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The China-U.S. Trade War:  
Deep-rooted causes, shifting focus and uncertain  
prospects

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## **The China-U.S. Trade War: Deep-rooted causes, shifting focus and uncertain prospects**

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The announcement of the imposition of sanctions against China based on Section 301 of the U.S. Trade Act in March 2018 triggered an escalation of the U.S.-China trade friction. As symbolized by the subsequent tit-for-tat exchange of tariff hikes, the situation has now developed into a trade war. Major factors leading to the trade war include the United States' dissatisfactions with China's "unfair trade practices," a reflection of its political and economic systems (widely known as the "China model"), which deviate widely from those of the West, and the rise of China, which the United States has taken seriously as a challenge to its hegemony. The trade war signifies a shift of the United States' China policy from engagement to deterrence.

In order to maintain its supremacy over China, the United States has strengthened the control of technology transfer to China. It is accusing China of imposing restrictions on investments by U.S. companies trying to advance into the Chinese market in some industries and of supporting Chinese companies' acquisitions of foreign companies possessing cutting-edge technologies as part of its industrial policy, as exemplified by the Made in China 2025 initiative, and it is calling for corrective measures. At the same time, the United States is strengthening its national security review system regarding foreign investments in U.S. companies, making it more and more difficult for China to import technology by acquiring U.S. companies. This may reduce China's economic growth rate in the long run by depressing the rate of productivity growth.

In China, public opinion on how to respond to the trade war waged by the United States was at first led by the hawkish camp, which was calling for outright resistance. Subsequently, with the negative impact of the trade war on the Chinese economy becoming more and more apparent, the tide has gradually turned in favor of the dovish camp, which argues that China should accept and use the U.S. demands as leverage to accelerate its reform and opening-up initiative. Some of its recommendations have come to be reflected in the government's stance when negotiating with the United States, leaving more room for China to make concessions needed to end the trade war.

China-U.S. relations have entered uncharted waters. Even with a final agreement reached

between the two countries to end the trade war, a return to "business as usual" is highly unlikely. There are now rising concerns that China and the United States may end up in a cold war, if not a hot war. The future course of China-U.S. relations will be a major factor determining the fortunes not only of the two major powers directly involved, but also of the world economy as a whole.

## **1. Why has the U.S. Waged a Trade War against China?**

As to why the United States has waged a trade war against China, there is apparently a clash of arguments between the U.S. side that accuses China as an unfair trader, and the Chinese side that criticizes the U.S. assessment of the rise of China as a threat. Each side's argument appears to have some grain of truth. Against the backdrop of China rising as an economic superpower without altering its trade practices and the China Model behind them, the United States has shifted its China policy from engagement to deterrence.

### **1) Criticism of China's unfair trade practices**

Attributing the cause of the U.S.-China trade friction and the ensuing trade war to China's failure to comply with the principles set by the WTO—openness and the leading role of the market—the United States is propagating the view of China as an unfair trader. Based on this view, U.S. Ambassador to the WTO Dennis Shea criticized China as follows and called for improvements (Shea 2018).

"Despite China's repeated portrayal of itself as a staunch defender of free trade and the global trading system, China is in fact the most protectionist, mercantilist economy in the world. Contrary to Members' expectations, China has not been moving toward a fuller embrace of market-based policies and practices since it joined the WTO in 2001. In fact, the opposite is true. The state's role in China's economy has been increasing."

"The Chinese government and the Chinese Communist Party have a constitutional mandate, echoed in China's broader legal framework, to develop a "socialist market economy." To this end, the government and the Communist Party continue to exercise control directly and indirectly over the allocation of resources through instruments such as government ownership and control of key economic actors and government directives. As a result, the means of production are not sufficiently allocated or priced according to market principles. Instead, the government and the Communist Party continue to control or otherwise influence the prices of key factors of production, including land, labor, energy and capital."

"Just as when China acceded to the WTO in 2001, state-owned enterprises continue to play an outsized role in China's economy. Moreover, the government and the Communist Party have

for decades exercised control over these enterprises through the appointment of key executives and the provision of preferential access to land, energy and capital and other important inputs. Recently, the Communist Party also has taken steps to increase the strength and presence of the Communist Party within all business organizations in China."

"China's system also treats law as an instrument of the state, in the sense that it is used to facilitate the government's industrial policy goals and to secure discrete economic outcomes. In addition, key legal institutions, such as the courts, are structured to respond to the Communist Party's direction. This type of system makes it very difficult for enterprises to act independently of approved industrial policies on a systemic or consistent basis."

"China is currently in its 13th five-year planning cycle, a hallmark of a planned economy that has become more, not less, salient since China joined the WTO. Various institutions participate in formulation and execution of industrial policy plans, including central government agencies with legislative and regulatory authority, thousands of local government authorities, various organs of the Communist Party and Chinese enterprises."

"A key focus of China's industrial policies is technology development, which China views as integral to its economic development. Currently, China is seeking to attain domestic market dominance and global leadership in a wide range of advanced technologies. In pursuit of this overarching objective, China has issued a large number of industrial policies, including, for example, the "Made in China 2025" industrial plan."

"China's industrial policies deploy massive market-distorting subsidies and provide other forms of financial support for targeted domestic industries. All too often, severe and persistent excess capacity results. Excess capacity hurts the global economy not only through direct exports from China, but also because lower global prices and a glut of supply make it difficult for even the most competitive producers to remain viable, as we have seen in the steel, aluminum and solar sectors."

"China has pursued a variety of unreasonable policies and practices that harm U.S. intellectual property rights, innovation and technology development. These types of policies and practices injure not only the United States, of course, but also other WTO Members."

Based on the above assessment of China's unfair trade practices and the "trade disruptive economic model," encouraging them, Ambassador Shea called on China to "take the initiative to fully

and effectively embrace open, market-oriented policies."

