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The U.S. should produce new products for export to China to reduce the trade deficit.

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Don't Miss the Bigger Picture

Zhang Ping

Speculation on a possible trade war has intensified as trade talks between the United States and China have yet to produce any breakthrough. The commentaries we highlight in this issue provide perspectives, propose solutions, and most importantly, warn of the consequences of a meltdown.

On May 5, top U.S. negotiators left Beijing after two days of talks, unable to narrow the growing trade rifts. The good news is that the two sides agreed not to give up. Three days later President Donald Trump spoke with President Xi Jinping on trade and North Korea during a call, and a high-level Chinese delegation will be on its way to Washington to give it another go. At press time, Trump tweeted that he has been working with Xi to grant reprieve to the Chinese tech giant ZTE that has halted operations after severe U.S. sanctions.

The list of U.S. grievances over China's trade practices and industrial policies is long. China has its own ask list. Trade rules and practices are immensely complex issues. Quick solutions are unlikely.

There are concerns that the discord could spill over to infect overall ties, fuel hostility, and reduce trust between Beijing and Washington over strategic and security issues. Many Chinese see the U.S. demands targeting the Made in China 2025 policy as an attempt to stop China's rise as an innovation powerhouse.

There is also deep concern around the world that the trade spat could disrupt the global supply and industrial chain, dampen global recovery, and even trigger a new economic depression. The stakes are indeed high, for both countries and the world. Despite tough rhetoric, neither the U.S. nor China will win from a trade war.

We are hopeful the trade disputes will be handled wisely, with both sides remembering the high stakes involved. Ultimately, the economic relationship is the anchor and driver for China-U.S. relations, and trade is not a zero-sum game.

We are also hopeful that China will implement the new measures it's announced to further open its market to foreign investors, not because of US pressure, but because of its own needs and interests.

In this issue, Professor Lawrence Lau of the Chinese University of Hong Kong, discusses the options available to reduce the U.S. trade deficit with China and examines the notion of "fair trade."

Reviewing the on-going trade rifts that reveal an emerging battle over tech, our U.S. contributor Josephine Wolff of the Rochester Institute of Technology criticizes the U.S. government's ban on American companies selling to ZTE.

In this issue, we also highlight the eye-popping turn of events on the Korean Peninsula with two analyses on the upcoming meeting between President Trump and DPRK leader Kim Jong-un.

I hope you will enjoy reading.


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A Better Alternative to Trade War

The U.S. should produce new products for export to China to reduce the trade deficit.

Lawrence Lau
Ralph and Claire Landau Professor of Economics
The Chinese University of Hong Kong

U.S. President Donald Trump wishes to reduce the U.S.-China trade deficit by US$100 billion. He proposes to accomplish this objective by imposing tariffs on up to US$150 billion worth of Chinese exports to the U.S. Whether this can be done in a manner consistent with the World Trade Organisation (WTO) rules is not so clear, but it is unlikely to deter President Trump from doing it. Under the new tariffs, Chinese exports to the U.S. will most certainly fall. However, just as increased voluntary trade between two trading partner-countries raises the aggregate welfare in both countries, an involuntary decrease in the trade between them lowers the aggregate welfare in both countries. It will be lose-lose.

Moreover, the most likely net outcome of these new country-specific tariffs is the substitution of imports from China by imports from other countries on the part of U.S. importers. Thus, while the U.S. trade deficit with China falls, its trade deficits with other countries will rise. The overall U.S. trade deficit with the rest of the world will not be significantly altered, and neither GDP nor employment in the U.S. will increase much.

> The U.S. trade deficit with China can also be reduced by the U.S. increasing its exports of goods to China.

More fundamentally, almost all mainstream economists, U.S. and otherwise, agree that the aggregate U.S. trade deficit with the rest of the world cannot be reduced without a corresponding reduction in the U.S. investment-saving imbalance. In other words, unless investment is decreased or savings are increased in the U.S., the U.S. trade deficit with the rest of the world will remain essentially the same, whatever happens to the U.S.-China trade deficit. Selective country-specific protectionist policies, such as tariffs and quota policies, can shift the source of the trade deficit, for example, from a U.S.-China trade deficit to a U.S.-ASEAN trade deficit, but cannot reduce the aggregate total. This is indeed true if the U.S. real GDP is taken as given. However, there is an exception: if there is an autonomous (unanticipated) increase in the demand for exports from the U.S. which increases the real GDP of the U.S. in the process, it is possible for the U.S. trade deficit to be reduced. The key lies in the production and export of goods not previously produced or exported so that there is a genuine increase in both real GDP and exports.

U.S. delegation led by U.S. Treasury Secretary Steven Mnuchin visited Beijing and had talks with Chinese Vice Premier Liu He on economic and trade issues from May 3-4. Tensions increased as U.S. officials handed Beijing a list of demands including a $200bn cut in its trade deficit and an end to state subsidies on strategic industries.

A Trade War is Lose-Lose

Imposing tariffs on Chinese exports to the U.S. is unlikely to do the trick of reducing the U.S.-China trade deficit also because of the possibility of retaliation by China, which would reduce U.S. exports to China at the same time. The problem of a trade war is that there are no winners—both countries lose because their feasible consumption choices are artificially restricted and reduced. Exporters in both countries will be hurt because of the reduction in their exports, and importers in both countries will see their businesses decline. And the consumers and producers who use imported goods in both countries will have to pay higher prices.

