Reshaping the U.S.-China Economic Relationship
Stephen Roach[1]

Few would dispute that the U.S.-China relationship is the world's most important bilateral economic relationship. Few would also dispute that this relationship is now deeply troubled. Notwithstanding hope of an imminent trade deal between the two nations, a tariff war remains in danger of morphing into something far worse. How did we get to the flashpoint, and what can be done to avoid a more serious and protracted clash?

To answer these critical questions, it is essential to delve into the character of the relationship. At its core, is a deeply entrenched codependency, with each nation depending heavily on the other. [2] Yes, China has long relied on the U.S. as its most important source of external demand — key to its export-led economic miracle. At the same time, a saving-short U.S. has depended on China as an important source of surplus saving, its largest foreign owner of U.S. Treasuries, and its third largest and most rapidly growing major export market.

Like China's reforms and opening up, the U.S.-Sino relationship is also celebrating a 40-year anniversary — dating back to the late 1970s when both economies were struggling. Back then, the U.S. was in the grips of a wrenching "stagflation" and China's economy was in near shambles in the aftermath of two decades of political, social, and economic instability. In desperate need of new recipes for economic growth, the U.S. and China found mutually beneficial gains from their codependent economic relationship. It was, in many respects, a marriage of convenience.

Unfortunately, as is the case in human relationships, codependency does not make for a healthy relationship between two economies. In search of self-improvement, one partner typically starts to change by addressing some of the strains that have arisen during the relationship. A similar development is unfolding in the economic sphere. China is changing, with a rebalancing that shifts the structure of its economy from exports to internal private consumption, from manufacturing to services, from surplus saving to saving absorption, and from imported to indigenous innovation. Codependency, however, is a highly reactive relationship. When one partner changes, and the other doesn't – very much the case with a U.S. economy that has done nothing to improve its woefully subpar domestic saving position — this typically gives rise to a sense of being scorned, which then leads to conflict. Indeed, sparked by a trade and tariff war, the U.S. and China have now entered the classic "conflict phase" of codependency.

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[1] Mr. Roach, a senior fellow at Yale's Jackson Institute for Global Affairs, was formerly Chairman of Morgan Stanley Asia and the firm's chief economist; this paper was prepared for the 20th annual China Development Forum, March 23-26, 2019.
[2] See Stephen Roach, *Unbalanced: The Codependency of America and China*, Yale University Press, 2014

A False Trade War

The trade war is a false war – a fixation on a large bilateral imbalance between two nations that are both afflicted with the multilateral problems of outsize saving imbalances. The U.S., with a chronic shortfall of domestic saving, had merchandise trade deficits with 102 nations in 2018. China, as the world's largest surplus saver, had trade surpluses in 2017 with 169 nations. There can be no bilateral fix for multilateral problems – any such attempts through tariffs or other restrictive measures would just rearrange the deficits (or the surpluses) among nations, rather than reduce the overall state of imbalance.

Notwithstanding this macroeconomic disconnect, China is attempting to negotiate an end to the trade dimension of its economic conflict with the U.S. by offering to make large multi-year purchases of agricultural products (soybeans), energy (liquid natural gas) and possibly electronics (semiconductors) and machinery (airplanes). This fairly standard Chinese response to U.S. pressure won't work. The best it can do is shift the Chinese piece of America's multilateral deficit to another foreign supplier – most likely to a higher cost producer. That is the functional equivalent of a tax hike on the ultimate consumer, in this case, the American consumer.

There is a longstanding inconsistency between bilateral and multilateral approaches to international economic problems. In May 1930, some 1,028 of America's leading academic economists wrote a public letter[3] to U.S. President Herbert Hoover urging him to veto the pending Smoot-Hawley tariff bill. Hoover ignored the advice, and the global trade war that followed made a garden-variety depression "great." U.S. President Donald Trump has put a comparable spin on what it takes to "make America great again."

