U.S.-China Tensions: Interplay Between Economics and Politics

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The agreement reached during President Xi’s April 2017 meeting with President Trump at Mar-a-Lago on a 100 day plan to ease trade tensions did not have a long shelf life. For several months, the agreement appeared to have defused any intentions to consider more contentious protectionist measures. Accusations regarding currency manipulations also evaporated, as did concerns about cyber-security violations for economic gain. From China’s perspective, President Trump’s assurance that the U.S. would not play the Taiwan card removed the most contentious of concerns from the agenda. All this seemed to suggest economic issues would not become intertwined with security and political concerns. Yet, over the summer, signs that this would not necessarily be the case become apparent and this was confirmed by the lack of significant progress in the July U.S.-China Comprehensive Economic Dialogue (CED).

The likelihood that trade and foreign investment factors will continue to be a source of tension is discussed in my recently published book: Cracking the China Conundrum—Why Conventional Economic Wisdom Is Wrong (Oxford University Press, July 2017). These tensions stem in part from basic misunderstandings of the nature of the trade and investment relations between the U.S. and China that has contributed to an unnecessarily antagonistic relationship. These negative and highly emotional perceptions are nurtured by insecurities in the mindsets of both nations and reflect the mistrust between their respective civilian and military leaders. Contrasting political systems and cultural norms of society have always made it difficult for these two nations to work together. But ironically, with President Trump’s

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election and President Xi’s consolidation of authority, the potential for conflict is now greater not because of these differences but because of commonalities in their personal aspirations.

**Public Perceptions Shape Policies**

That the media pays so much attention to China is not surprising given that its economy has now superseded that of the U.S. in purchasing power terms. This has created anxieties as Washington ponders the extent that America’s global dominance has been diminished. Meanwhile, the American public believes China’s rise has contributed to their stagnating salaries and lost jobs. Whether one is a politician, a foreign investor or the average citizen, one’s views on China are strongly influenced by location, culture and values.¹

China was a convenient target in the recent presidential campaign, as evidenced in Mr. Trump’s accusations about China’s economic policies. But long-prevailing public perceptions have nurtured these positions. Opinion polls conducted by Gallup and Pew over the past decade show that most Americans worry about China’s increasing economic strength and think China is untrustworthy. A majority of both Democrats and Republicans hold China responsible for America’s trade deficits and outsourcing of jobs abroad, with Republicans significantly more negative than Democrats. This has encouraged punitive actions, including claims with the WTO that China’s exports are unfairly subsidized.

Such negative sentiments provided a rationale for the U.S.’s major trade initiative, the Trans-Pacific Partnership (TPP), to exclude China, reinforcing the view that most Americans believe China’s trade practices are unfair. President Trump has now taken this position one step further in dropping the TPP, even as many still believe it is the best option for checking China’s influence in the Asian region.

Globally, there is a marked shift in security concerns coming from China’s increasing economic might and willingness to exercise it. In

¹ For a discussion of the source and nature of the poll results see chapter two in Yukon Huang, Cracking the China Conundrum: Why Conventional Economic Wisdom Is Wrong (New York, New York: Oxford University Press, 2017).
the past, many saw China’s accomplishments as a laudable outcome that benefited the world. But the majority of Americans now see China’s economic rise as a threat to their country’s international stature.

Ironically, the Chinese people do not see the U.S. so critically, with various polls showing that their sentiments include considerable admiration for American ideas, values and scientific accomplishments. This reaffirms the major advantage the U.S. has in projecting its soft power as a complement to its military superiority.

**Economic Factors Also Shape Perceptions**

The U.S.-China relationship is unique because these perceptions have been influenced as much by economic trends as political factors. China’s emergence as the world’s largest trading nation is mirrored in America’s relative economic decline over the past decade, as the latter’s financial vulnerabilities triggered the 2008 global financial crisis.

While size matters in judging global significance, China’s direct impact on other countries comes primarily through its emergence as the world’s largest trading nation, a premier destination for foreign investment and a source of surging outward capital flows. These shifts have fundamentally altered China’s external economic relations with the U.S., Europe and its neighbors. All this has been part of a globalization process that until recently was seen as generally having benefited both developing and developed countries. But rising protectionist sentiments have led to pushback against globalization in the West, even as emerging economies like China continue to embrace its positive consequences.