Imports can indeed help to keep the rate of inflation low. Research has shown that between 1994 and 2017, a one-percentage-point increase in the Chinese share of U.S. non-oil imports reduced the annual rate of growth of the U.S. non-oil price index by 1.0 percentage point. The Chinese share of total U.S. non-oil imports rose more or less continuously from 2.7 percent in 1989 to almost 22 percent in 2009, where it more or less remained through 2017. Between 1989 and 2017, the average annual rate of growth of the U.S. non-oil price index was 2.5%, a drop of 2.6% from the 5.1% in the previous 28-year period of 1961–1989. The slowdown in the core rate of inflation since 1989, which in turn permitted a lower U.S. rate of interest, can be partially attributed to the increase in Chinese imports. Imposing tariffs on Chinese imports will definitely lower its share of U.S. non-oil imports and may raise the U.S. core rate of inflation.

Thus, if a trade war breaks out between China and the U.S., both countries stand to lose, and not insubstantially. While the threat of a trade war may make sense from a tactical point of view, no one really wants to see it actually happen. There is, however, a better alternative: the U.S. trade deficit with China can also be reduced by the U.S. increasing its exports of goods to China. Moreover, there are two different ways for the U.S. to increase its exports. The first is rerouting its existing exports to other countries to China instead, and the second is producing new output for export to

China, especially using resources that are currently underutilized. The first way is mostly cosmetic. U.S. GDP and employment will not increase much even though the U.S.-China trade deficit will fall. There is little net real benefit to the U.S. (or, for that matter, to China), except to be able to claim that the trade deficit has been successfully reduced. The second way, however, will lead to genuine increases in economic well-being in both the U.S. and China. U.S. producers and exporters will benefit, as will Chinese importers and consumers and producers who use the new imported goods.

Furthermore, tariffs against China may not even lower the overall U.S. trade deficit with the rest of the world because U.S. importers may substitute for Chinese imports with imports from other countries. The history of the U.S. apparel trade provides an interesting example. Between 1989 and 2017, the share of Hong Kong, Taiwan and South Korea combined in U.S. apparel imports declined from 36.9% to 1.7%, replaced by the share of Chinese imports, rising from 11.7% to 36.6%. With new tariffs on apparel imports from China, the Chinese share will fall sharply, to be replaced by imports from Vietnam, Cambodia, Indonesia and Bangladesh. The total U.S. apparel imports may remain more or less the same.

> Tariffs against China may not even lower the overall U.S. trade deficit with the rest of the world because U.S. importers may substitute for Chinese imports with imports from other countries.

A trade war between China and the U.S. can and should be averted. It is certain to lower the aggregate welfare of both countries and that of the rest of the world as well. Producing new output for export to China is a much better alternative for narrowing the U.S.-China trade deficit. It will be a win-win for both China and the U.S., with positive spillover effects for the rest of the world. It deserves to be seriously considered by both countries.

Of course, the trade deficit is not the only U.S. grievance with the economic relationship. Intellectual property protection is one of them, but China has made great progress in the last few years in this area, by establishing special intellectual property courts that have jurisdiction over the entire country. Restrictions on market access for direct investments is another. China has recently announced the removal of restrictions on majority and even eventually wholly foreign ownership in many industries. This should help alleviate some concerns over forced technology transfer. State support for technology development is also an issue, but this is not unique in China. For example, U.S. Government agencies funded Sematech for many years. Finally, state-owned enterprises, while rare in the U.S., will remain important in the Chinese economy for a long time to come. Chinese enterprises, like the enterprises of all other countries, should be judged on the basis of their actual behavior, and not on their ownership. Moreover, not all Chinese state-owned enterprises receive positive net subsidies—there are too many of them. Instead they are frequently assigned significant social responsibilities, well beyond what may be accustomed to enterprises in capitalist economies.

WTO Rules Key to Trade Talks

Trade talks, not trade war.

He Weiwen
Senior Fellow
Center for China and Globalization

China and the U.S. had a high-level trade consultation from May 3-4, 2018 in Beijing, ending with some positive results and lots of major differences.

Long Road Ahead for Trade Talks after Consultation

The checklist given by the U.S. delegation includes a number of demands: China must cut $200 billion dollars in trade surplus by 2020, halt all subsidies to advanced manufacturing industries in its Made in China 2025 program, accept that the United States may restrict imports to industries listed under the 2025 program, strengthen intellectual property protections, accept United States restrictions on Chinese investment in sensitive technologies without retaliating, and cut its tariff to the same level as the United States. It was also reported that the U.S. demanded that China withdraw its case at the WTO on the Section 301 investigation and the 25% tariffs by July 1, 2018. Evidently, China and the U.S. have significant differences.

The escalation of China-U.S. trade tension over the past weeks has caused great anxiety. The USTR announcement of a 25% tariff on $50 billion of imports from China, based on its Section 301 Investigation on Chinese practices on technology transfer, was met with a strong counter-measure from the Chinese government 13 hours later, with a 25% tariff on $50 billion worth of imports from the U.S. Also, China immediately referred the U.S. Section 301 Investigation and the tariffs to the Dispute Settlement Mechanism of WTO. President Trump then asked the USTR for additional tariffs on $100 billion of imports from China. This only resulted in an even stronger resolve from the Chinese Ministry of Commerce to "fight to the finish."

> This only resulted in an even stronger resolve from the Chinese Ministry of Commerce to "fight to the finish."