## 2) Assessment of the rise of China as a threat

Responding to the criticism from the U.S. side, the *People's Daily*, which represents the official view of the Communist Party of China, retorted that the real motive of the United States in waging a trade war is to contain China as a challenger to U.S. hegemony and asserted that the view of China as an unfair trader is groundless and is nothing more than an excuse (People's Daily, 2018). The major arguments put forward there are summarized as follows.

- In the past, the United States started what came to be known as the Cold War against the Soviet Union, a powerful country with an entirely different ideology, and contained and attacked it at every level. As a result, the Soviet Union collapsed and the United States congratulated itself for winning "the end of history".<sup>1</sup> In the 1980s, the United States forced Japan, a rapidly rising economic power, to accept "voluntary export restrictions" and the "Plaza Accord," which was accompanied by the yen's appreciation, thereby causing Japan to be trapped in a prolonged period of stagnation known as the "lost two decades."

- Therefore, the U.S. trade war against China can in no way be interpreted in terms of the stress in U.S.-China relations caused by China's aggressive diplomacy or ideological differences. Targeting a rival has consistently been U.S. strategy since the United States became the global No. 1 in GDP size in 1894. The United States always views a number-two country which threatens its global supremacy as a rival and makes every possible effort to contain it.

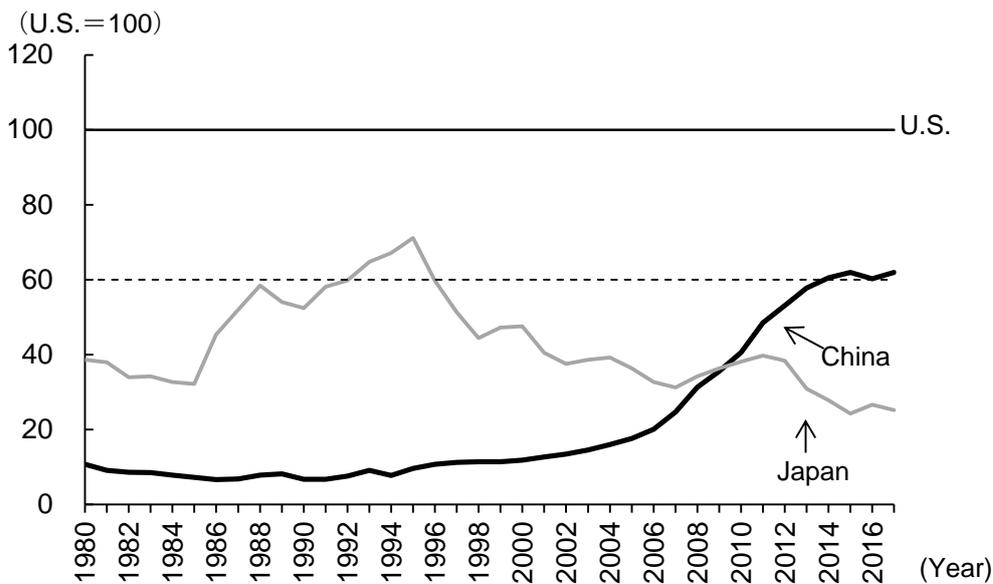
- U.S. foreign policy follows a "60% rule," which dictates that whenever a foreign country reaches 60% of the United States in economic size and continues to grow fast, threatening to overtake the U.S. economy, the United States should view it as a rival and vanquish it by all means. China is now the target, as Japan was in the past (Figure 1).

- For the United States, China has become a threat to the "America First" principle. China is now the world's second largest economy, with GDP surpassing 60% that of the United States, and equivalent to that of Japan, Germany and the United Kingdom combined. China is also the global No. 1 in terms of the value of trade in goods and the amount of foreign exchange reserves. China accounts for a quarter of global industrial production capacity, and it is rapidly approaching the United States in terms of technological innovation capability as well. As its economic and trade relationships with countries around the world are becoming closer, China has become a very attractive country for the outside world. As a result of more than a century

of hard work since the Opium War, China has returned to the center of the world stage at long last. Being an economic elephant, China cannot make itself invisible even if it keeps a low profile.

- For the United States, China is an unprecedented rival that is achieving faster economic growth and is richer in potential than either of its previous rivals—the Soviet Union or Japan—was. The United States has adopted two ways of countering this new rival. One is mobilizing the American people's political support through the "Make America Great Again" slogan. The other is containing China at every level. The real motive of the United States in waging a trade war is not merely reducing the U.S. trade deficit but curbing China's development in a broad range of fields.

Figure 1. Change in the economic size of China and Japan relative to the United States in terms of GDP



Source: Compiled by the author based on IMF, *World Economic Outlook Database*, April 2018 data.

This interpretation of U.S. intentions is shared by some U.S. scholars and policymakers. Professor Jeffrey Sachs of Columbia University, for example, writes: "The Trump administration's conflict with China has little to do with U.S. external imbalances, closed Chinese markets, or even China's alleged theft of intellectual property. It has everything to do with containing China by limiting its access to foreign markets, advanced technologies, global banking services, and perhaps even U.S. universities" (Sachs, 2018).

Steven Bannon, while serving as White House Chief Strategist, also said in an interview with *The American Prospect*: "One of us (the United States or China) is going to be a hegemon in 25 or 30 years and it's gonna be them if we go down this path." He went on to predict: "If we continue to lose it, we're five years away, I think, ten years at the most, of hitting an inflection point from which we'll never be able to recover" (Kuttner, 2017). This assessment of China as a threat appears to epitomize the Trump administration's perception of the country, rather than reflecting Mr. Bannon's personal opinion.

### **3) United States' China policy shifts from engagement to deterrence**

Indeed, against the backdrop of China rising as an economic superpower while maintaining political and economic systems different from those of the West, the United States has shifted its China policy from engagement to deterrence. The United States characterized its relationship with China as a "strategic partnership" under the Clinton administration, as a relationship with a "responsible stakeholder" under the Bush (junior) administration, and as a "partnership based on mutual respect and win-win cooperation" under the Obama administration. However, in the National Security Strategy Report published in December 2017, the Trump administration emphasized that economic security is the foundation of national security and labeled China and Russia "strategic competitors" (White House, 2018). The report offered the following observations concerning the geopolitical situation:

"China and Russia challenge American power, influence, and interests, attempting to erode American security and prosperity. They (China and Russia) are determined to make economies less free and less fair, to grow their militaries, and to control information and data to repress their societies and expand their influence."