Such shifts in opinions have made it more difficult to forge constructive solutions. Trade and foreign investment flows have played a major role in shaping China’s development and its impact on other countries. From being largely a regional player, it is now the primary export destination for some 40 countries—compared with 10 a decade ago—with key relationships extending to all continents.
With success came concern. In the mid-2000s, the international financial community, with the U.S. in the lead, was preoccupied with China’s huge trade surpluses and its impact on global macro-imbalances. China’s soaring levels of foreign reserves drew largely misplaced outcries that America would be held hostage to Beijing’s commands and would allow China to broaden its external economic influence.

Despite China’s recent economic slowdown, public sentiment on the nature of U.S.-China economic relations have not evolved as quickly. Presidential campaign charges made by Mr. Trump and his key economic advisors reinforced long-standing complaints from congressional leaders and segments of the business community about China’s exchange rate being undervalued, even though years of appreciation have led most analysts to conclude otherwise. China’s persistent bilateral trade surpluses with the U.S. are seen as harming America’s competitiveness. Moreover, there has been a noticeable shift in the sentiments of U.S. investors in recent years over the difficulties they now have in accessing China’s domestic market. This is occurring despite China being ranked consistently as a highly attractive foreign investment destination—second only to the United States.

**Evolving U.S. Views on China**

President Trump’s election did not alter the fact that American perceptions of China are influenced by both economic and security concerns. While nearly half of Americans surveyed see China as a military threat, compared with about a third in Europe, a poll from the Chicago Council on Global Affairs shows that the American public overwhelmingly—by a measure of 77 to 23 percent—feels China’s economic strength, rather than its military might, determines its power to influence global events. Nevertheless, much attention these days is being given to security-related issues given the tensions surrounding cybersecurity attacks, island-related territorial disputes and maritime incidents.

Since the Global Financial Crisis, Gallup polls have indicated that a majority of Americans believe China is the world’s leading economic
power while a smaller share of around 30-35 percent see the U.S. as dominant—a sentiment which is also broadly shared in Europe. This was not the case in 2000 when only 10 percent named China and 65 percent of Americans saw the U.S. as on top.

With one exception, Pew surveys show that the rest of the world sees the U.S. as the leading economic power, and that exception is Europe which until last year also viewed China as the leading economic power. Is there a simple reason the U.S. and Europe are more inclined to see China as the leading economic power, when the rest of the world, including China itself, feels otherwise?

In part, this comes from the misleading impression that a country's economic might is shaped by simple financial indicators such as trade balances or a country's size. China has a huge trade surplus with the U.S. and to a lesser extent with Europe, but it runs deficits with the rest of the world, most notably with commodity exporters and its East Asian neighbors. This generates considerable insecurities in the U.S. as well as Europe about its competitiveness that for the most part are overdone.

A country’s economic power comes more from the strength of its institutions, its human capital base, and technological prowess, which is more closely correlated with per capita GDP than trade balances or the size of its population. With a per capita GDP placing it between 70-80th globally, China is far from ready to assume the mantle of being the leading economic power. And given its relatively weak command of “soft power” skills and underdeveloped alliances, it fares poorly regarding the usual criteria used to define great powers in terms of their foreign policy influence.

The sense that the U.S. is no longer unchallenged economically has contributed to the increasingly negative American sentiments toward China, based in part on long-standing concerns about China’s political system and position on human rights. Some see a military threat in the making, but most realize China is decades away from seriously challenging America’s military superiority.
A decade ago, many did appreciate that the world is better off with a more prosperous China. This is evidenced in the Pew polls on whether the public has “favorable” or “unfavorable” feelings toward China. Americans had quite favorable feelings about China in the first half of the 2000s (see Figure 1). But by 2006, America’s trade deficits and increasing complaints of unfair competition drove an increase in the share that rated China unfavorably, bottoming out with the Global Financial Crisis in 2008. From 2009-11, China’s strong growth was again seen positively in propelling up global demand as the West struggled with its financial problems and this led to a decline in unfavorable ratings. Sentiments turned and have remained strongly unfavorable in recent years as the U.S. reasserted itself in Asia and China became more aggressive in challenging its neighbors and the U.S. over the island disputes in Asian waters.