Politicians have long favored the bilateral perspective, because it simplifies blame: In effect, you "solve" problems by targeting a specific country as the proverbial villain. By contrast, the multilateral approach appeals to most economists, because it stresses the balance-of-payments distortions that arise from mismatches between saving and investment. This contrast between the simple and the complex is an obvious and important reason why economists often lose public debates. The dismal science has never been known for communicative clarity.

Such is the case with the U.S.-China debate. China is an easy political target. After all, it accounted for 47% of America's colossal $891 billion merchandise trade gap in 2018.[4] Moreover, China has been charged with egregious violations of international rules, ranging from allegations of forced technology transfer and cyber-hacking to earlier charges of currency manipulation and state-subsidized dumping of excess capacity.

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[3] Published in the *Congressional Record* of the U.S. Senate, May 5, 1930; see John Cochrane, *The Grumpy Economist* Blog, March 4, 2018

[4] This figure is on a balance-of-payments basis; on a U.S. Census basis, the merchandise trade gap was slightly smaller in 2018 at $879 billion; source: U.S. Department of Commerce.

Equally significant, China has lost the battle in the arena of public opinion – chastised by Western policymakers, a few high-profile academics[5], and others for having failed to live up to the grand bargain struck in 2001, when the country was admitted to the World Trade Organization. A recent article in *Foreign Affairs* by two former senior officials in the Obama administration says it all: "(T)he liberal international order has failed to lure or bind China as powerfully as expected."[6] As is the case with North Korea, Syria, and Iran, strategic patience has given way to impatience, with the nationalistic Trump administration leading the charge against China.

The counterargument from multilateral-focused economists like me rings hollow in this highly charged political climate. Tracing outsize current-account and trade deficits to an extraordinary shortfall of U.S. domestic saving — just 3% of national income in 2018 versus a 6.3% average over the final three decades of the 20th century — counts for little in the arena of popular opinion. Likewise, it doesn't help to emphasize that China is merely a large bilateral piece of a much bigger multilateral problem. Nor does it matter when we point out that correcting for supply-chain distortions – reflecting inputs from other countries that enter into Chinese assembly platforms – the bilateral U.S.-China trade imbalance would be reduced by 35-40%.[7] Instead, politicians simply dismiss the bottom line of the multilateral assessment of an ill-conceived bilateral "fix": Tariffs and supply-chain disruptions directed at America's low-cost foreign supplier (China) place significant new burdens directly on U.S. consumers and companies — an analytical conclusion very much supported by recent empirical research.[8]

Flawed as it may be both in theory and practice, the bilateral case resonates in a U.S. where there is enormous political pressure to ease the angst of the country's beleaguered middle class. Trade deficits, goes the argument, lead to job losses and wage compression. And, with the merchandise trade gap hitting 4.3% of GDP in 2018, these pressures have only intensified in the current economic climate. As a result, targeting China has irresistible political appeal.[9]

So, what can be made of a potential deal that is likely to feature a joint commitment to reduce the U.S.-China bilateral trade deficit? Given the extent of America's multilateral problem, this would be largely a meaningless outcome. Moreover, with budget deficits projected to widen significantly in the years ahead due largely to massive and ill-timed tax cuts in late 2017,[10] America's saving shortfall will only deepen. That points to rising balance-of-payments and multilateral trade deficits, which are impossible to resolve through targeted, bilateral actions against a single country. Unfortunately, the

[5] See David H. Autor, et. al., "The China Shock: Learning from Labor Market Adjustment to Large Changes in Trade," NBER Working paper No. 21906, Jan 2016.
[6] See Kurt M. Campbell and Ely Ratner, "The China Reckoning: How Beijing Defied American Expectations," *Foreign Affairs*, March/ April 2018.
[7] This estimate comes from the trade-in-value-added database jointly constructed by the OECD and the WTO and accessible on http://www.oecd.org/sti/ind/measuring-trade-in-value-added.htm

[8] See Mary Amiti, et. al., "The Impact of the 2018 Trade War on U.S. Prices and Welfare," Center for Economic Policy Research, Discussion Paper DP13564, Mar 2019 and Pablo Fajgelbaum, et. al., "The Return to Protectionism," Mar 2019.
[9] For the latest in a long string of commentary on this point, see David Brooks, "How China Brings Us Together: An existential threat for the 21st century," *The New York Times*, Feb 14, 2019.
[10] See Congressional Budget Office, "The Budget and Economic Outlook: 2019 to 2029," Jan 28, 2019.

big-wallet mindset of a China eager to cut a deal reinforces the narrative of U.S. politicians that China is guilty as charged.