The trade tension extended to the technology and investment areas when the U.S. Department of Justice on April 16 banned U.S. companies from supplying chips to ZTE for seven years, and the Federal Communication

Commission suggested on April 19 a ban on buying Chinese telecom products. Meanwhile, the U.S. Treasury Department is busy finding a new legal basis for blocking Chinese high-tech M&A in the U.S.

Section 301 Investigation and Tariffs are in Violation of WTO Rules

There have been complaints from U.S. businesses on China's practices in tech transfer, IPR protection, and fair competition. These have been the subjects of bilateral dialogues and joint efforts by both governments for years. They might well be handled under the bilateral or WTO framework.

The USTR Section 301 investigation report cited cases offered by the U.S. China Business Council (USCBC), which comprises of the leading American multinationals operating in China. According to the USCBC China business environment survey 2017, 81% of member respondents said that they had no compulsory tech transfer problems in China, while 19% answered yes. Of this 19%, 67% said that the transfer requirement was from Chinese businesses, 33% said it was from the Chinese central government, and 25% said it was from the local government. The survey gave no concrete evidence on who forced which U.S. companies to transfer what technology in what project. As a result, the Section 301 investigation report also failed to give any hard, concrete evidence. Even if we take that into account, it amounted to less than one fifth of total U.S. companies, and the Chinese central government (no hard evidence here either) accounted for one third of that. Hence, it is a limited issue, not representative of bilateral trade as a whole.

We could easily have those issues resolved at the WTO. The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) under the WTO

covers issues of technology transfer, layout design of integrated circuits, patent, industrial design, and copyrights. It is based on recognition of all the international treaties under the World Industrial Property Organization (WIPO), and on three WTO principles: national treatment, most favored nation, and balanced protection. Hence, international rules and standards are there for practically all the U.S. businesses.

However, the USTR did not follow that path. Instead, Robert Lighthizer launched the Section 301 investigation, in violation of the WTO rules. Clause 23 of the WTO "Understanding on Rules and Procedures governing the Settlement of Disputes" stipulates that members shall "not make a determination to the effect that a violation has occurred," and "shall make any such determination consistent with the findings of the panel of Appellate Body report." It means that only the WTO Dispute Settlement Mechanism has the right to determine if China is in violation of relevant WTO rules. The U.S., as a leading member of the WTO, signed the Understanding. In 1998, USTR launched a Section 301 Investigation on the EU. EU then turned to the WTO, and the U.S. lost the case. The USTR then promised not to resort to unilateral Section 301 moves any more.

Twenty years later, the USTR forgot its promise and made the same violation. Unilateral tariffs are banned under WTO rules, as tariff levels are set by multilateral negotiations, not by unilateral government decisions. During the recent high-level consultation, the U.S. delegation still insisted on the Section 301 investigation and 25% unilateral tariffs, neglecting the WTO governance once again.

Multilateral Trade Mechanism under Threat

USTR even went further, forcing other countries to give the U.S. "good bargains". It used the steel and aluminum tariffs to this effect in U.S.- Korea Free Trade Agreement renegotiation. South Korea agreed to increase the U.S. automobile quota to South Korea to escape tariffs. If China makes this same mistake and negotiates with the U.S. under pressure from tariffs and the Section 301 Investigation, the unilateral violation would be legitimized, and the WTO rules would be useless. Then all the countries can do whatever they want to impose tariffs, or other restrictive measures. World trade would fall into chaos, creating significant risks to the world economy.

In 1930, the U.S. adopted the Smoot-Hawley Act to considerably raised tariff levels across the board, which hit an average of 53.2% in 1932, to protect the American jobs. Then Canada, the UK, and France retaliated with equal tariff hikes. As a result, U.S. exports shrank by 66%, and imports shrank by 62% from 1929-1933, and world

trade fell by 66%. The U.S. unemployment rate shot up to 30%, the opposite of what the policy hoped to achieve.

The USTR's Section 301 Investigation and tariffs have posed a major challenge to the authority and effectiveness of the multilateral trade mechanism established after the end of World War II. The current China-U.S. trade tension is not only a bilateral showdown, still less a tech transfer issue, but a major struggle between unilateral protectionism and multilateral free trade.

Tariff Measures Targeting Made in China 2025

A close look at the tariff checklist shows it has nothing to do with the Section 301 Investigation which addresses technology transfer and IPR, not products. The list includes iron/non-alloy steel semi-finished products, central heating boilers, textile printing machinery, cooking stoves, dishwashing machines, and sowing machine needles. No one would believe that China needs to force tech transfer for those very low-end items. Further down the list, the main categories include nuclear reactors and parts, marine purpose internal combustion piston engines, and aircraft. Across the board, not a single one of these was covered in the Section 301 Investigation report. However, they fall within the 10 focal industries identified in the Made in China 2025 plan.

The Trump Administration could dispute specific measures within Made in China 2025, but not the Made in China plan itself.

Peter Navarro, Chairman of the National Trade Committee, abandoned all pretense when he said in a Bloomberg interview that "the target" of President Trump's tariff order is certainly the focus industries in Made in China 2025. His remarks were later confirmed by the USTR.

China, as a sovereign state, has its legal right to development. The Trump Administration could dispute specific measures within Made in China 2025, but not the Made in China plan itself. China never challenges President Trump's tax policy, because it is a domestic issue of the U.S.

