The Geopolitical Logic of the US-China Trade War

by George Friedman - August 26, 2019

Since Donald Trump took office in 2017, the United States has introduced a series of measures to try to reduce its trade imbalance with China. But Trump's decision to impose tariffs on China was preceded by a decade of failed negotiations aimed at establishing a more equitable trade relationship between the two countries. The Obama administration had multiple high-level meetings with Chinese officials over Chinese barriers to U.S. imports and Chinese manipulation of the yuan. Whether fair or unfair, the perception of multiple U.S. administrations was that China enjoyed free access to U.S. markets without reciprocating.

The Chinese made gestures toward accommodation, but they could not grant U.S. demands for greater access to the Chinese market. China's economy had long been heavily dependent on exporting to foreign markets, since its own domestic market could not absorb the vast quantity of goods that Chinese industry was producing. But with the onset of the 2008 financial crisis, the domestic market took on a whole new significance.

The Japanese Example

There are several similarities between U.S.-China trade relations today and U.S.-Japan trade relations in the 1980s. During the 1970s and 1980s, Japanese industrial production significantly exceeded domestic needs, and Japan had closed off much of its own market to imports from the U.S. The mid-to-late 1980s were a time of extreme tension between the two countries. The U.S. made serious threats of retaliation, but none came to pass for two reasons. First, Japan was a strategic ally of the United States. The need to close off Vladivostok – which required Japanese cooperation – was ultimately more important than the U.S. trade imbalance with Japan. Second, in

the late 1980s, the Japanese economy began to crumble. Competition from other manufacturing hubs forced Japan to reduce the price of its exports, which reduced profit margins and weakened the banking system that was underpinning the Japanese export industry. The banks tottered and collapsed, meaning Japanese manufacturers were no longer able to export at the same level they once were.

But before the banks collapsed, there was extreme bitterness and anti-Japanese sentiment in the United States over the loss of jobs to Japanese manufacturers. We're seeing similar responses today to the Chinese. And China is also now facing intense competition and also lowering prices, while trying to enter other highly competitive markets in technology.

That said, there is a fundamental difference between Japan and China. Japan was a strategic asset to the United States – which, to some extent, helped contain the economic friction. Not only is China not a strategic asset to the U.S., but it's actually increasingly viewed as a strategic threat. Either way, the Chinese have emphasized their growing military prowess, meaning that the arresters that were present in U.S.-Japan relations are absent from U.S.-China relations. Beijing being both a military and economic threat will force different responses from Washington.

But China had followed the Japanese strategy on dealing with the U.S. It held numerous meetings that ended without a resolution. Since there appeared to be no lever to force the Chinese to shift their policy, multiple U.S. administrations simply continued to hold talks that ultimately seemed to go nowhere. In these negotiations, the Chinese were aided by the large investments in China made by U.S. companies, which pushed Washington to maintain a stable relationship with Beijing. But while these companies profited from the relationship with China, it was always questionable whether the U.S. economy did as well. They were in China to take advantage of cheap Chinese labor, but in doing so, they closed U.S. factories and got rid of their American workers. This helped their bottom line, but the wealth that was created remained in China.

A Shift

In prior administrations, the outsourcing of manufacturing for U.S. businesses made it difficult to take action against the Chinese. But after the 2008 financial crisis, the massive displacement of the formerly powerful industrial working class created a large and angry segment of the population that became as politically powerful as the U.S. businesses that operated in China. The option of simply continuing inconclusive talks that had no impact on Chinese policy slowly evaporated.

And so, the Trump administration has used tariffs to try to force the Chinese to open their markets to

U.S. competition. The problem is that the Chinese economy is in no position to accept such competition. The financial crisis severely affected China's export industry as the global recession reduced the appetite for Chinese goods. This hurt the Chinese economy greatly, throwing it off balance in a crisis that still reverberates in China today. China's main solution to this problem has been to increase domestic consumption – a task that has proved difficult because of the distribution of wealth in China, the inability of financial markets to massively increase consumer credit, and the positioning of Chinese industry to target foreign, rather than domestic, consumers. Selling iPads to Chinese peasants isn't easy.

Allowing the U.S. to access the Chinese market would have been painful if not disastrous. The Chinese domestic market was the only landing pad China had, and U.S. demands for greater access to it were impossible to meet. The Chinese retaliated against U.S. tariffs, but it was feeble. China derives 4 percent of its gross domestic product from exports to the U.S. The U.S. derives only 0.5 percent from exports to China. China can do much less harm to the United States than the U.S. can do to harm China. Critics of the Trump administration's use of tariffs will show that various farms or factories have been hurt by the tariffs, and those criticisms are valid, but they do not capture the full picture.

The Chinese responded by lowering the value of the yuan, thereby making their exports cheaper. This strategy works in the short run, but since it increases the price of commodities like oil, it is not a solution in the long run. It has also strengthened the case of those who say China manipulates its currency to strengthen its position as an exporter. It's important to remember that this is not a new charge; the Obama administration was aggressive on this point but held off on retaliating. The Trump administration has also repeated the claim and, earlier this month, **officially labeled China a currency manipulator**.

But Trump has recently threatened to take more severe action: forcing U.S. firms in China to leave and return to the United States. There is some legal precedent for this, but should the U.S. follow through, it will be challenged in the courts for a long time. Such a move would be a major threat to U.S. businesses, possibly more so than to China itself. Politically, the move strengthens Trump's position among Americans who blame their own economic struggles on the outsourcing of jobs to China. And with an election coming up, the political strategy of Trump's threat is clear. But so too is the pressure that the U.S. is imposing on China. Foreign high-tech companies operating in China have been a major conduit for Chinese access to new technology.

Geopolitics consists of politics, economics and military matters. In comparing China and Japan, we can see all three at work. In the case of Japan, military considerations took precedence over the

other two and limited U.S. actions. In the case of China, politics and economics are both pushing the U.S. to take action, while there are no military considerations to hold the U.S. back. If the Chinese decide to counter militarily, it's better that they do so now when they remain weak, rather than later when they are stronger. The logic of geopolitics has brought us to this point. And the U.S. is unlikely to back down without concessions that China cannot make.

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