Dubious Evidence

Notwithstanding the pitfalls of attempting to seek a bilateral fix for a multilateral problem, the U.S. has moved aggressively to confront China for its alleged unfair trading practice. The so-called Section 301 report issued on by the U.S. Trade Representative on March 22, 2018 provides the foundational evidence for this assault. It is a detailed 182-page document, with 1,139 footnotes and five appendices, that would make any legal team blush with pride.[11]

Nor has the Section 301 report appeared out of thin air. It is based on a body of knowledge that has been assembled in recent years that seems to make an irrefutable case against China's alleged technology theft. But there is a serious problem with this case: It is based on dubious evidence that would not stand up in any U.S. court of law.

It all starts with the baseline for these allegations — the findings of the "IP Commission Report" co-chaired by two renowned public servants, former Director of National Intelligence Adm. Dennis Blair and former Utah governor Jon Huntsman Jr., previously ambassador to China and now ambassador to Russia.[12] In 2017, the Commission estimated that intellectual-property theft cost the U.S. economy somewhere between $225 billion and $600 billion annually, an incredulously broad range. Stolen trade secrets are thought to account for 80-90% of the total, the remainder being counterfeit and pirated hardware and software.

When it comes to the estimates of stolen trade secrets, though, there's a serious problem. There are no hard data to support the claims. Here is where the plot thickens. The IP Commission rests its case on another study, this one a 2014 effort by PricewaterhouseCoopers LLP and the Center for Responsible Enterprise and Trade.[13] And it turns out that this investigation relies on dubious "proxy modeling" – in essence, attempting to put a fix on stolen trade secrets be constructing statistical linkages to data on nefarious activities such as narcotics trafficking, corruption, occupational fraud and illicit financial flows. While these are problematic characteristics of any nation, it takes a large leap of faith to convert this information into the 1-3 percent of U.S. GDP that the IP Commission claims is lost to theft of intellectual property.

The Commission's estimates of how much of this loss to attribute to China are even more suspicious. They come from the U.S. Customs and Border Patrol (CBP), which reported $1.35

[11] See Office of the United States Trade Representative, "Findings of the Investigation into China's Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation under Section 301 of the Trade Act of 1974, March 22, 2018.
[12] See The Commission on the Theft of American Intellectual Property, "Update to the IP Commission Report," published by the National Bureau of Asian Research, 2017.
[13] See Center for Responsible Enterprise and Trade and PricewaterhouseCoopers LLP, "Economic Impact of Trade Secret Theft," Feb 2014.

billion in seizures of counterfeit and pirated goods in 2015. Yes, another model — this one constructed by researchers at the OECD[14] — was used to convert this to a U.S. total. Then 87 percent of that was attributed to China — 52 percent from the mainland and 35 percent from Hong Kong. With no direct tally available for pirated software, once again yet another "model" was used to impute 61 percent of that total to Asia Pacific.[15]

Meanwhile, no real attempt was made to quantify the Chinese share of stolen trade secrets, which, as noted above, accounts for the bulk of the overall estimate of America's IP losses. The bottom line: There is no hard evidence that supports the widely accepted contentions of outsize Chinese theft of U.S. intellectual property. At best, these charges are supported by flimsy evidence derived from largely irrelevant and highly dubious models.