Based on these judgments, the Trump administration has shifted its China policy from engagement to deterrence. At the core of the previous policy of engagement was fully accepting China as a member of the international community and encouraging the country to become a stakeholder responsible for fulfilling some of the international responsibilities performed by the United States. In contrast, at the core of the policy of deterrence is preventing China from threatening U.S. leadership in the world by constraining China's behavior and economic growth.

The U.S. policy of deterrence against China is comprised of three pillars—cracking open China's market, curbing technology transfer to China and reforming the international trading system (Zhang & Feng, 2018).

### (1) Cracking open China's market

Citing the trade imbalance as a reason, the United States has proposed "fair trade" and is urging China to further increase imports of U.S. products and open its market. Even so, the United States must be aware that, in fact, its trade deficit is not the central issue for the U.S.-China relationship. That is because the deficit is a problem closely related to excessive consumption, which is a structural problem in the United States itself, and the dollar's status as the world's key currency. Even if the United States succeeds in forcibly shrinking its deficit with China, its overall trade deficit is unlikely to decline as deficits with other countries increase. However, as the trade friction is a matter of strong interest for the general public, it can be exploited as a means to fuel populism and extreme nationalism. It is possible to win voters' support in elections by using trade friction as an excuse to rally the nation. Moreover, taking up market opening and other trade issues is an effective way of obtaining support from other countries exposed to competitive pressure from China.

### (2) Curbing technology transfer to China

China's presence in the global chain has grown, and competition between China and advanced industrialized countries, including the United States, has intensified in the field of technology and in technology-intensive industries. As a result, China is coming under increasing criticism for engaging in such practices as forced technology transfer, theft of technology and infringement on intellectual property rights. As the United States is wary of technological advances in China, it is striving to maintain the dominance and competitive advantage of U.S. technologies by curbing technology transfer to China.

### (3) Reforming the international trading system

The United States is trying to hold back China through the rebuilding of the international trading system. The United States is claiming that it has suffered a huge disadvantage as a result of China's exploitation of the multilateral trading system centered around the WTO and is insisting that the WTO should revise its preferential measures for developing countries that are benefiting China.

The economy is not the only area of confrontation between the United States and China. In a speech at the Hudson Institute on October 4, 2018, U.S. Vice President Mike Pence strongly condemned not only China's economic policies and systems but also its political systems, religious policy, Taiwan policy and foreign policy initiatives (e.g., the Belt and Road Initiative), maritime expansion, and interference in the internal affairs of the United States (particularly interference in U.S. elections) (Pence, 2018). Moreover, he made clear the United States' readiness to confront China on all fronts, for example by raising tariffs and strengthening the control of foreign investments in the United States on the economic front, and also by reinforcing the military and strengthening

cooperation with Indo-Pacific nations that share values with the United States.

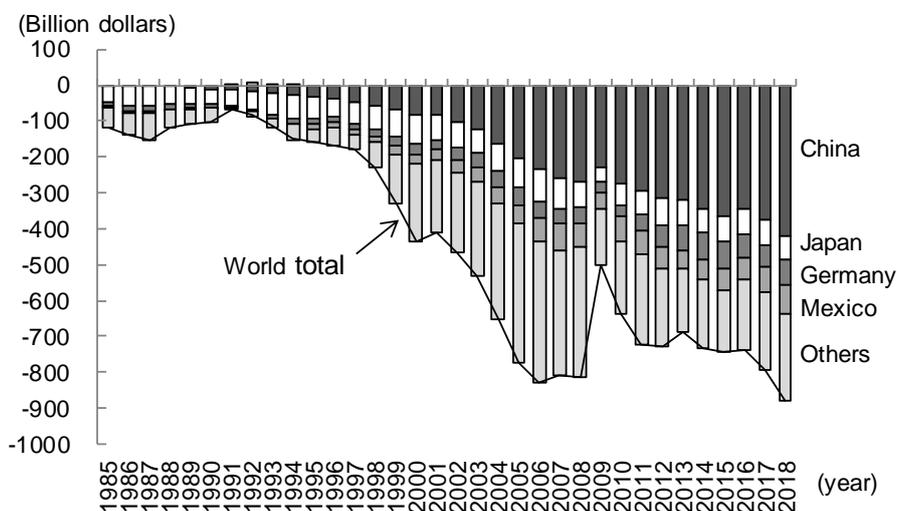
## 2. From Trade War to Tech War

Curbing technology transfer to China has become more and more important policy for the United States to deter the rise of China. As a result, the focus of dispute between the two countries is shifting from trade to technology transfer, and the trade war has evolved into a tech war.

### 1) Imposition of sanctions on China based on Section 301 of the Trade Act

The protectionist tendency of U.S. trade policy has become increasingly prominent since President Donald Trump took office. The United States' protectionist initiative has been targeted mainly at China, a trading partner with which the United States has been recording the largest bilateral trade deficit since 2000. The U.S. trade deficit with China amounted to \$375.6 billion, or 47.2% of its total trade deficit in 2017, rising further to \$419.2 billion (47.7% of its total deficit) in 2018 (Figure 2). The U.S. Department of the Treasury has kept China on the list of countries whose currency practices should be closely monitored on the grounds that it accounts for a large and disproportionate portion of the U.S. trade deficit (U.S. Department of the Treasury, Office of International Affairs, 2018).

Figure 2. Changes in the U.S. trade balance in goods by major trading partner



Source: Compiled by the author based on U.S. Census Bureau data.