![Figure 1: U.S. Opinions of China (Source: Pew Surveys, author)](image)

**U.S.-China Trade Tensions**

President Trump has capitalized on the fact that sentiments toward China are quite unfavorable in raising the specter of China being an unfair competitor. Ask the average person in Detroit or even Washington DC, and he or she will likely say that China’s manipulation of its currency is one of the causes of America’s trade deficit and job losses. However, economic principles tell us that the current account balance of each country is determined within its own borders, not by
its trading partners, and that employment gains or losses are rarely a trade issue.

The confusion comes from having China as the final assembly point for shipping to the U.S. of parts produced by other Asian countries. This makes it difficult to determine which country is really responsible for the bulk of the value of finished products that end up in America.

China’s foreign investment-led industrialization process, along with reforms, created the capacity for it to become globally competitive, while membership in the WTO provided it access to Western markets. This led to a dramatic increase in China’s account surpluses by the time of the global recession a decade ago. This has led to China being blamed for lost jobs, unfair competition, and low wage growth, although much of the surplus actually represents an “accounting” shift among countries in the Asian region.

Nonetheless, the fact that China accounts for the largest share of America’s trade deficit provides credibility for the storyline that Beijing has not played fairly. However, there is no direct link between the emergence of America’s huge trade deficits and China’s trade surpluses. Moreover, there is little evidence that an undervalued renminbi played a major role in driving China’s trade surpluses over the past two decades.

That the U.S. and China’s trade balances are not directly linked is clearly illustrated by the historical trends (see Figure 2). America’s trade problems became significant around the late 1990s when its current account deficit, as a share of global GDP, increased sharply and only began to moderate around 2007. But China’s surpluses did not become significant until around 2004-05. As China’s surpluses increased, the U.S. deficit actually started to moderate. How could China be responsible for America’s trade deficits, when America’s huge deficits emerged long before China even became a major export power?
A trade deficit is often the result of excessive government deficits and/or households consuming beyond their means—both of which have characterized the American economy for decades. In such circumstances, a large trade deficit is inevitable. The countries that show up as being the source of the offsetting trade surpluses are incidental.

America’s bilateral trade deficits were concentrated among the more developed East Asian economies in the 1990s, most notably Japan, South Korea, and Taiwan. But this shifted to the Chinese mainland after it became the center of the regional production line in the early 2000s. U.S. manufactured imports from East Asia (without China) have decreased from about 45 percent of total U.S. manufactured imports in 1990 to about 20 percent in 2014 (see Figure 3). However, this is a reflection of China gradually capturing an increasing share of the last stop in the global assembly chain. Thus, the appearance that U.S. trade deficits are linked with China’s surpluses is misleading. It is really about deficits with East Asia and notably the more advanced economies like Japan, Taiwan and South Korea where many of the higher-value components are being produced.

The recent failure of G-7 financial leaders to reaffirm their support for free trade illustrates the chasm between the views of the U.S. and other major economies. The Trump administration sees the U.S. trade deficit as impeding economic growth and prefers taking a bilateral approach to trade imbalances. This includes protectionist options
such as renegotiating the North American Free Trade Agreement and de-emphasizing the World Trade Organization. This line of reasoning, however, is misguided.

Figure 3: Share of U.S. Manufactured Imports for Asia

America’s overall trade balance has little to do with the bilateral deficits of any specific country, even China. Bilateral trade balances do not matter. What matters is a country’s overall trade balance.

Consider a simple three-country world. Country A sells something to country B, country B sells something of similar value to country C and country C sells something of similar value to country A. Each country has a bilateral surplus or deficit with the other two, but overall, each country’s trade is balanced. Moreover, a country’s trade balance does not depend on whether its trade regime is relatively open or protected. Brazil and India, for example, have highly protected trade systems but incur persistent deficits. Germany and Singapore have relatively open economies yet generate large trade surpluses. The link between trade deficits and growth is also tenuous at best. Rapidly growing economies often experience trade deficits because surging consumption requires more imports, while a stagnant economy has less need for imports.