The Section 301 Folly

This background is important because it frames a similar highly questionable approach used by United States Trade Representative Robert Lighthizer in making the case against China on charges of unfair trading practices pertaining to technology transfer, intellectual property, and innovation. The Section 301 report released a year ago has quickly been accepted as irrefutable evidence in support of the tariffs and other punitive trade measures that the Trump Administration has initiated against China. It has become powerful ammunition in the current trade war.

But don't be fooled. Like the findings of the IP Commission, the Section 301 Report is wide of the mark in several key areas. First and foremost in the long list of allegations, it accuses China of "forced technology transfer," arguing that U.S. companies must turn over the blueprints of proprietary technologies and operating systems in order to do business in China. This transfer is alleged to take place within the structure of joint-venture arrangements – partnerships with domestic counterparts on which China and other countries have long established as models for the growth and expansion of new businesses. Currently, there are more than 8,000 JVs operating in China, compared to a total of over 110,000 JVs and strategic alliances that have been set up around the world since 1990.[16]

Significantly, U.S. and other multinational corporations *willingly* enter into these legally-negotiated arrangements for commercially sound reasons – not only to establish a toehold in China's rapidly growing domestic markets, but also as a means to improve operating efficiency by transferring high-cost domestic production to a low-cost offshore Chinese platform. By contrast, the USTR portrays U.S. companies as innocent victims of Chinese pressure — very much at odds with the well-developed strategic expertise of highly sophisticated multinational corporations.

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[14] See OECD/ EUIPO, "Trade in Counterfeit and Pirated Good: Mapping the Economic Impact," 2016.
[15] See BSA/ The Software Alliance, "Seizing Opportunity Through License Compliance: BSA Global Software Survey," May 2016.
[16] See Deloite, "A Study of Joint Ventures: The challenging world of alliances," Jul 2010.

Ironically, the USTR actually confesses that it has no hard evidence to prove that technology sharing is *forced* — the essence of the accusation. Buried on page 19 of the 182-page USTR report is the admission that "transfer policies and practices have become more implicit, often carried out through oral instructions and 'behind closed doors.'" Here, the USTR borrows a page from the script of the IP Commission and rests its case on surveys conducted by the U.S.-China Business Council,[17] in which 19 percent of respondents claim they've been forced to transfer technology to their Chinese partners. Curiously, in the Council's latest survey (conducted in 2018), 99 percent of respondents saw no deterioration in IP protection over the past year.

Second, the USTR's Section 301 report portrays China's focus on outward investment – its "going out" strategy – as a unique state-directed plan aimed at gobbling up newly emerging U.S. companies and their proprietary technologies. This allegation is framed as China's blatant predatory grab of America's most precious assets as the world's leading innovator.

Unsurprisingly, this assertion cannot be supported by hard data either. An annual tally of outbound mergers and acquisitions activity from China into the United States conducted by the American Enterprise Institute reveals that there were only 17 transactions in the technology sector over the 13-year period, 2005-17.[18] By contrast, there were 52 deals in the real estate sector. Indeed, the deal count of Chinese acquisitions of U.S. technology companies also lags transactions in finance, energy, transportation, and entertainment.

Undeterred by the lack of evidence, the USTR argues that the "Made in China 2025" campaign of the Chinese government is *prima facie* evidence of a devious socialist plot to attain global dominance in the great industries of the future: autonomous vehicles, high-speed rail, advanced information technologies and machine tools, exotic new materials, biopharma and sophisticated medical products, as well as new power sources and advanced agricultural equipment.

Never mind that industrial policies are a time-tested strategy for developing countries seeking to avoid the dreaded middle-income trap by shifting from imported to indigenous. innovation[19]. China is accused by the USTR of sponsoring a unique strain of state-directed, heavily subsidized industrial policy — unfairly aimed at snatching competitive supremacy from free and open market-based systems like the U.S. who are supposedly playing by different rules.