In addition, upon instruction from President Trump, the Office of the United States Trade Representative (USTR) conducted investigations into China's acts, policies, and practices concerning technology transfer, intellectual property, and innovation under Section 301 of the Trade Act (hereinafter referred to as the "Section 301 investigation"), starting in August 2017.<sup>2</sup> The report on the investigation, which was announced on March 22, 2018, is a scathing critique of China. What is notable about the report is that the focus of argument is on technology transfer, rather than on the trade

imbalance (USTR, 2018a, 2018b).

The report argued the following points:

First, China uses foreign ownership restrictions, including joint venture requirements, equity limitations, and other investment restrictions, to require or pressure technology transfer from U.S. companies to Chinese entities. China also uses administrative review and licensing procedures to require or pressure technology transfer, which, inter alia, undermines the value of U.S. investments and technology and weakens the global competitiveness of U.S. firms.

Second, China imposes substantial restrictions on, and intervenes in, U.S. firms' investments and activities, including through restrictions on technology licensing terms. These restrictions deprive U.S. technology owners of the ability to bargain and set market-based terms for technology transfer. As a result, U.S. companies seeking to license technologies must do so on terms that unfairly favor Chinese recipients.

Third, China directs and facilitates the systematic investment in, and acquisition of, U.S. companies and assets by Chinese companies to obtain cutting-edge technologies and intellectual property and to generate large-scale technology transfer in industries deemed important by Chinese government industrial plans.

Finally, China conducts and supports unauthorized intrusions into, and theft from, the computer networks of U.S. companies. These actions provide the Chinese government with unauthorized access to intellectual property, trade secrets, or confidential business information, including technical data, negotiating positions, and sensitive and proprietary internal business communications, and they also support China's strategic development goals, including its science and technology advancement, military modernization, and economic development.

In light of the investigation results, Trump signed a memorandum directing the following acts:

- (1) to file a WTO case against China for discriminatory licensing practices;
- (2) to restrict investment in key technology sectors; and
- (3) to impose tariffs on Chinese products (such as aerospace, information communication technology and machinery).

In response, the following day, March 23, 2018 the Office of the USTR initiated dispute settlement procedures under the WTO and requested bilateral consultations with China as the first

step. On April 3, the Office of the USTR announced a sanction plan that would impose additional tariffs of 25% on 1,300 items of products imported from China, including high-tech products, which are worth \$50 billion. The following day, China responded by expressing its readiness to impose additional tariffs of 25% in retaliation on 106 items of products imported from the United States, including soybeans and automobiles. In light of the Chinese announcement, which he viewed as an unjustified retaliation, President Trump immediately ordered the Office of the USTR to consider whether an additional \$100 billion of US imports from China should be subject to new tariffs. In this way, the U.S.-China trade dispute escalated rapidly.<sup>3</sup>

Since then, three rounds of additional tariffs have been implemented on each other by both sides. On one hand, total U.S. tariffs applied exclusively to China amount to \$250 billion (equivalent to about one half of the United States' imports from China in 2017), with a tariff rate of 25% for the first two rounds (July 7 and August 23, 2018) totaling \$50 billion, and 10% (initially scheduled to be raised to 25% by the end of 2018) for the third round (September 24, 2018) amounting to \$200 billion. On the other hand, total Chinese tariffs applied exclusively to the United States amount to \$110 billion (equivalent to about 70% of China's imports from the U.S. in 2017), with a tariff rate of 25% for the first two rounds totaling \$50 billion, and 5% or 10% for the third round amounting to \$60 billion.

The Office of the USTR's Section 301 investigation targeted at China is notable for the following three points.

First, it focuses exclusively on the technology field. This reflects the United States' concerns that its advantage in this field could be lost.

Second, the issues covered mostly concern the Chinese government's market-interventionist approach. The United States believes that the Chinese government's unjustified market intervention is weakening its advantage in the technology field.

Third, many of the issues pointed out in the Section 301 investigation report have no relation to existing binding international rules such as the WTO agreement. Concerning such issues, even if a trading partner's behavior does not violate international rules, investigation may be conducted if the United States concludes that the behavior is unreasonable or discriminatory or if it has undermined U.S. interests. However, if the United States imposes sanctions based on the results of the Section 301 investigation, this could in turn constitute a violation of international rules.<sup>4</sup>

## **2) Growing vigilance against the Made in China 2025 plan**

Of the Chinese government's "unjustified market intervention," what keeps the United States vigilant is its industrial policy, particularly the "Made in China 2025" plan announced in 2015.<sup>5</sup> Specifically, the American Chamber of Commerce in China criticized the implementation of Made in China 2025 as follows in a report published in March 2017 (America Chamber of Commerce, 2017).

Unlike other countries' plans to develop manufacturing industries, such as German Industry 4.0, Made in China 2025 is intended to promote Chinese companies' research and development capabilities by providing them with preferential access to capital and to enhance their competitiveness by introducing technology from abroad. In concert with the 13th Five-Year Plan, the Internet Plus Action Plan, and other state-led development plans, Made in China 2025 constitutes a broad strategy to use state resources to establish comparative advantage for China in the manufacturing sector on a global scale. Regarding the implementation of Made in China 2025, it is necessary to keep a watchful eye over the following three aspects in particular:

(1) Reinforcing government control

Contrary to the principle of giving the market a decisive role in the allocation of resources, which was determined at the Third Plenum of the 18th Central Committee of the Communist Party of China held in November 2013, Made in China 2025 reaffirms the government's central role in economic planning.

(2) Intensifying preferential policies and financial support

Made in China 2025 illustrates the Chinese government's intent to leverage China's legal and regulatory systems to favor Chinese companies over foreign ones in targeted sectors. Moreover, industries targeted by Made in China 2025 will likely receive hundreds of billions of yuan in government support over the coming years. That could distort Chinese domestic and global markets. Such support may be used not only to invest in local innovation but also to fund foreign technology acquisitions. State-backed support for acquisition of specific technologies represents a new feature and natural extension of China's industrial policy.

(3) Setting global benchmarks

Made in China 2025 represents the latest far-reaching industrial policy on a continuum of such policies to develop not only national champions but also global champions. Policy documents related to Made in China 2025 set global sales growth and market share targets that are to be filled by "domestic products."