Persistent trade deficits reflect a range of structural and macroeconomic policies. For one, trade-deficit countries are not saving enough relative to investment needs, while trade-surplus countries are saving too much. America’s low savings rate is the
consequence of its large budget deficits and households spending beyond their means. But a country’s savings rate is not totally independent of the savings rates of its trading partners.

China’s high savings rate over the past decade led to huge capital flows to the United States. This helped drive down interest rates, making it easier for the U.S. government and households to borrow. The resulting decline in net savings then shows up in America’s persistent trade deficits, as net savings are equal to net exports.

This pattern is exacerbated because the U.S. is the preferred global safe-haven for capital flows. This boosts the value of the dollar, making it virtually impossible for the U.S. to avoid running a trade deficit, explaining why the U.S. has been running trade deficits for forty years. From this perspective, America’s trade deficit has little to do with alleged unfair trade practices and more with the unique role of the dollar. This gives the U.S. the “exorbitant privilege” of running deficits with impunity.

**Exchange Rates Now Matter Less**

A contributing factor to these misguided trade tensions is the perception that China’s export strengths are largely due to its exchange rate being deliberately undervalued, giving it an unfair production advantage. How important was a fixed exchange rate in driving China’s trade surpluses?

After joining the WTO in 2001, many analysts thought the renminbi would be under pressure to depreciate since China had to liberalize its import regime as a condition of membership and new exports would take time to develop. But the reality was far different. China gained a significant share of the global export market from productivity-enhancing infrastructure investments that led to a surge in labor productivity. This made China the center of regional assembly activities. Structural shifts and policy changes, not the exchange rate, were the major factors driving China’s export success.

But appreciating the exchange rate can help moderate trade imbalances once they emerge. When China’s trade surpluses
increased to 5 percent of GDP, it moved away from a fixed peg to the U.S. dollar and began to appreciate the renminbi in 2005. The combination of a steady appreciation of its nominal exchange rate and increasing consumer prices contributed to China’s real effective exchange rate appreciating by about 50 percent by the end of 2015 compared with a nominal increase of 35 percent since 2005. This occurred during a period when most of the other major East Asian economies were depreciating their currencies. Thus, the wide-spread view that the renminbi has not been appreciating significantly over the past decade is simply wrong.

More generally, studies have shown that adjustments in exchange rates have a much smaller impact on trade balances today than they did decades ago. Manufacturers are increasingly reliant on imported components for production rather than trying to produce all the parts themselves. As a consequence, if the exchange rate falls, the boost to exports is not that great because increases in the price of imported components will partially offset the benefits from higher export receipts. Similarly, if the exchange rate appreciates, exports do not fall that much because the cost of imported inputs will decline. This factor is especially relevant for China’s trade given the very high share of imported inputs in its exports of finished products to the West.

**Employment Concerns Drive Trade and Investment Tensions**

Even if China’s exchange rate becomes less of a concern, emotions in the U.S. and Europe are likely to remain strong as long as the public continues to believe globalization is the main reason manufacturing jobs have been lost to developing countries like China or Mexico. This view has been strongly advanced by President Trump and his advisors.

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The decline in manufacturing jobs in the U.S. is not strictly a China issue. The share of manufacturing workers in the U.S. has been declining for quite some time, with the total number of manufacturing jobs peaking in 1979. China’s trade with the U.S. did not take off until the early 2000s, well after the U.S. job decline began.

The loss of American manufacturing jobs, however, has been driven by forces largely beyond the control of any leader or country. Technological advances or productivity increases have been the major reasons for the decline, although shifting industrial expertise around the world and the availability of low-cost labor, if not in China then elsewhere in countries like India and Vietnam, have contributed to the decline in the United States. The process can be moderated, but trying to stop it with trade barriers or restrictions on migration will ultimately prove to be ineffective with the costs showing up in reduced growth and welfare for all countries. Nor would higher tariffs bring many of these jobs back.