Of course, most developed countries have long relied on industrial policies of their own to achieve national economic and competitive objectives. It was central to Japan's so-called plan rational

[17] See U.S.-China Business Council, "2016 Membership Survey: The Business Environment in China."
[18] See American Enterprise Institute and the Heritage Foundation, "Chinese Investment in the US Dataset," available at http://www.aei.org/china-global-investment-tracker/

[19] See Barry Eichengreen, et. al., "Growth Slowdowns Redux: New Evidence on the Middle-Income Trap," NBER Working Paper No. 18673, Jan 2013.

development state, which underpinned its rapid growth in the 1970s and the 1980s .[20] The Ministry of International Trade and Industry perfected the art of state-subsidized credit allocation and tariffs to protect Japan's sunrise industries, an effort that was matched by Germany's equally impressive *Wirtschaftswunder*, augmented by strong support for the *Mittelstand* of small- and medium-size enterprises.[21]

And it was U.S. President Dwight Eisenhower, who in 1961 drew attention to America's powerful military-industrial complex[22] as the linchpin of state-sponsored, taxpayer-funded innovation in the U.S. NASA-related spinoffs, the Internet, GPS, breakthroughs in semiconductors, nuclear power, imaging technology, pharmaceutical innovations, and more are all important and highly visible manifestations of industrial policy the American way. The U.S. simply does it though the Defense Advanced Research Projects Agency (DARPA) of its federal defense budget – where total military outlays of close to $700 billion this year are more than the combined total earmarked for defense in China, Russia, the United Kingdom, India, France, Japan, Saudi Arabia, and Germany.[23]

Yes, the USTR is entirely correct in underscoring the role that innovation plays in shaping any country's future. Perhaps that is why President Trump just signed an executive order creating the "American AI Initiative."[24] But to claim that China, alone, relies on industrial policy as a means toward this end is the height of hypocrisy.

Cyber-espionage is the third leg of the stool in the USTR's case against China. In this area, there can be no mistaking the evidence underscoring the role played by China's People's Liberation Army as a major actor in cyber intrusions directed at U.S. commercial interests. These problems were, in fact, so serious that President Barack Obama presented top-secret evidence of state-sponsored computer hacking to President Xi Jinping at the so-called Sunnylands Summit in September 2013, which then lead to agreement on a joint U.S.-China cyber accord in 2015.[25] Since then, most reports point to a reduction in Chinese incursions.[26] Unfortunately, the evidence cited in the USTR report in support of cyber-related trade violations largely predates the 2015 cyber accord.

In short, the USTR's seemingly impressive Section 301 report is largely a biased political document that has further inflamed anti-China sentiment in the U.S. As a result, Chinese-sponsored intellectual property theft is now taken as a given by an America that increasingly sees itself as a victim. Yes, like the rest of us, the Chinese are tough competitors, and they don't always play by the rules. For those transgressions, China must be held accountable. But the imposition of tariffs, with the potential to

[20] See Chalmers Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975*, Stanford University Press, 1982.

[21] See BDI, *The Mittelstand: The Heart of the German Economy*, https://english.bdi.eu/topics/germany/the-mittelstand/

[22] See Dwight D. Eisenhower's Farewell Address to the Nation, "The Military-Industrial Complex," January 17, 1961.

[23] See Daniel Cebul, "U.S. Remains Top Military Spender," *Defense News*, May 2, 2018.

[24] See Tom Simonite, "Trump's Plan to Keep America First in AI," *Wired*, Feb 11, 2019.

[25] See" Remarks by President Obama and President Xi in Joint Press Conference," Sep 25, 2015.

[26] As per Akamai's "[State of the Internet]/ Security: Q2 2017 Report," in the two years after the US-China cyber accord was signed in 2015, China fell to #6 in the cyber-attack global rankings, while the U.S. rose to #1.

spark an ever-escalating trade war, is very serious development that demands ironclad, irrefutable evidence to substantiate the charges and proceed with adjudication. Instead, by relying on flimsy evidence, the allegations leveled by the USTR and the complicit endorsement by the U.S. body politic does this critical debate an enormous disservice.