It would be naïve to think that the moonshot tariffs and other tech restrictions could stop or slow down the Made in China 2025 plan. As the Chinese and American high-tech sectors are closely interrelated in the global supply chain which also spans Europe, Japan and the rest of Asia, any disruption will hit American high-tech companies as well. Apple Inc. has 25% of global net income from the greater China area, and the loss of the Chinese market could lead to 27,000 job losses and a stock market crash. Qualcomm even draws two thirds of its income from China. Its stock fell by 18% since the USTR announced the tariff measures. The seven leading American IT and telecom providers – HP, Dell, Microsoft, IBM, Intel, Cisco, and Unisys – got an average of 51% of their components from China during 2012-2017, according to a report requested by the U.S.-China Economic and Security Review Commission. Made in China 2025 will offer an even larger China market for world leading technology players. If they lose the China market, they can't support the R&D in cutting edge technologies that's critical to their future.

Made in China 2025 is open to America and the rest of world. As stated by President Xi Jinping, China will further open up its manufacturing and services as soon as possible. The Chinese economy will grow by an aggregate of 50-60% over the next eight years by 2025, meaning a tremendous new market, new industries, and new services, far outstripping the potential in any other part of the world. The Trump Administration should encourage the American business community to ride on China's coattails.

WTO Rules-Based Talk the Only Solution

Despite all the major differences, the consultation on May 4-5 itself was very constructive, and the agreement for further talks is headed in the right direction. Hopefully both sides will have enough political will and wisdom to reach an agreement in the end. However, the China-U.S. trade talks can only be successful on three conditions.

First, common approach. China and the U.S. used to have numerous differences and will continue to have differences in the years ahead. If both sides share the approach of managing differences through dialogue and negotiation while seeking new opportunities for cooperation, the bilateral trade relationship will be stable.

Second, common basis. All the major issues can only be settled on the common standards and rules, or WTO rules. China and the U.S. are members of the WTO and governed by the same set of rules. No domestic laws should apply to the other party. If both sides recognize the relevant WTO rules as the common standard, China and the U.S. will be much closer to a framework agreement.

Third, equal position. Both China and the U.S. are equal in the talks. There should be a checklist from each side for equal respect, with no threat hanging over anyone's head.

China and the U.S. should strive to anchor the talks on these three conditions, and work together towards a reasonable, balanced agreement, which will be crucial for the world's two largest economies, and for the whole world as well.

Newer, better technology has moved China into higher end manufacturing.

Improving Upon Trump's High-Risk, Low-Yield China Trade Policy

Many countries, not just the United States, are disadvantaged by China's unfair trade practices. Rather than confront the challenge alone, the United States should work to address the problem as a team sport.

Ryan Hass
David M. Rubenstein Fellow
Brookings Institution

The foundations of the United States–China relationship are as brittle as they have been in decades. A confluence of factors from both sides of the Pacific have pushed the relationship to its present precarious point. China's mercantilist economic policies bear a significant brunt of the blame, along with China's growing military assertiveness, internal suppression of dissent, non-responsiveness to legitimate U.S. concerns on trade, efforts to influence American political discourse, and injection of ideological tension into bilateral relations. Rather than pursuing a serious strategy to tackle specific problems, though, the Trump administration has embraced an undisciplined instinct for confrontation. Such an approach will not generate greater Chinese responsiveness to U.S. concerns, but it could do harm to American businesses and workers.

> President Trump regularly talks in glowing terms about Xi Jinping as if he were disconnected from the Chinese policies the administration opposes.

In Washington, a lack of emphasis on policy coordination has enabled various parts of the U.S. government to interpret Trump's rhetoric on China as permission to pursue their preferred initiatives. The result has been a cascade of near-simultaneous actions — on Taiwan, Tibet, trade, technology, law enforcement, and maritime issues — which have overloaded the circuits in Beijing. Such an absence of prioritization in the relationship has removed any pretense of American seriousness in seeking to resolve specific problems, and instead has reinforced suspicions in Beijing that America's efforts are animated by anxiety about its decline and China's rise.

President Donald Trump signed a presidential memorandum imposing up to US$60 billion in new tariffs and investment restrictions on China in the Diplomatic Reception Room of the White House, March 22, 2018.

On trade issues, in particular, the Trump administration has not conveyed a consistent, coherent narrative that defines specific concerns, identifies clear objectives, and articulates a strategy for achieving those objectives. Instead, President Trump has fixated on the trade deficit, while his Treasury secretary has talked about negotiating a deal with China, and his trade representative has harped on the need to change China's economic model. At the same time, President Trump regularly talks in glowing terms about Xi Jinping as if he were disconnected from the Chinese policies the administration opposes, thus deflating the pressure American trade officials are trying to exert.

Meanwhile, by taking new steps on Taiwan at the same time as threatening tariffs, the Trump administration has diluted the focus on trade and diverted Beijing's concentration toward pushing back on Taiwan. Trade and Taiwan compete for top billing in Beijing these days, to the consternation of American trade hawks who are seeking to focus China on its need to dismantle its industrial policies.

The Chinese have responded with a combination of bewilderment and steadfastness. In addition to concluding that Trump has little interest in the substance of governing or little control over the levers of power, many in Beijing also believe Trump lacks conviction to sustain a strong push to alter China's economic model. The mainstream Chinese view is that Trump is a dealmaker in search of a better bargain than his predecessors could secure, or at least one that could be portrayed as better. But in the event the Trump administration organizes itself to challenge China's economic model, Beijing is laying the groundwork to defend its economic system.

Domestically, President Xi has begun girding the public for a fight. He has called for China to stand firm, become more self-reliant, and reduce dependence on the United States. Chinese state-controlled media have signaled that the state-led sector will maintain a central role in the Chinese economy, the Made in China

Xi believes China's political system enables him to absorb more pain than Trump.