What made the process seem like a China issue is the speed and size of the loss in jobs that began as China became the center of the East Asian production network. With the recent decline in East Asia’s trade surpluses, the pattern of job loss has changed. Contrary to today’s popular perceptions, manufacturing jobs have actually been increasing of late in the United States. America’s exports to China are also becoming a major source of U.S. job generation, with the Department of Commerce estimating that some 350,000 new jobs were created for this purpose during 2009-14. In contrast, the manufacturing labor force in China has been declining, as workers’ salaries a decade ago were comparable to Vietnam’s and Bangladesh’s but are now multiples higher.

Yet, the reality is that the “hollowing” out of the middle class in the U.S. and Europe has given rise to frustrations that can no longer be placated by simply appealing to the supposed virtues of globalization. There are uncompensated losers in the process. Political systems need to find ways to address local interests without giving up the benefits globalization can bring rather than blaming China as many of the White House advisors are in the habit of doing. But China also needs to play a role in the process by being more sensitive to the external
consequences their own structural shifts have created in the West.

**Investment Relations Between China and the United States**

Employment concerns also underpin the prevailing perception that U.S. firms invest a lot overseas in China and that this has led to a loss in jobs at home. The logic is reinforced by the fact that the U.S. and China are the two largest economies and trading nations. The reality, however, is the opposite, since over the past decade UNCTAD data indicates that only about 1-2 percent of America’s investment has been going to China and only about 2-3 percent of China’s outward investment has been going to the United States. These estimates understate the actual amounts given that considerable investment is channeled through tax havens. In contrast, countries like South Korea and Japan have historically invested around 20 percent of their FDI in China.

For comparison, consider the EU, which in its economic size ($18 trillion) and trade with China ($500+ billion) is comparable to the United States. Over the past decade, annual flows of EU’s FDI to China have been roughly double that of the U.S., although they began at around the same levels a decade ago (see Figure 4). Similarly, until last year, much more of China’s outward flow of FDI has been going to the EU compared to the United States. So why have the U.S. and China not been investing as much in each other?

The EU is known globally for its manufacturing prowess and a comparison done by Rhodium using transactions data covering 2008-2011 shows that it has almost double the investment of the U.S. in both manufacturing and services in China. Though China presents a large and potentially attractive market, its relative lack of natural resources compared to its population, its significant investment restrictions (particularly in areas of U.S. strengths) and its weak property rights enforcement are seen as reasons for the low flow of

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5 Considerable foreign investment goes to tax havens and thus the actual country specific amounts are higher but there is no way to tell how much higher. However, the tax haven issue affects all countries, thus relatively speaking less is coming and going to the U.S. relative to Europe or the other East Asianmajor economies.

FDI from the United States. However, the question remains that given similar barriers to entry in China, security concerns, and weak intellectual property enforcement, why did EU investment flows with China grow more rapidly?

![Graph showing FDI in China, EU vs U.S.](sources: UNCTAD, MOFCOM)

**Figure 4: EU and U.S. FDI in China**

**Trade Patterns Explain U.S. and EU FDI Differences with China**

From 2004 to 2013, U.S. exports to China nearly tripled to $120 billion, yet it still ranked behind South Korea, Japan and the EU—which is ranked number one. The EU’s exports to China totaled 164 billion Euros in 2014. This suggests that the EU’s economic strengths in manufacturing have been more complementary with China’s market needs than has been the case for the United States.

The EU’s top exports to China are dominated by machinery and transport as well as items targeted to both high-end consumers and industrial firms. These sectors logically lead to FDI flows to support market penetration and servicing as well as the establishment of localized production capacity when conditions warrant.

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In comparison, the top three categories of U.S. exports to China over the past decade and a half have been oilseeds and grains followed by aerospace products and then, surprisingly, by recycled waste (scrap metal and discarded paper) (see Figure 5). None of these categories have led to significant FDI. The reasons are obvious regarding food products and recycled waste. For aerospace products, Boeing has refrained from opening operations in China while its European competitor, Airbus, has had manufacturing centers in China since 2008 and continues to expand its production as China expands flight services to its interior.