From Art of the Deal to Wisdom of the Compromise

At a time of a rising animosity between the United States and China, the imperatives of resolution cannot be understated. Negotiating tactics are key in assessing the likelihood of such a constructive outcome. The U.S. president has made a name for himself as a practitioner of the "art of the deal."[27] An alternative approach would replace bluster and intimidation with the more patient wisdom of the compromise. Compromise requires both parties to cede ground on key sticking points — in effect, producing joint concessions that offer the shared commitment to a constructive path forward rather than a deep-seated resentment that comes from one party squeezing the other into submission. It is essential that both sides seize this opportunity for compromise. While there are many roads that could lead to the promised land, the following four issues are critical to a lasting resolution:

Market access. After ten years of tortuous negotiations, the time for a breakthrough on a U.S.-China bilateral investment treaty (BIT) is at hand. Both sides would need to offer concessions. A robust BIT could eliminate ownership caps on foreign direct investment by multinational corporations in both countries, effectively abolishing the contentious. joint-venture structure in China that the U.S. continues to insist – incorrectly, in my view – has become a mechanism for forced technology transfer. A BIT would also enable an expansion of Chinese ownership of U.S.-domiciled assets – posing a challenge to the anti-China thrust of recent legislation that broadens the oversight powers of the Committee on Foreign Investment in the United States.[28]

Saving. Both countries need to commit to responsible macroeconomic adjustments. The U.S. needs to save more, reversing the reckless budget-busting trajectory reinforced by last year's ill-timed, outsize tax cuts. Rebuilding saving, rather than tariffs, is the most effective strategy to reduce trade deficits with China or any other trading partner. At the same time, China needs to save less, putting its vast pool of capital to work funding the country's social safety net, which is essential to reduce fear-driven precautionary saving and spur consumer-led economic rebalancing.

Cyber security. The digital realm is the battleground of the Information Age, and the September 2015 accord between President Barack Obama and Xi clearly did not go far enough in defusing persistent tensions over cyber espionage, hacking, and other related disruptions. Like trade imbalances, cyber security is a global problem that demands global resolution. Here as well, there can be no bilateral solution to global cyber security threats. The U.S. and China should take the lead in forging a global

[27] See Donald J. Trump (with Tony Schwartz), *Trump: The Art of the Deal*, Random House, 1987.
[28] See Alan Rappeport, "In New Slap at China, U.S. Expands Power to Block Foreign Investments," *The New York Times*, Oct 10, 2018.

cyber accord, complete with pooled metrics of cyber incursions, attack-reduction targets, and a robust dispute-resolution mechanism.

***Dialogue*.** It is terrific that the two presidents are meeting again after their earlier tête-à-têtes in Mar-a-Lago, Beijing, and Buenos Aires. Those gatherings follow more formal engagements such as the Strategic and Economic Dialogue. But all of these efforts have been episodic events that are long on glitz and short on substance. A permanent secretariat that would engage in full-time collaborative efforts on key policy issues of mutual concern (including data sharing, joint research, public-private consultation, and a neutral-site location) would be far more productive.

As of this writing (March 6, 2019), rumors are rampant of a pending deal between the United States and China to be signed by the two presidents in late March. As a gesture of good faith in just such an outcome, President Trump has suspended further tariff hikes on China previously threatened for March 1. Unfortunately, the broad outlines of such a deal are not very encouraging. As noted above, the emphasis appears to be on a narrowing of the US-China trade deficit — a bilateral political fix for a multilateral economic problem.

The rumor mill hints that resolution of the so-called structural issues appears likely to take the form of a "framework approach" — centered around separate agreements on seven issues: agriculture, services, technology, intellectual property, technology transfer, non-tariff barriers, and the currency.[29] To its credit, this list is well aligned with the debate as framed by the USTR, with one exception: a surprising inclusion of the currency issue. Yes, the Chinese currency has slipped a bit in recent months as the economy has weakened. But the 3% decline in the broad trade-weighted RMB (in real terms) since May 2018 pales in comparison to the 51% increase since late 2004. With China's current account surplus having all but been eliminated after peaking at 9.9% of GDP in 2007, currency manipulation is a "dated charge" that really has no meaningful role to play in resolving the US-China conflict. It's hard to see why either party is elevating this issue to such attention right now.