2025 initiative will stay intact, and the state-backed Belt and Road Initiative will move forward. Xi has also used U.S.-China trade tensions as a rallying call for China to indigenize development of chips, semiconductors, and other inputs for the high-technology industries of the twenty-first century.

So, why does it matter if the United States and China clash over trade issues, and what is a better path forward?

A likely consequence of these dueling approaches will be a test of political pain tolerance between Trump and Xi. Xi will enter the challenge with the tools to: impose geographically targeted tariffs; squeeze American firms operating in China using regulatory pressure points; push down markets and shrink Americans' IRA accounts; paint the United States as the unilateralist instigator and China as the "principled protector" of the global trading system; and dilute American pressure on North Korea to denuclearize.

With full control of his government and of the Chinese media narrative and no referendum on his performance on the horizon, Xi believes he has an advantage over Trump, who faces midterm elections in November and a reelection campaign in 2020. Even though China would lose more in an economic battle of attrition, Xi believes China's political system enables him to absorb more pain than Trump.

From a domestic political perspective, Xi also benefits by standing firm and enjoying the rallying effect of unified

Attendees use new iPhone X during a presentation for the media in Beijing, China. Apple, Boeing and Qualcomm would be biggest losers in a China-US trade war, Chinese state media said on March 24, 2018.

opposition to U.S. attempts "to keep China down." He puts himself in jeopardy if he is seen as capitulating to pressure from Trump or overseeing the collapse of the Chinese economy.

At the same time, Trump also has major cards to play with China. China's comparatively low level of U.S. imports gives the United States an advantage in tariff escalation because Beijing will run out of targets before Washington. Washington also has ample room to tighten inbound and outbound investment screening, and the ability to further restrict the export of key inputs for China's economic modernization, thereby slowing China's climb up the value chain. Washington also could restrict visas for Chinese students, including in STEM fields, to thwart the transfer of know-how, although in practice, Chinese students would simply shift to British, Canadian, Australian, and other universities and laboratories.

If both sides commit to a race to the

bottom, there would be no winners, just losers. Such a downward spiral could lead to economic disengagement, and over time, decoupling of the world's two largest economies and trading powers. An economic divorce would be financially costly for both sides. It would produce in China a generation of ill-will toward America paired with an overdose of nationalism. An end to U.S.-China economic interdependence also would deprive leaders in Washington and Beijing of a coolant for controlling escalation when incidents arise.

Given these factors, the United States confronts a dilemma on trade. The status quo — a Chinese state-led economic model that favors national champions, disadvantages U.S. competitors, and distorts global industries — is no longer acceptable, given the central position that China now occupies in the global economy. A narrow deal for China to buy American goods to temporarily shrink the trade deficit would be tantamount to kicking the can down the road. And Washington's current approach of using high decibel unilateral threats to extract Chinese concessions holds little hope of meaningful progress.

> If both sides commit to a race to the bottom, there would be no winners, just losers.

Some American market participants are hopeful that risk will be contained because Trump routinely threatens extreme positions and then falls back to conventional policy terrain, and also because personal chemistry between Trump and Xi will put a floor under the relationship. While it would be a mistake to ignore these factors, it might also be naïve to rely upon them: particularly since Trump signed Taiwan legislation during China's National People's Congress — which many in Beijing interpreted as a "slap in the face" for Xi — the likelihood that Xi would do anything to make life easier for Trump has diminished considerably.

If Washington is serious about altering China's economic and industrial policies, it must focus the relationship on these issues and then redefine the costs/benefits for Beijing. On specific concerns, Washington could use the threat of targeted sanctions to press the Chinese to enter into time-bound negotiations to address solvable problems. More broadly, the United States could muster a strong chorus of countries and companies that each underscore to Beijing a uniform set of specific priority requests about areas where it needs to adjust its practices. In other words, Trump could shift the problem from a U.S. vs. China contest of wills toward a world vs. China effort to create a level playing field for all to compete fairly in the 21st century global economy.

Many countries, not just the United States, are disadvantaged by China's unfair trade practices. Rather than confront the challenge alone, the United States should work to address the problem as a team sport. Doing so would be more effective and less costly than hoping U.S.-China tit-for-tat tariffs do not do significant harm to American workers, but do lead to a change in China's economic policies.

Hedging Bets on the Future of U.S.-China Economic Relations

A stable and growing commercial relationship between the United States and China is essential to the well-being of the global economy. A smarter, more durable approach to the problems we confront would be for Washington and Beijing to make lists of all of their gripes, put them on the table, and see whether, and to what extent, they can be resolved.

Daniel Ikenson
Director
Cato's Herbert A. Stiefel Center for Trade Policy Studies

This year has witnessed a series of U.S. trade actions that threaten to throw the U.S.-China economic relationship and the global economy into turmoil. Following five investigations launched under three rarely invoked trade laws, President Trump has imposed — or announced plans to impose — tariffs on thousands of products from China.

Beijing has responded in kind, so prospects for an escalation of tit-for-tat protectionism are ripe, and a debilitating trade war is not out of the realm of possibilities. But, ironically, reduced tensions and improved opportunities for trade and investment are also possible as a result of Trump's aggressive approach.