Motor vehicle exports only became significant in recent years, and its emergence is somewhat surprising. Most of the surge in exports of cars ironically is accounted for by European luxury branded SUVs such as Audi and Mercedes. These are made in the U.S. but, given China’s tax policies, can be imported at a price that is lower than those made in China. The related FDI then turns out to be European rather than American.

EU and U.S. trade relations with China illustrate how composition matters in shaping FDI flows. Manufacturing exports and investments are largely welcomed in China’s domestic market and cater more to EU strengths, while China’s closed services sector has a
disproportionately more negative effect on the U.S., whose strengths lie in higher value services, notably in IT and finance. Of total U.S. services exports in 2014, 19 percent of exports came from the use of intellectual property compared to the EU’s 6.4 percent of total service exports from royalties and licensing fees. Financial services also made up 12 percent of U.S. services exports compared to the EU’s 8.6 percent.\(^8\)

China’s economy has one of the most restrictive FDI services sectors in the world, especially for high-value services such as communications, mobile telecoms, legal, insurance, financial, and banking services, precisely the areas of interest to American and European firms. China’s leadership seems to have finally recognized the importance of this issue. Last January, a directive was issued liberalizing investment in several sectors including financial services, telecommunications and education and the 100 day plan includes actions to allow more U.S. financial companies to operate in China, including credit card companies. But how rapidly these intentions will be implemented is unclear as indicated in the July CED discussions.

Another reason for lower U.S. investment in China compared to the EU is because EU trade provides about twice as much value added in the manufacturing process within China than does the United States. American firms like Apple also operate in a way that tends to involve little direct FDI coming from the United States. Although Apple products are manufactured in China, the company actually responsible for production is a Taiwanese firm Foxconn, which accounts for the bulk of the FDI required. Thus, while most Americans think Apple must be heavily invested financially in China, the reality is that most of the investment comes from other sources.

Furthermore, major U.S. companies with a visible presence in China, such as fast food and hotel chains, operate as franchises. These U.S. companies do not own their local affiliates but license and receive franchise fees, although they may be involved in providing some of the products needed by their franchisees. Thus the presence of these U.S. multinational icons in China does not necessarily show up as a larger

\(^8\) Eurostat and Bureau of Economic Analysis data, various years.
share of FDI in the official tallies, although one can argue the impact of these U.S. companies is much greater than the dollar value of their FDI would suggest.

Overall, the structure of trade relations between the United States and China does not lend itself as naturally to foreign investment as it does with the EU. But if China liberalizes its investment regime in favor of more high-value services this could alter prospects.

**Political and Security Sensitivities Affect China’s Outward FDI Flows**

The U.S. and the EU have reacted quite differently to China’s rising outward investment. In addition to reciprocity and more complementary trade sectors, not to be overlooked is the basic fact that despite some recent setbacks the EU is more willing to let the Chinese come in. China’s outward FDI stock in the EU is about double that of the United States. The divergence is largely due to the post-Global Financial Crisis years when annual flows were typically multiples higher for the EU (see Figure 6). The rise in China’s investment in the EU was significantly impacted by the opportunities for Chinese investors during the euro-zone crisis. However, no similarly large spike in investment was seen when the U.S. suffered its own financial crisis.

![Figure 6: China FDI to the EU and US (Source: UNCTAD, MOFCOM)](image-url)
For Chinese companies, the EU also represents a much easier market to penetrate because it offers a greater choice of partners. This could be seen as a form of a “divide and conquer” strategy. If one EU member country restricted access to its market, a Chinese company could still enter through a different member country and gain access to the greater EU market in that way. Though partnerships with individual U.S. states are possible, the more agglomerated nature of U.S. companies and overarching federal policies are a greater challenge.

Security concerns are also a major concern because many Chinese investments into the U.S. are subject to review by the U.S. Committee on Foreign Investment (CFIUS), which determines whether deals with foreign corporations raise anti-trust or national security issues. Although China accounts for only a few percent of FDI into the United States, it comprises nearly a quarter of CFIUS cases and topped the list of countries whose proposed transactions were reviewed by CFIUS.9 China’s investments within the U.S. attract particular scrutiny due to wariness over China’s state-owned enterprises and security concerns.