And that gets to my greatest concern over the current thrust of the negotiations. Both sides seem so willing to reach a high-profile deal, that they are focusing on the easy issues – bilateral trade and the currency — rather than on the really tough existential issues that have come between them. In evaluating the ultimate success of any deal, it will be important to measure progress against the four critical issues noted above — market access, saving, cyber security, and dialogue. A superficial deal is not the answer to repairing the serious damage that has been done to the U.S.-China relationship over the past year.

[29] See Jenny Leonard, "U.S. and China Are Working on Multiple Memorandums for Trade Deal," *Bloomberg*, Feb 20, 2019.

Hot or Cold War?

But what if no deal is struck, or as more likely, a weak deal is concluded that does not make meaningful progress on the tough structural issues that continue to drive a wedge between the U.S. and China? First of all, despite frictions in the South China Sea, and ever-present tensions across the Taiwan Strait, I do not share the dire prognosis of a hot war that some have associated with the so-called Thucydides Trap.[30] The destructive force of modern warfare suggest putting a very low probability on such a dire outcome.

At the same time, I would reluctantly concede that a Cold War is a very distinct possibility for two nations locked in a protracted clash over the competitive strategies of their two very different economic models. As noted above, the Section 301 complaint of the U.S. Trade Representative makes the case for China as an existential threat to America's economic future. While my analysis suggests that the evidence behind these allegations is very weak, the U.S. seems determined to push ahead on all of these fronts – many of which are key to China's own longer-term economic strategy.

America does not have a monopoly on existential fears as this relationship veers off course. China has deep-rooted concerns that that the U.S. is fixated on a "China containment" strategy — doing everything in its power to throw up obstacles to the next phase of Chinese development. While Trump's tariffs underscore China's concerns, they follow on the heels of the Obama Administration's "Asia pivot" and TPP ambitions — with the latter excluding China from its original 12-nation framework. Those actions can certainly be seen as forerunners to today's more full-blown efforts at containing China.

Inasmuch as I do not expect China to capitulate on its core economic strategy, there is a strong likelihood of a protracted struggle between two systems, with the very real potential to usher in an era of economic Cold War. This, of course, would be very different from the last Cold War, which was more of a military struggle between two superpowers, the U.S. and the former USSR. But fears of Cold War 2.0 are an unmistakable message recently conveyed in public speeches by U.S. Vice President Mike Pence,[31] with similar warnings echoed by former U.S. Treasury Secretary Hank Paulson.[32]

Significantly, for the United States, its economy is in much weaker shape to wage a cold war today than was the case during the Cold War 1.0. During that earlier period, U.S. real GDP growth averaged 3.5% per year from 1947 to 1991; by contrast, over the past five years, real growth in the U.S. has slipped to 2.2%. Similarly, during the first cold war, productivity growth averaged 2.2% per annum, while over the past five years the pace has slowed to just 0.8%. And perhaps even more significant, America's domestic saving position is woefully deficient – a 3.3% net national saving rate over the past five years versus an 8.8% average during Cold War 1.0. Such a profound shortfall of saving raises serious questions about America's wherewithal to fund the investments in physical or human capital that

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[30] See Graham Allison, *Destined for War: Can America and China Escape Thucydides's Trap*, Houghton Mifflin Harcourt, 2017.
[31] See "Remarks by Vice President Pence on the Administration's Policy Toward China," The Hudson Institute, Oct 4, 2018.
[32] See Remarks by Henry M. Paulson, Jr., "The United States and China at the Crossroads," Nov 7, 2018.

would be needed for competitive revival. The United States operated from a position of great economic strength in taking on the former Soviet Union in the first four decades of the post-World War II era. That is not the case today if chooses to wage a similar struggle with China.