U.S. trade policy under President Trump has departed sharply from the course pursued over the past 85 years. Whereas the previous 13 presidents — Democrats and Republicans, alike — have viewed trade as a mutually beneficial, win-win proposition that fosters economic growth and good relations among nations, Trump sees trade as a zero sum game with distinct winners and losers. To Trump and his advisors, the large U.S. trade deficit with China means the United States is losing at trade and that it's losing because Beijing cheats. Hence, Trump speaks of waging and winning trade wars because the Chinese are more dependent on the U.S. market than Americans are on the Chinese market.

> Trump sees trade as a zero sum game with distinct winners and losers.

All of that thinking is absurd. But even though Trump attaches meaning to irrelevant metrics like bilateral trade deficits in a global economy, where two-thirds of trade flows are intermediate goods and only 3.6% of the value of an Apple iPhone is Chinese (yet

Chinese President Xi Jinping shook hands with Dennis Muilenburg, president and CEO of the Boeing Company, after Xi's tour of the Boeing factory in Everett, Washington September 23, 2015. Boeing secured a $38 billion deal with Commercial Aircraft Corp. of China to sell 300 planes and open a facility in China during Xi's visit. (Reuters)

the entire $179 cost is chalked up as an import from China, exacerbating the bilateral deficit), the fact is that frictions in the relationship have been increasing since well before this president assumed office.

Concerns over trade imbalances, alleged trade-rule violations, subsidization and state-owned enterprises, metastasizing industrial policies, discriminatory treatment of non-Chinese companies, and other forms of trade and investment protectionism have preoccupied Washington for a decade — ever since the United States limped out of a debilitating recession to find that China had supplanted it as the world's largest manufacturer and had set its sights on leapfrogging the United States, at all costs, to the technological fore. President Obama — and to a lesser extent, President George W. Bush — pursued resolution of trade issues with China through dispute settlement at the World Trade Organization and by pointing aggrieved domestic industries to familiar U.S. trade laws for the mitigation of problems. Wisely, neither made it a U.S. policy aim to "fix" the trade imbalance. But, in retrospect, there may have been too much complacency about condemning China's technology mercantilism and compelling Beijing to refrain from forcing technology transfers and stealing intellectual property.

As far as Trump's actions are concerned, the Section 201 safeguards on solar cells and large residential washers are small potatoes. The actions make for stupid, self-flagellating economics, but they are disputes that won't leave deep marks on the relationship. The Section 232 "national security" tariffs on steel and aluminum provoked some retaliation from Beijing, but again it's just not that significant a scuffle, and will be put behind us without long-lingering animus.

What is of major importance, however, is the Section 301 case, which gets to the crux of the most important issues in the economic relationship. Trump's unilateralism puts the rules-based trading system at greater risk of collapse.

The Trump administration sounds serious about punishing the Chinese government and Chinese companies that allegedly have benefited from years of intellectual property theft and forced technology transfer policies. But U.S. businesses and consumers will pay a steep price, as well, if the raw materials, components, and other intermediate goods they require to manufacture their own output are hit with tariffs. Moreover, Chinese retaliation would also seriously impede — and likely reduce — revenues on export sales. Meanwhile, if the United States follows through with the proposed tariffs on $50 billion of Chinese goods, there will be nothing stopping other governments from going rogue when it suits their needs. The collateral damage will be broad and deep.

If the United States follows through with the proposed tariffs on $50 billion of Chinese goods, there will be nothing stopping other governments from going rogue when it suits their needs.

Trump administration officials are visiting Beijing this week, presumably to find a way to negotiate trade peace. The Chinese may seek to purchase that peace with promises to buy more Boeings and grain. The Americans may demand reciprocal access to services and investment markets, as well as tariff reciprocity. But what will remain an enduring source of friction in the relationship is the absence of rules and trust that must underpin each country's commitment to innovation and commercialization of technology. The high-tech trade skirmishes over the past decade are close to devolving into a state of technological autarky, where foreign firms, foreign capital, and foreign researchers are banned from each other's markets. That outcome would punish businesses and consumers in both countries and make the world a poorer place.

Imported nuts from the United States displayed at a supermarket in Beijing. China announced a $3 billion list of U.S. goods including pork, apples and steel pipe on March 23, 2018 and it said may be hit with higher tariffs.

A stable and growing commercial relationship between the United States and China is essential to the well-being of the global economy. A smarter, more durable approach to the problems we confront would be for Washington and Beijing to make lists of all of their gripes, put them on the table, and see whether, and to what extent, they can be resolved or mitigated in a bilateral trade or investment agreement. The United States and China have not yet dealt seriously with the prospect of a bilateral free trade agreement, and, given the current climate, such talks may be difficult to commence. However, what better way is there to avert a deleterious trade war than to resolve issues by putting them in writing and signing the document for all the world to see?

China-U.S. Trade: Does the Ballast Still Work?

Long the ballast of China-U.S. relations, bilateral trade is now a sore point.

Liao Zhengrong

Executive Deputy Director Institute for Peace Development, Chinese Academy of Social Sciences

> The US side worries Chinese firms may acquire sensitive advanced technologies through the purchase of American companies.

After the end of the Cold War, with the collapse of the former Soviet Union as a common security threat to China and the United States, the benefits arising from economic and trade cooperation have taken the place of common security interests as the cornerstone of stable China-US relations. Economic ties have been considered the ballast of bilateral relations. When the China-US relationship runs into trouble, economic ties usually serve as a stabilizer, preventing bilateral relations from sliding into greater conflict. But conditions have changed.