The policies incorporated in Made in China 2025 will have an impact not only domestically but also in other countries. Made in China 2025 aims to leverage the power of the state to alter competitive

dynamics in global markets in industries core to economic competitiveness. However, Made in China 2025 risks generating market inefficiencies and sparking overcapacity on a global scale, according to the report.

These accusations are also included in the Section 301 investigation report of March 2018 that was mentioned earlier. In addition, in a statement issued when the list of products subject to additional tariffs on imports from China was announced on April 4, 2018, the USTR made clear that the list was targeted at products benefiting from policies that aim to promote the manufacturing sector, including Made in China 2025.

### **3) Strengthening of U.S. restrictions on investment by Chinese companies**

The United States has become strongly vigilant against Chinese companies acquiring cutting-edge technologies through direct investments in the United States, including mergers and acquisitions (M&A). In response, the government is strengthening the national security review system concerning investments by foreign companies.

In the United States, an inter-agency committee called the Committee on Foreign Investment in the United States (CFIUS) is charged with the task of monitoring foreign direct investments based on the Foreign Investment and National Security Act of 2007 (FINSA). CFIUS is empowered by law to review national security risks that may arise from M&A through which foreign companies aim to acquire control over U.S. companies. If it judges that foreign investment in a U.S. company is posing a threat to the national security of the United States, CFIUS recommends "mitigation measures" that, if not accepted, could lead to withdrawal of the application.

FINSA, which was enacted in 2007, is a modified version of the Exon-Florio Provision of the Omnibus Foreign Trade and Competitiveness Act of 1988. On the basis of FINSA, CFIUS's guidance concerning national security review cites 12 factors that should be taken into consideration in the national security review process (Table 1).

Table 1. Factors that should be taken into consideration in CFIUS's national security review process

(1) Domestic production needed for projected national defense requirements.
(2) Capability and capacity of domestic industries to meet national defense requirements, including the availability of human resources, products, technology, materials, and other supplies and services.
(3) Control of domestic industries and commercial activity by foreign citizens as it affects the capability and capacity of the U.S. to meet the requirements of national security.
(4) Potential effects of the transactions on the sales of military goods, equipment, or technology to a country that supports terrorism or proliferates missile technology or chemical and biological weapons; and transactions identified by the Secretary of Defense as "posing a regional military threat" to the interests of the United States.
(5) Potential effects of the transaction on U.S. technological leadership in areas affecting U.S. national security.
(6) Whether the transaction has a security-related impact on critical infrastructure in the United States.
(7) Potential effects on United States critical infrastructure, including major energy assets.
(8) Potential effects on United States critical technologies.
(9) Whether the transaction is a foreign government-controlled transaction.
(10) In cases involving a government-controlled transaction, a review of (A) the adherence of the foreign country to nonproliferation control regimes, (B) the foreign country's record on cooperating in counter-terrorism efforts, (C) the potential for transshipment or diversion of technologies with military applications.
(11) Long-term projection of the United States requirements for sources of energy and other critical resources and materials.
(12) Such other factors as the President or the Committee determine to be appropriate.

Source: Compiled by the author based on the CFIUS statute as summarized in Jackson (2018).

Among them, factors (6)-(12) were added through the FINSAs Act potentially broadening the scope of CFIUS's reviews and investigation (Jackson, 2018). Previously, CFIUS had been directed by Treasury Department regulations to focus its activities primarily on investments that had an impact on U.S. national defense security. The additional factors, however, incorporate economic considerations into the CFIUS review process in a way that was specifically rejected when the original Exon-Florio amendment was adopted and refocuses CFIUS's reviews and investigations on considering the broader rubric of economic security. In particular, CFIUS is now required to consider the impact of an investment on critical infrastructure as a factor for considering recommending that the President block or postpone a transaction. Critical infrastructure is defined in broad terms within FINSAs as "any systems and assets, whether physical or cyber-based, so vital to the United States that the degradation or destruction of such systems or assets would have a debilitating impact on national security, including national economic security and national public health or safety."

As a further step toward curbing technology transfer, the National Defense Authorization Act for Fiscal Year 2019, signed by President Trump on August 13, 2018, contains the Foreign Investment Risk Review Modernization Act (FIRRMA) of 2018, which strengthens the authority of CFIUS, and the Export Control Reform Act of 2018, which provides for countermeasures against the transfer of critical U.S. technologies to other countries. Although no particular country has been specified, it is widely believed that these legislations are intended mainly to restrict technology transfer to China.

In particular, as a result of the enforcement of FIRRMA, the scope of transactions under CFIUS review has been broadened to include the following business activities by foreign persons.

- (1) a purchase, lease, or concession by or to a foreign person of real estate located in proximity to sensitive government facilities;
- (2) non-passive (but non-controlling) investments in U.S. businesses owning critical technology, critical infrastructure or personal data of U.S. citizens.<sup>6</sup>
- (3) any change in a foreign investor's rights resulting in foreign control of a U.S. business; and
- (4) any other transaction, transfer, agreement, or arrangement designed to circumvent CFIUS jurisdiction.

Consequently, it will become more difficult for Chinese companies and investment funds to acquire or invest in U.S. companies, particularly in the high-tech sector.

Even before the enactment of FIRRMA, Chinese companies had already found it difficult to acquire cutting-edge technologies from the United States through M&A. Of foreign companies' acquisition plans that have been abandoned due to failure to obtain approval from CFIUS since the inauguration of the Trump administration, Chinese companies accounted for the largest number by nationality (Table 2).

Among the abandoned acquisition plans, Canyon Bridge's plan to acquire Lattice Semiconductor and Ant Financial's plan to acquire MoneyGram International are typical cases.