What can be gained from a new Cold War that, in many respects, would turn the world order inside out? Hints were first evident in January 2017. Back then, the two presidents of the United States and China laid out sharply contrasting views of their nations' global roles. Donald Trump said in his inaugural address on January 20, 2017, that "Protection will lead to great prosperity and strength."[33] Three days earlier on January 17, 2017 at the World Economic Forum in Davos, Xi Jinping said, that China "should adapt to and guide economic globalization."[34]

Those were not idle words. Both nations have moved to act forcefully on those statements. That is especially evident with Trump's unmistakable resistance to multilateralism — withdrawing from the Trans-Pacific Partnership and the Paris Agreement on Climate Change and threatening to do the same with NATO and the WTO. It is also the case with Xi with his endorsement of multilateralism through China-centric efforts such as the Belt and Road Initiative, the Regional Comprehensive Economic Partnership (RCEP), and the Asian Infrastructure Investment Bank (AIIB).

Donald Trump mistakenly believes that tariffs will "make America great again" by bringing back U.S. manufacturing jobs; however, with the manufacturing share of U.S. employment down from 40% in the aftermath of World War II to just 8.5% today — in large part due to technological change and productivity enhancement — that will be all but impossible to achieve. By contrast, Xi's multilateralism draws on the efficiency enhancements of trade liberalization, global value chains, and hopefully a renewed commitment to the rules-based governance of globalization — principles that place much greater emphasis on the collective growth opportunities for the world economy.

The last thing the global economy needs is a breakdown of the post-World War II world order, with integration and trade liberalization giving way to fragmentation and currency and trade wars. Collectively, only the U.S. and China are in a position to neutralize this risk. Yet they can do so only if they both operate from a position of strength.

In a codependent relationship, strength and healing ultimately comes from within. If both the United States and China work on addressing their own economic issues and imbalances, they will be better able to resolve the issues that have come between them. For China, that means continuing to focus on rebalancing and structural change by putting its vast reservoir of surplus saving to work in promoting its domestic challenges. For the United States that means

[33] See Donald J. Trump, "The Inaugural Address," Jan 20, 2017

[34] See Xi Jinping, "Jointly Shoulder Responsibility of Our Times, Promote Global Growth," keynote speech at the World Economic Forum, Jan 17, 2017.

addressing its chronic shortfall of domestic saving and putting any new increments of saving to work in rebuilding infrastructure, manufacturing capacity, and human capital.

No Winners

There is no winner in a trade war — especially between two codependent economies who rely so heavily on one another as do the United States and China. President Trump has mistakenly argued that the U.S. has the upper hand in a trade war because China is already hurting. That could be a serious miscalculation. Yes, the Chinese economy is weakening now and likely to slow further in the months ahead. But in light of recent policy stimulus actions — both monetary and fiscal — that weakening could run its course by mid-year 2019. But those who live in glass houses should be especially careful about throwing stones. The sharp plunge in the U.S. stock market in December 2018, in conjunction with a significant weakening in global trade, suggests that U.S. economic resilience could well be tested in the months ahead.

In light of increasingly contentious developments between the U.S. and China, it is hard to be optimistic that a meaningful breakthrough is at hand. The real risk is that the relationship has now suffered lasting damage. This is very much in keeping with the conflict phase of codependency, when it becomes exceedingly difficult, if not impossible, to restore trust. It will take nothing short of bold, courageous, and strategic vision by leaders in both nations to rebuild the U.S.-China relationship.

Only by strengthening from within, will the world's two largest economies be better positioned to transform their relationship from a destructive codependency into a more constructive interdependency. Such a reshaping of the U.S.-China economic relationship would then once again reinforce their respective growth journeys rather than create frictions that pose serious impediments to their shared future. Unfortunately, at this point in time, the odds of a weak deal far outweigh the possibilities of a more substantial and lasting agreement that diffuses the existential threats that both nations fear the most. The world is watching — and hoping.

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