First, as the scale of China-US trade expands, the driving force for bilateral relations has weakened, even becoming an obstacle in some ways. Since the establishment of diplomatic relations, China-US trade has grown from $4 billion to $636 billion. As the volume of bilateral trade increases, so does the trade deficit. In 2017, the deficit in China-US commodity trade reached $375.2 billion, growing 8% over the previous year, surpassing the growth of overall trade. The US side is pushing the idea that bilateral trade benefits China while harming the US. Now that the US has defined China as a strategic rival, since the increase in trade benefits China more, it is no longer a driver for better relations, but a barricade. The Trump administration is planning to resort to such destructive means as tariffs and quotas to disrupt the future growth of China-US trade.

Second, while Chinese and American industrial structures remain more complementary than competitive, the US side is worried about Chinese products moving toward the higher end of the value chain. For the time being, US exports to China are mainly technology-intensive products, farm produce, and energy and resource products, Chinese exports to the US are mostly labor-intensive manufactured products with little added value. The pattern remains by and large complementary. But the US is concerned about the rapid rise of Chinese manufacturing on the value chain. According to Stephen Bannon, it would be too late if the US does not take action until China fulfills its "Made in China 2025" plan.

Third, investment between China and the US is unbalanced, with both parties facing changes in the investment environment. Facing more forceful competition from European, Japanese, and local rivals in the Chinese market, American investments have plateaued. Chinese investments in the US have increased very rapidly in recent years, growing 200% in 2016. Considering the depreciation of the yuan and the dramatic drop in Chinese foreign exchange reserves during the same period, there obviously was abnormal capital outflow. China moved to restrain investments in overseas real estate, hotels, cinemas, entertainment, and sports clubs. The US side worries Chinese firms may acquire sensitive advanced technologies through the purchase of American companies, "threatening US national security", and so continuously tightens national security examination of acquisitions by Chinese firms. In 2017, global Chinese overseas direct investment dropped more than a third, with direct investments in North America dropping 35%. The Trump administration is plotting more measures to limit Chinese investments in sensitive industries and technologies in the US.

Fourth, the fact that China holds a mammoth amount of US treasury bonds inspires concern. Currently China holds about $1.1 trillion in US treasury bonds. At the critical juncture of the outbreak of the 2008 financial crisis in the US, China took great pains to withhold US government-guaranteed bonds, helping the US greatly in surviving the crisis. There has since been a certain kind of political mutual confidence between the two parties. As suspicions about China increases, the US side worries those bonds may be used as leverage against it. Meanwhile, the Chinese side is concerned about its tremendous foreign exchange reserves being exceedingly reliant on the US treasury bonds market, and thus seeking to diversify its investments.

Fifth, mechanisms of China-US economic communication have been compromised. China has established communication mechanisms like the Joint Commission on Commerce and Trade and the Strategic and Economic Dialogue. After Trump assumed office, the two countries set up a series of new dialogue mechanisms, including the Comprehensive Economic Dialogue. But recently the US side has made significant changes to such mechanisms. The US has discontinued the Comprehensive Economic Dialogue, and adopted a unilateral approach to promote its policy agenda. At the crucial juncture when economic and trade conflict threatens to escalate, the two countries found themselves in an awkward situation where there seems to be no viable channel for communication, which was rare in the past few decades.

> The US has discontinued the Comprehensive Economic Dialogue, and adopted a unilateral approach to promote its policy agenda.

The US believes today's world has returned to an era of major power rivalry, so it backpedalled and applies Cold War thinking to its competition with China. Before and after Trump announced punitive tariffs against China, the Taiwan Travel Act took effect, the US navy sailed 12 nautical miles off China's South China Sea features, and the US government greatly increased financing for Tibetan exiles in India, revealing the American attempt to mount strategic pressure on China politically, economically, diplomatically, and militarily. Against this backdrop, trade, the giant cornerstone of China-US relations has become a source of shock, instead of a stabilizer.

China-US economic ties will continue moving forward in the future. But its nature will change, ushering more challenges and fierce conflicts. The Trump administration is highly adventurous, and the Chinese side must prepare for all possibilities and be ready to face the worst. Meanwhile, it is worth noticing that Trump and his team have stated on multiple occasions they are not after a "trade war", and are in favor of solving differences via negotiation. Both parties have demonstrated restraint and reason in the initial measures announced. As long as they remain committed to a negotiated outcome, they can still find a way out of the present standoff.

Sustained, steady progress in China-US economic ties means a lot to China, the US, and the rest of the world. No matter how US policy orientations change, China should remain steadfast about deepening economic relations with it. We should work with people of insight in the US and strive to establish and perfect rules for engagement amid increasingly fierce conflicts. Since the ballast has been shaken, it is imperative to try to stabilize it. The US needs to adjust. We should make efforts to press for such adjustments even if the US doesn't want to make them. At the same time, China also needs to reflect on some of its previous ideas and practices, draw lessons from the past, constantly refresh its thinking and adjust responses to cope with new challenges.

Trump is Serious About a Trade War with China

Most trade experts would agree that none of the concessions China is likely to make in the near future would significantly erode China's massive trade surplus with the United States.

James H. Nolt
Adjunct Professor
New York University

There are two major views about President Trump's approach to trade. The cynical view from much of the business community is that his bark is worse than his bite. He complains loudly about foreign trade practices, especially by China, compounded by the supposed weakness of past U.S. presidents and previous trade agreements, but that is mainly to appease his voter base. When push comes to shove, he will be satisfied with minor adjustments or progress that was already occurring even without his trade war threats . . . and then call it a victory.