In September 2017, based on the recommendation of CFIUS, President Trump issued an order blocking the acquisition of Lattice Semiconductor, a U.S. semiconductor manufacturer, by Canyon Bridge, an investment fund backed by the Chinese government. In addition to designing semiconductors used in mobile terminals, including smartphones, automobiles, medical devices, and telecommunications equipment, Lattice also develops devices for military use. In a statement, Treasury Secretary Steven Mnuchin explained that the national security risk posed by the transaction relates to the potential transfer of intellectual property to the foreign acquirer, the Chinese government's role in

supporting this transaction, the importance of semiconductor supply chain integrity to the U.S. government, and the use of Lattice products by the U.S. government (Mnuchin, 2017).

Table 2. Acquisition Plans Abandoned Due to Failure to Obtain Approval under the Trump Administration

Target	Would-be acquirer	Country	When killed	Deal size
Qualcomm	Broadcom	Singapore	Mar-2018	\$117 billion
Xcerra	Hubei Xinyan Equity Investment Partnership	China	Feb-2018	\$580 million
MoneyGram International	Ant Financial Services Group	China	Jan-2018	\$1.2 billion
Cowen	China Energy Company Limited	China	Nov-2017	\$100 million
Aleris	Zhongwang USA	China	Nov-2017	\$1.1 billion
HERE	NavInfo	China	Sep-2017	\$330 million
Lattice Semiconductor	Canyon Bridge Capital Partners	China	Sep-2017	\$1.3 billion
Global Eagle Entertainment	HNA Group	China	Jul-2017	\$416 million
Novatel Wireless	T.C.L. Industries Holdings (Hong Kong)	China	Jun-2017	\$50 million
Cree	Infineon Technologies	Germany	Feb-2017	\$850 million

Source: Compiled by the author based on David McLaughlin and Kristy Westgard, "All about CFIUS, Trump's Watchdog on China Dealmaking: Quick Take," Bloomberg, April 20, 2018.

Ant Financial is a financial services company affiliated to the Alibaba group and is mainly responsible for operating the Chinese e-commerce giant's payment system. MoneyGram International of the United States, headquartered in Dallas, provides international money transfer service. In April 2017, Ant Financial agreed with MoneyGram on an acquisition plan worth \$1.2 billion, beating competition from Euronet Worldwide, a U.S. e-payment company. However, as the plan was not approved by CFIUS, Ant Financial and MoneyGram announced on January 2, 2018 that they had to abandon the deal. Reuters, quoting an informed source, reported that the companies were unable to obtain approval from CFIUS probably because concerns over the handling of personal information could not be eliminated (Roumeliotis, 2018). In the future, investments by foreign companies in financial services companies handling personal data will become a major focus of national security review by CFIUS.

Some Chinese high-tech companies, notably the two telecommunications equipment giants Huawei and ZTE, are also facing higher and higher hurdles when doing business in the United States in areas outside the jurisdiction of CFIUS.

The United States has publicly treated Huawei, as a threat to U.S. national security since 2012,

citing the risk associated with allowing its hardware into U.S. communications networks: that the Chinese government will use it as an espionage platform (Morell & Kris, 2018). Huawei is the world's largest supplier of telecommunications networks, second-biggest maker of smartphones and the leader in 5G technology. The U.S. government has taken a series of steps to block the firm from U.S. markets, including banning sales of its equipment to public agencies. Huawei's chief financial officer Meng Wanzhou was arrested in Vancouver, Canada on Dec. 1, 2018 at the United States' behest, for conduct relating to U.S. trade sanctions against Iran.

Meanwhile, the U.S. Commerce Department announced on April 16, 2018 a ban on U.S. companies selling components to ZTE for seven years. ZTE's provision of false explanations concerning measures to prevent the recurrence of violation of the export embargoes against Iran and North Korea was cited as the reason for the decision. However, mainstream media, not only in China but also in other countries, shared the view that the imposition of such a heavy penalty against ZTE has something to do with the U.S.-China technology dispute. Indeed, the possible relaxation of the ban on exports to ZTE was used by the United States as a bargaining chip in subsequent trade talks with China, according to media reports.

### **3. China Softening its Stance as the Cost of the Trade War Keeps Rising**

In China, the opinion on how to respond to the trade war waged by the United States is divided between the hawkish and dovish camps. At first, the Chinese government shared the view of the hawkish camp and took a hardline stance, as symbolized by the retaliatory tariffs imposed on imports from the United States, but as the trade war lingers on, with its negative impact on the Chinese economy becoming more and more apparent, it has turned conciliatory toward the United States, as advocated by the dovish camp.

#### **1) The hawkish camp versus the dovish camp in China**

The hawkish camp and the dovish camp have put forward recommendations that contrast sharply with each other, reflecting their very different judgments regarding whether China can win the trade war.

The hawkish camp has strong faith in the strength of China, particularly its economy, and is confident about defeating the United States in the trade war (Jin 2018). It also believes that the following factors may prompt the Trump administration to moderate its aggressive China policy: (1) The EU member countries and Japan will cooperate with each other in pushing back against President Trump's trade policy; (2) U.S. consumers, farmers and industries will obstruct President Trump's anti-China trade policy; and (3) U.S. voters' discontent will grow and affect the mid-term elections unfavorably for the Republican Party, prompting President Trump to back down (Cheng, 2018).

Moreover, the hawkish camp expects not only that the trade war will lead to the improvement of China's economic structure by promoting the expansion of domestic demand and industrial upgrading, but also that the U.S. restrictions on investments from China and the strengthening of control of visa issuance for Chinese people will help prevent capital outflow and brain drain.

In contrast, the dovish camp believes that China, with its current level of economic strength, cannot defeat the United States in the trade war, so it argues that China should accept and use the U.S. demands as a leverage to accelerate the reform and opening-up initiative. The opinion of Professor Yu Zhi of Shanghai University of Finance and Economics is representative of this argument (Yu, 2018).

