

OPINION

Taking sides -- US or China

As Washington and Beijing expand trade conflict, Tokyo
and other capitals must choose

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The deterioration of the U.S.-China relationship has now gone far beyond what we can call a trade war. U.S. President Donald Trump and his administration have expanded the rivalry from an economic battle to all-out confrontation with Beijing over military and even ideological fields.

U.S. Vice President Mike Pence's speech on Oct. 4 about China reminded me of Winston Churchill's Iron Curtain speech. While I have long thought that serious confrontation between Washington and Beijing was unavoidable, I am frankly surprised that it reached this point so swiftly.

Given the intertwined economic interests that have evolved during many years of globalization -- not just for the U.S. and China but for many countries -- it is hard to imagine that the world could once again be divided into two camps, and split by an Iron Curtain like in the Cold War era.

However, the intensified U.S.-China rivalry will eventually force Japan and other countries to take sides. In fact, the signs are already there. The new United States-Mexico-Canada Agreement, or USMCA, which replaces NAFTA, includes a crucially important clause (Article 32.10) that targets Beijing. It gives Washington a veto on Mexico or Canada if either of them intends to reach a free trade agreement with a nonmarket economy without U.S. permission. While China is not named, the clause is squarely aimed at isolating Beijing.

Likewise, Washington will certainly ask for a similar clause in its trade negotiations with Japan, the European Union or any other nations. They too will be likely forced to choose between the U.S. and China,

Pence's speech solved one of my longtime puzzles. That is, could this trade war have been ended through early negotiations at the beginning? The answer, now, is clearly no. The gap is too big to bridge between what Trump expects to achieve via a trade war and what president Xi Jinping could possibly concede.

It appears that the Trump administration's real aim was always a total transformation of China's economy. Any compromise Xi could make would have been in vain.

Speaking in Washington, Pence called on Beijing to "return to the spirit of reform and opening that characterizes the beginning of the relationship (between the U.S. and China) decades ago," combined with the simultaneous opening of the Chinese economy to the same level as the U.S.'s. Given China's current political and economic situation, such a request is obviously all but impossible for Beijing.

While the possibility of ending the trade war seems unlikely for the time being, it does not mean the current impasse between Beijing and Washington will last forever. In other words, the current deadlock over the trade war will be eventually broken.

Therefore, it is important to find the keys that may open up the deadlock and so try to foresee the direction of the conflict.

One possible key that may affect the Trump administration's approach to China is U.S. domestic politics.

Both Democrats and Republicans have come to a bipartisan consensus on the get-tough-on-China policy. Yet a considerable number of voices, including some Republicans, disagree with the high-pressure approach the Trump administration has taken. They even emphasize that the U.S. should respect Chinese culture such as face-saving in the dialogue with Beijing. The crisis may be eased if such voices are sufficiently loud to affect Trump's presidency. However, U.S. domestic politics could equally lead Trump's China policy to an opposite direction, for example, if protectionist views grow even stronger, in response to a possible economic slow down.

For China, the domestic economy is the key factor. Beijing is extending its control on speech and information from politics to the economy -- a sign that the real state of the economy is even worse than the official data shows. A rapid decline in exports to the U.S. accompanying the trade war would inevitably further undermine growth.

Trump is constantly criticized by economists for his focus on cutting the bilateral trade deficit with other countries. Certainly, from the point of view of economics, it is difficult to find a reasonable causal relationship between reducing the trade deficit and his agenda of "Make America Great Again." However, I have to say that reducing the trade deficit with China might be an effective lever to make China change since its huge trade surplus with U.S. (the flip side of the U.S. deficit) really matters to China.

As is well known, a huge money supply has made China's investment-oriented economic growth possible and the trade surplus has played a major role in powering

China's monetary easing. Specifically, the trade surplus has contributed to an increase of base money since all foreign currency amounts must be converted into Chinese yuan. Thus, the trade surplus contributes directly to boosting China's economic growth. And the surplus with the U.S. has in the past decade, accounted for 66 percent of China's total trade surplus.

In addition, the trade surplus with the U.S. has also greatly supported Beijing's economic diplomacy since the world's largest foreign exchange reserves are mostly fueled by the trade surplus. From 2001, the year China joined the World Trade Organization, to 2017, China's cumulative trade surplus with the U.S. was \$4.1 trillion. Meanwhile, the foreign exchange reserve was \$3.9 trillion, even at its peak.

Thus, any big reduction of the trade surplus with the U.S. will add significant downward pressure on China's foreign exchange reserves, and potentially, reduce Beijing's capacity to deploy funds in its economic diplomacy, such as One-Belt One-Road Initiative, a mammoth infrastructure program that China has intended to boost its global influence.

Like Washington, Beijing has choices. By reducing the trade surplus, it may compromise and try to end the trade war. Yet equally Beijing may attempt to overcome the crisis by spurring nationalism in the Chinese public. If so, then Beijing's approach to international issues, including Taiwan, may become even more aggressive.

It is hard to assess exactly how either Trump or Xi will change in their approaches to their conflict. But it is clear that the key elements to watch are politics in the U.S. and the economy in China.

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