Contrary to the high profile negative sentiments over Chinese state-owned enterprise investments in the United States, a majority of Chinese investment to the U.S. may actually be private. Nevertheless, the negative sentiments around CFIUS cases may be counterproductive to attracting smaller private Chinese investors. According to the 2015 report to Congress by CFIUS, China ranks number one in terms of CIFIUS reviews although it ranks 14th regarding the amount of foreign investment that is coming into the United States.

National security concerns are especially relevant in U.S. high-tech sectors. Huawei, a Chinese telecommunications company, is one example of how U.S. national security concerns prevented its expansion while the EU was much more open. The House Intelligence Committee recommended that CFIUS should block acquisitions involving Huawei and another Chinese telecom company, ZTE, citing

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both as a “threat to U.S. national security interests.”

While being virtually shut out of the U.S., Huawei has had better luck in Europe. While Canada and Australia followed the U.S. lead in blocking Huawei over cyber espionage concerns, the United Kingdom took another approach. The U.K. set up a special center to examine Huawei’s technology that enabled U.K. experts to work with Huawei to gain the necessary assurance that the products met security standards. Huawei now comprises nearly a quarter of mobile-network infrastructure spending in Europe, the Middle East and Africa. By contrast, Huawei has less than 3 percent share of the telecom market in North America. 10

A bilateral investment treaty (BIT) has been under negotiation for many years between Beijing and the United States. But the Trump administration may be resistant to any agreement that would encourage American companies to invest more abroad. Yet, for many American businesses operating in or hoping to operate in China, liberalizing China’s FDI policies would create commercial opportunities that would generate more jobs at home. Thus, moving forward with a bilateral investment treaty should be high on President Trump’s agenda.

Without a BIT, economic tensions may become more serious in the coming years even as trade related issues become less of a concern. Surveys of American firms operating in China suggest their primary worries relate to recent actions taken by Beijing to promote “indigenous innovation” by excluding foreign companies from various sectors given national security concerns. China is seen as keen to develop its own technology as a means of offsetting rising wages and a shrinking labor force and has launched many initiatives to support this objective. Western governments and business associations have warned that any discriminatory policies will adversely impact future foreign investments in China. All this is occurring at a time when the political environments in both the U.S. and China have created the potential for relations to go astray if not carefully managed.

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Conflict and Commonality Between Donald Trump and Xi Jinping

If not carefully managed, President Trump’s election and President Xi’s consolidation of authority could exacerbate tensions between the U.S. and China given similarities in their political and foreign policy aspirations.

Both seek to elevate the profile of their countries—Mr. Xi by achieving his “Chinese Dream” and Mr. Trump by fulfilling his promise to “Make America Great Again.” They are also trying to enhance their own power bases within their respective political systems: Mr. Trump by making repeated references to the strength of his electoral victory and downplaying allegations Russia was interfering in the U.S. presidential elections and Mr. Xi by being named as a “core” leader, with reports suggesting he may wish to extend his term. Both see their objectives as requiring a robust economy with foreign policy playing a supportive role. Nationalism tinged with nostalgia is part of this approach, but its manifestations differ.

For Mr. Trump, it means reaffirming the U.S.’s position as the dominant superpower. An “America First” theme is part of this blueprint, and his ban on travel from seven mainly Muslim countries is one of the consequences.

Mr. Xi’s brand of nationalism stems from the legacy of humiliation by foreign powers and the desire to reassert China globally as a great power commensurate with its economic rise. This has been supported by a series of actions aimed at curbing Western influences at home, including registration of foreign NGOs and limiting access of Western media to the Chinese market.

Both are catering to populist sentiment as income disparities widen: Mr. Trump to a largely rural and white middle class that feels neglected; Mr. Xi to restless workers and stalwart party members who see capitalism as having concentrated wealth and rendered Maoist principles less relevant.

Populism in the United States translates into the view that globalization has wiped out many industrial jobs, making
protectionism central to the solution. In this environment, multilateral approaches will give way to bilateral options that at times mix economic with political objectives. America’s strategic alliances with Japan and South Korea and dangling the “One China” policy are seen by some in the White House as bargaining chips since traditional economic measures such as WTO sanctions have proved ineffective in molding the China economic relationship.

