S. approach could stabilize global economic growth and supply chains as well as reduce pressure on Japan in its own trade talks with the United States, especially if U.S. farmers are selling a lot more to China. Yet a weak deal might limit Chinese concessions to simply buying more U.S. goods to reduce the bilateral trade deficit, with few benefits flowing to Japan. A tough Trump stance carries its own dangers for Tokyo. If China does not compromise, expanded economic warfare or even a global recession could ensue. Yet if Beijing does make concessions, this could counterintuitively set a bad precedent for U.S.-Japan trade talks. New (and intrusive) trade enforcement mechanisms and currency restraints could become standard U.S. trade demands.

- **The risks of further Chinese economic inroads**: There is a danger that China could succeed in spurring an economic revival at the expense of the United States (by hollowing out key U.S. industries, reducing competitiveness, and locking in Chinese technical and economic standards globally, for instance). Such outcomes would harm the U.S. and Japanese economies and would erode the allies' military advantages. But it is worth noting that Chinese economic growth and success by itself is not a major risk, unless it stems from zero-sum competition with the allies. The United States, Japan, Germany, and other countries have all found ways to compete and grow richer overall without systemic disruptions to key industries; and when there have been tensions—in the automobile or semiconductor industries, for example—they revisited trade rules and fostered cross-border investment. There are ways to compete and coexist peacefully.

Potential Opportunities

The aforementioned risks notwithstanding, Tokyo's and Washington's ongoing efforts to coax Beijing to chart a new economic course could pay some dividends. Specifically, these efforts could help Japan and the United States:

- **Encourage China to embrace economic reforms**: Some Chinese policy elites support more aggressive economic policy changes and might see U.S. trade pressure as an opportunity for further pro-market reforms. If Japan and the United States can effectively support such parties in China, the reforms that could result may help foster a more open, less centralized Chinese economy that might be more amenable to rules-based governance. Such progress could improve global governance standards and positively influence other countries in Central, South, and Southeast Asia. The intensifying U.S.-China trade war makes this more difficult, however, as a declining sense of mutual goodwill and win-win spirit emboldens skeptics in China who believe they must protect their way of conducting business even more aggressively.

- **Create commercial openings for domestic firms**: Balanced Chinese economic growth can provide commercial opportunities for certain U.S. and Japanese firms and support global economic development. For instance, real Chinese economic reform could create openings for Japanese biotechnology companies, as U.S. negotiators are pushing for faster Chinese approval of imported products in that domain. Enforceable rules to protect foreign intellectual property in China would apply to every country, not just the United States. The same would apply to the service industry, where U.S. strength in fields like financial, legal, and consulting services could give U.S. firms an edge.

- **Tackle climate change more collectively**: If China were to enact more ecofriendly economic growth policies, such measures could have a major positive impact on the global environment and help mitigate climate change.

- **Address shared economic woes in concert**: Market-led and state-led capitalism both are under pressure for failing to deliver balanced growth and equal economic opportunities for all citizens. China, Japan, and the United States could perhaps collaborate to help ameliorate economic inequality and maximize economic opportunity. In theory at least, China's economy has a lot in common with those of the United States and Japan in such areas as prioritizing stable markets and efficient supply lines. And when it comes to IP protection, legal guarantees of due process independent of political influence, and reliable means of nonviolently enforcing rules, Beijing may find that its interests gradually align more with Tokyo and Washington as its economy continues to grow and mature. China's largest and most successful companies will suffer if other countries begin to treat them in a way similar to how China treats large multinational corporations, so there could be a growing Chinese constituency for change on this front.

Next Steps

As Japan and the United States seek to more closely align their policy responses to China's economic behavior, the following areas hold promise for greater coordination:

- **Ensuring allies stayed synced up on trade negotiations**: It will be important for the U.S. government to step up consultations with Japan on progress in bilateral negotiations with China, as a subpart of U.S.-Japan-EU discussions regarding potential WTO reforms and structural change to China's economic behavior. China is more likely to make the desired reforms if allied countries share information and experiences and apply pressure on Beijing uniformly.

- **Promoting a rules-based economic order**: Since the Trump administration withdrew from the Trans-Pacific Partnership (TPP) trade agreement in 2017 and has undermined multilateral trade liberalization in other ways, Japan has emerged as a champion of this cause. (This is evident from a revived TPP-11 deal, a trade agreement with the EU, and efforts to conclude negotiations on the pan-Asian Regional Comprehensive Economic Partnership trade pact.[1]) Japan's goal is to strengthen the WTO process by applying high-standard modern rules of trade to a wider range of countries and instituting a fair and effective dispute resolution process. Even if the Trump administration is not supportive, many U.S. political and economic actors are supportive (including some members of Congress, governors, business leaders, and various interest groups). There might be ways that these groups can support Japanese efforts to create a rule-based bridge-building approach in Asia and possibly even with China.

- **Helping the world economy adapt for the twenty-first century:** It is crucial for Japan and the United States to work together to help the world adapt to the economic needs of today. Setting rules for trade in services and data flows has become as important as the rules of finance and trade in goods. Harmonizing international approaches to data privacy protection, considering acceptable methods for taxing cross-border digital activities, and developing ethical standards for artificial intelligence and other new innovations will all be important ingredients of a new commercial order that goes beyond what the WTO was designed to manage. In that spirit, a major theme of the 2019 G20 summit that Japan hosted was "data free flow with trust."

About the Authors

James L. Schoff is a senior fellow in the Carnegie Asia Program. His research focuses on U.S.-Japan relations and regional engagement, Japanese technology innovation, and regional trade and security dynamics.

Asei Ito is an associate professor at the Institute of Social Science at the University of Tokyo, where he specializes in the Chinese economy and industrial development.

Notes

1 This potential trade deal is being negotiated between several Asian countries, including Australia, China, India, Japan, New Zealand, South Korea, and the members of the Association of Southeast Asian Nations.

For your convenience, this document contains hyperlinked source notes as indicated by teal-colored text.

CARNEGIE
ENDOWMENT FOR
INTERNATIONAL PEACE

1779 Massachusetts Avenue NW | Washington, DC 20036 | P: + 1 202 483 7600

CarnegieEndowment.org