According to Professor Yu, the impact of the trade war is much greater on the Chinese economy than on the U.S. economy. Thus, the Chinese government should strive to resolve the problems behind the U.S.-China trade friction and do its utmost to prevent the trade war from escalating. There is still much room for effort on the Chinese side. As the U.S. side points out, the Chinese government's support for exports and strategic industries (the provision of various direct and indirect subsidies) is one factor in the bi-lateral trade imbalance. In addition, China's external economic and trade strategy and its industrial development strategy, which depend on various subsidies, are causing a lot of problems, including the deterioration of the terms of trade due to export price drops, a decline in the efficiency of industries and companies receiving subsidies, accounting fraud, excess production, dumping, and bribery. In particular, such industries as solar power generation, new energy vehicles and robotics are in serious trouble. The management of external economic and trade strategy and industrial development strategy is in no way a domestic affair. When such strategies are formulated and implemented, consistency with international rules, such as the WTO Agreement on Subsidies and Countervailing Measures, and a possible negative impact on other countries must be taken into consideration.

## **2) The Chinese economy hurt by the trade war**

The trade war with the United States has become a major factor determining short-term economic growth in China. Since November 2018 China's exports to the United States, which had remained robust until October, supported by last-minute demand ahead of the imposition of additional tariffs, have slowed down sharply subsequently. In addition, since the second half of 2018, declines in such major economic indicators as the Purchasing Managers' Index (PMI) and the growth rates of industrial production, retail sales and fixed asset investment, have also become more and more apparent. Reflecting this situation, China's annual economic growth rate in 2018 fell to 6.6%, the lowest level since 1990 (3.9%). The economic growth rate in the fourth quarter of 2018 was 6.4%, the same as the

growth rate in the first quarter of 2009, when the Chinese economy was hit by the Lehman crisis. Meanwhile, stock prices in China dropped sharply, with the Shanghai Stock Exchange Composite Index losing 25% in 2018.

While in the short term, the U.S.-China trade war is dampening the Chinese economy, mainly through a decline in demand, over the medium to long term, it could depress China's potential economic growth rate through supply-side factors. First, in order to avoid additional costs associated with U.S. tariff hikes against Chinese products, some industries will relocate business operations out of China to Southeast Asia and other regions. Moreover, the U.S. government's move to strengthen restrictions on acquisitions of U.S. high-tech companies by Chinese companies, coupled with the tightening of capital control in China, has led to a steep decline in Chinese direct investments in the United States, from 46 billion dollars in 2016 to 29 billion dollars in 2017 and to 4.8 billion dollars in 2018 (Hanemann, Gao & Lysenko, 2019).

For China, which is catching up with the industrial countries from behind, importing technology from abroad has been one major factor contributing to its high economic growth. If China can no longer make the best use of this advantage of being a latecomer to raise productivity as a result of its trade war with the United States, its potential economic growth rate, which has already been falling on the back of aging population and the drying up of surplus labor in rural areas, may decline further. In response, China should devote more effort to indigenous innovation and diversify the sources of technology.

### **3) China ready to compromise**

With the trade war heating up and concerns of a slowdown in economic growth rising, China's State Council published on September 24, 2018 a white paper which sets forth the following eight principles that are supposed to form the basis of negotiation with the United States (State Council, "The Facts and China's Position on China-US Trade Friction, September 24, 2018).

(1) China is firmly committed to safeguarding its national dignity and core interests.

China does not want a trade war, but it is not afraid of one and will fight one if necessary. China has kept the door to negotiations open, but negotiations can only happen when there is mutual respect, equality, good faith and credibility. Negotiations cannot be conducted under the threat of tariffs, or at the cost of China's right to development.

(2) China is firmly committed to the sound development of China-U.S. economic and trade relations. China would like to work with the United States in the same direction, act in a spirit of mutual respect

and win-win cooperation, focus on economic and trade cooperation, and properly manage economic and trade differences. Under the condition of equality and mutual benefit, China is willing to resume negotiations with the United States on a bilateral investment treaty and to launch bilateral FTA negotiations when appropriate.

(3) China is firmly committed to the reform and improvement of the multilateral trading system. China firmly observes and upholds the WTO rules and supports an open, transparent, inclusive and non-discriminatory multilateral trading system. China supports necessary reform of the WTO and firmly opposes unilateralism and protectionism. China supports initiatives to enhance cooperation within the G20, APEC and other multilateral frameworks and to make economic globalization more open, inclusive, balanced and beneficial to all.

(4) China is firmly committed to protecting intellectual property rights (IPR). China will keep improving its laws and regulations on IPR protection and enhance the quality and efficiency of IPR reviews. China protects the lawful IPR of foreign businesses in strict accordance with the law and takes stern measures to address all types of IPR infringement cases. China will enhance its cooperation with all countries to protect IPR.

(5) China is firmly committed to protecting the lawful rights and interests of foreign businesses in China. China treats all businesses registered in the country equally and always protects the lawful rights and interests of foreign-invested businesses and takes firm measures to address violations of their lawful rights and interests in accordance with the law.

(6) China is firmly committed to deepening reform and widening opening-up. China will always continue to deepen its reform without reversing course. China will not close its doors to the world but will only open them wider. The market will play a decisive role in the allocation of resources and the government will play a better role to encourage competition and oppose monopoly. China will manage its own affairs well and pursue economic development with higher quality.

(7) China is firmly committed to mutually beneficial cooperation with other developed and developing countries. China will accelerate the negotiations on the China-EU Investment Agreement and the China-Japan-ROK Free Trade Area and promote deeper international cooperation under the framework of the Belt and Road Initiative.

(8) China is firmly committed to building a community with a shared future for mankind. China will continue to act as a responsible major country and join other countries in building a world that enjoys common prosperity.

As is indicated by the inclusion in those principles of actions to accommodate many of the U.S. demands, this white paper signifies a softening of the Chinese side's stance toward resolving the trade friction and ending the trade war.

As a major step toward reconciliation, at a summit meeting between Chinese President Xi Jinping and U.S. President Donald Trump on December 1, 2018, the United States gave China a 90-day reprieve (until March 1, 2019) from additional import tariffs. On February 24, 2018 President Trump announced that he would extend the March 1 trade deal truce deadline, citing progress in trade talks. This has raised the hope that a final deal to end the trade war may soon be forthcoming.