In China, populism is fed by the sense that widespread corruption is undermining the credibility of the system. Thus, Mr. Xi’s anti-corruption campaign is motivated by urgency to preserve the dominance of the Communist party. And while his directives also contain a healthy sprinkling of economic reform sentiments, progress has been limited by the desire to protect state-owned enterprises—the fulcrum for party support.

But Beijing has moved more vigorously than the U.S. on its external agenda to capitalize on a China-centric globalization without the usual Western-focused liberal ideologies. This is reflected in trade liberalization, the establishment of the Asian Infrastructure Investment Bank to complement and compete with Western-inspired multilateral institutions and the “Belt and Road Initiative” to improve connectivity with Europe and the rest of Asia. Beijing’s leadership role, however, is limited by its restrictions on capital movements and foreign investment, and on the flow of information and ideas.

Rising nationalism is pushing China to increase its presence in Asian waters so one day it can challenge U.S. maritime superiority. It has invested in a vast network of harbors and in its coast guard and fishing fleet. Beijing’s assertiveness has pushed Mr. Trump to consider a more muscular Asian presence than his predecessor. Non-economic actions may once again come to the fore if punitive economic measures such as ad hoc tariffs and import restrictions turn out to be counterproductive in triggering retaliation, at a time when abandoning the Trans-Pacific Partnership has further reduced America’s economic leverage.

Mr. Xi cannot afford to be seen as caving in to a more determined U.S. presence in the region lest he lose popular support. Thus, aside from
strengthening his overtures to Europe, as illustrated by his speech at Davos in response to America’s retrenchment and China’s May 2017 Belt and Road leader’s summit, he may not be as tough on North Korea as the United States has requested nor willing to moderate island-related activities in Asian waters.

Any escalating of tensions in the South China Sea would give rise the possibility that the two nations will fall into what some have depicted as the “Thucydides trap” in which a rising power’s perceived threat to the established power results in a clash. Avoiding conflict means addressing the more legitimate concerns of their populist constituencies—not by blaming foreign antagonists but by putting their own houses in order. With much at stake, the world must hope the two leaders are capable of such statesmanship.

In dealing with each other, the Chinese political system has one major advantage over America’s. China’s leaders have the luxury of working with a much longer time framework spanning a decade or two rather than America’s preoccupation with 2-4 year election cycles. The latter creates pressure for short-term political gains rather than providing the patience to work toward longer-term objectives.

**What to Expect**

Increasing tensions over the past decade have driven China’s neighbors to welcome the U.S. playing a stronger role in the region, including the more visible military presence its high-profile rebalancing to Asia has come to embody. There is considerable nostalgia for a past when the U.S., as the dominant regional power, provided the security blanket and framework that allowed East Asia to prosper.

In the immediate future, the triggering point for increased tensions might be foreign policy driven. This could show up, for example, if the U.S. became disappointed in China not applying enough pressure on North Korea to curb its nuclear ambitions. Or it could arise from some maritime incident in the South China Sea.

Or the triggering incident could be the U.S. becoming more aggressive
on economic issues that are particularly sensitive for China. This might involve a ban on steel imports from China or lobbying WTO not to grant China so-called market status which has made it easier to levy punitive countervailing duties on China for dumping products. Such an intention was noted by the media last June in statements made by the U.S. Special Trade Representative.

A more sustained improvement in relations between the U.S. and China would require a shift in the economic as well as political environment. An American economy that has moved to a more robust growth path would make it less likely that its citizens and political leaders would continue to see China as the culprit for economic woes at home. Similarly, a China that has been able to stabilize its economic slowdown would be in a better position to continue liberalizing its trade and investment regime. But more harmonious relations would ultimately require China to shift to a more sensitive posture in dealing with its neighbors while promoting more accountability and transparency in governance at home. For the U.S., it might mean recognizing that the “new kind of great power relations” Beijing is seeking is necessary to build trust between these two nations. Whether such events might lead to more serious conflicts or a more conciliatory process that will allow the Asia region to remain stable and prosper remains to be seen.