A deal that largely incorporates U.S. demands should help dilute the view of China as an unfair trader. On the other hand, the resulting deepening of reform and opening-up is expected to further intensify competition between China and the U.S., as it accelerates China's catch-up with the United States by injecting fresh energy into the Chinese economy. With the prospect of China's GDP surpassing that of the United States moving closer to reality, the U.S. view of China as a threat is likely to persist. Therefore, even if a compromise is reached between the two sides in the near future and the trade war is brought under control, the trade friction is likely to drag on for long, with the possibility left open of the war flaring up again.

#### **4. Concluding Remarks – Whither China-U.S. relations?**

As symbolized by the ongoing trade war, U.S.-China relations, probably one of the most important bilateral relations of the world, are at a crossroads. Opinion leaders have identified various scenarios regarding these relations. Among them, the following three have attracted the most attention.

##### **1) Thucydides's Trap**

Professor Graham Allison of Harvard University suggests that "Thucydides's Trap" is the best lens for understanding the future course of the relations between the United States and China (Allison, 2017). Thucydides's Trap was used by the ancient Greek historian Thucydides to describe the war between Athens and Sparta in 500 B.C. The war continued for 30 years and ended in the demise of both city-states. Thucydides pointed out: "What made war inevitable was the growth of Athenian power and the fear which this caused in Sparta." When a rising power threatens to displace a ruling one, the most likely outcome is war. Twelve of sixteen cases in which this occurred in the past 500 years ended

violently. It is natural for China under the Xi Jinping administration—which has made a major shift from the policy of "hiding your strength and biding your time" that was set by Deng Xiaoping in the early 1990s to the policy of seeking to realize the "Chinese Dream" of achieving the "great renaissance of the Chinese nation"—to clash with the Trump administration, which has pledged to "make America great again" under the "America First" principle.

## **2) A new Cold War**

Former U.S. Treasury Secretary Hank Paulson warns of an "Economic Iron Curtain" dividing the world if the U.S. and China fail to resolve strategic differences (Paulson, 2018). More people in both the U.S. and China are advocating policies that could forcibly de-integrate the two countries. Some in the U.S. are advocating a "Cold War-style technology denial regime" that may disrupt supply chains. In trying to isolate China, the U.S. risks isolating itself. Companies may look to base themselves in countries that are less hostile to China, instead of in the United States. U.S. actions against China risk setting up a new round of conflict with partners the U.S. needs to alter Chinese behavior.

## **3) Cooperative rivalry**

Professor Joseph Nye of Harvard University describes today's bilateral relations between the United States and China as "cooperative rivalry" (Nye, 2018). He rejects the notion that China and the U.S. are destined for war or even for a cold war. During the Cold War, the United States and the Soviet Union targeted tens of thousands of nuclear weapons at each other and had virtually no trade or cultural ties. By contrast, China has a more limited nuclear force, annual Sino-American trade totals \$500 billion, and more than 350,000 Chinese students and three million tourists are in the United States each year. China and the U.S. each face transnational challenges that are impossible to resolve without the other, including climate change illicit drugs, infectious diseases, and terrorism. Some aspects of the relationship will involve a positive-sum game. U.S. national security will require power with China, not just over China. The key question is whether the United States is capable of thinking in terms of a "cooperative rivalry."

While the final outcome is still highly uncertain, there is little doubt that the future of both the U.S and the Chinese economies, if not of the global economy, will hinge crucially upon it.

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### Notes

<sup>1</sup> Fukuyama (1992) presented the argument that the development of social systems and the history of ideological evolution will reach an end point, as liberal democracy as the final form of human government, liberal nations, political liberalism and economic liberalism triumph over other

ideologies. The collapse of the Soviet Union and the end of the Cold War were widely regarded as the "end of history" as defined by Fukuyama.

<sup>2</sup> Section 301 of the Trade Act of 1974 provides for consultations with trading partner countries engaging in unfair trade practices and sanctions to be imposed when problems are not resolved. When the Office of the USTR has concluded that a country is engaging in an unfair trade practice, the president has the power to take retaliatory measures, such as increasing tariffs.

<sup>3</sup> Earlier, President Trump signed a decree ordering the imposition of restrictions on imports of steel and aluminum products on national security grounds on March 8, 2018. While exempting Canada, Mexico, Australia, Argentina, South Korea, Brazil, and the EU from the restrictions, the United States imposed tariffs of 25% on steel imports and 10% on aluminum imports. In response, on March 23, China announced the imposition of additional tariffs of up to 25% on imports of 128 items of U.S. products, including pork, wine, some fruits and nuts (the additional tariffs took effect on April 2). In addition, China filed a complaint with the WTO on April 5.

<sup>4</sup> Ambassador Zhang Xiangchen, China's representative at the WTO, pointed out that the United States' announcement of additional tariffs on Chinese products based on the Section 301 investigation report is a deliberate and serious violation of the most fundamental spirit and principles of the WTO and is a typical unilateralist and protectionist approach (Xinhua, 2018).

<sup>5</sup> Made in China 2025 is a roadmap for the development of the manufacturing industry as envisioned by the Chinese government (State Council, "The Notification Concerning the Promulgation of Made in China 2025," May 8, 2015). The roadmap includes nine strategic tasks and the following 10 priority sectors: (1) next-generation information technology; (2) advanced digitally controlled machine tools and robots; (3) aviation and aerospace equipment; (4) marine engineering equipment and high-tech vessels; (5) advanced rail transit equipment; (6), low and new energy vehicles; (7) power equipment; (8) agricultural machinery; (9) new materials, and (10) biopharmaceuticals and high-end medical equipment.

<sup>6</sup> Non-passive investments include an investment that affords the foreign person (1) access to any material non-public technical information; (2) membership or observer rights on the board of directors or an equivalent governing body of the business or the right to nominate an individual to a position on that body; or (3) any involvement, other than through voting of shares, in substantive decision-making regarding sensitive personal data of U.S. citizens, critical technologies or critical infrastructure.

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