> Those who take Trump more literally on trade issues, including me, warn that he really does measure success by rebalancing trade in favor of significantly more U.S. exports and fewer imports.

Those who take Trump more literally on trade issues, including me, warn that he really does measure success by rebalancing trade in favor of significantly more U.S. exports and fewer imports. By that measure, China is the biggest problem, with a persistent trade surplus now over $350 billion. Most trade experts would agree that none of the concessions China is likely to make in the near future would significantly erode China's massive trade surplus with the United States.

The U.S. stock market seems to be taking the cynical view. Although the initial announcement of Trump's $50 and then $100 billion dollar tariff threats and China's tit-for-tat responses caused stocks to fall initially, reassurances from

Trump's economic advisors, especially economic adviser Larry Kudlow and Treasury Secretary Mnuchin, seemed to restore business optimism that a trade war with China is not very likely. Most of the threatened tariffs will not go into effect for some months. Meanwhile there are supposedly backchannel talks underway that might avert a trade war (although China denies this.)

U.S. markets were further reassured by Chinese President Xi's apparently conciliatory speech at the Boao Forum for Asia on April 9. He promised to lower China's auto tariffs and further open China's financial markets to foreign firms. Trump tweeted his approval of Xi's remarks, even though these are proposals China has made for years, often with no tangible result. Furthermore, even if everything Xi promised were done, the impact on the U.S. trade deficit with China would be limited. "So what?" cynics say: like Trump's bombing raids on Syria, the point may not be to actually accomplish anything definite, but merely to appear to be a man of action.

Cynics also point to Trump's recent turnaround on the Trans Pacific Partnership (TPP). During his presidential campaign, he criticized it again and again. One of his first acts as president was to withdraw from the TPP. Now that the other 11 countries who are party to the agreement are going forward with it anyway, Trump has suddenly realized it might be useful to rejoin. Maybe Trump is not the hardcore economic nationalist that his over-the-top rhetoric seems to convey.

But it is a mistake to think Trump will back down easily now that he has brought the U.S. to the brink of a trade war with China. He lauds President Xi's words about further opening of China's economy, but having laid over $150 billion of new tariffs on the table, he is not likely to back away from the brink without an obvious and incontrovertible win. Conciliatory words may not suffice. Much like in his pending negotiation with North Korea about its nuclear program, his timetable is for swift action by the summer, not negotiations that drag on for years.

The reason Trump is more impatient than past presidents is his political vulnerability. This year, before the November 2018 midterm elections, he must score some momentous foreign policy victories on the scale of Nixon's great initiatives during 1972. Otherwise, he is facing repudiation by the voters as his Republican Party faces voter wrath. Already, a record number of powerful incumbent Republican congressmen, including the Speaker of the House, Paul

None of the concessions China is likely to make in the near future would significantly erode China's massive trade surplus with the United States.

Ryan, are retiring rather than fighting for reelection. They anticipate a strong showing by the opposition Democratic Party that could win majorities in both houses of Congress. If this happens, Trump faces — based on the relentless progress of the investigation led by Special Prosecutor Robert Mueller — a real prospect of impeachment. I reject the cynical view of Trump aiming at only superficial public relations victories, because I believe Trump knows these will not be enough to energize his voter base and stave off defeat at the polls, and perhaps disgrace.

If Trump does stay the course, demanding that North Korea abandon its nuclear weapons and that China acts to significantly reduce its massive trade surplus with the U.S., then this is the critical year for him. If he does not succeed this year, he might not have another chance. Trump has thrown down the gauntlet by putting a massive trade threat on the table. This is a bolder and more drastic move than any previous president has done. It is a high stakes gamble. If he backs down with little to show for it, he will look weak.

> I reject the cynical view of Trump aiming at only superficial public relations victories, because I believe Trump knows these will not be enough to energize his voter base.

Broadly speaking, the U.S. has two major categories of disputes with China: the old economy and new economy. The old economy disputes relate to Chinese overcapacity in such industries as steel, aluminum, and soda ash. The U.S. and other foreign producers argue that Chinese firms receive unfair subsidies in the form of tax rebates and subsidized infrastructure, credit, etc. These sorts of subsidies are not at all unique to China. Furthermore, excess capacity and price wars have emerged in every crisis of capitalism for centuries, even without government intervention, as during the 1860s oil boom in Pennsylvania and the post-Civil War railroad boom and crash cycle of the later 19th century. Dealing with these problems is difficult within institutions such as the World Trade Organization, whose rules falsely presume that problems like this only emerge from government action, not from private power and the cyclical nature of capitalist investment. The problem is compounded in China's case because of the decentralization of economic power since Deng Xiaoping launched "market socialism." Many

> The reason Trump is more impatient than past presidents is his political vulnerability.

> Trump has thrown down the gauntlet by putting a massive trade threat on the table.

investment decisions are spurred by local governments more bullish than the Beijing authorities, but also somewhat autonomous. Even in the absence of government intervention though, monopoly power and episodic disequilibrium guarantee perpetual trade disputes.

The "new economy" disputes may be even more intractable. China wants a tight rein over the internet as a critical means of communication and, frankly, spying. Therefore, China is trying to force companies to share technology and proprietary code so that it can assure that there are backdoors for the Chinese government, but not for outside intruders. China is also worried about the vast amounts of data the internet companies acquire and what they or foreign governments might do with it. This is an issue of political power as much as economic competition. The recent scandals in the U.S. about Russian interference in the U.S. 2016 election highlight the dangers. The U.S. arguments for both corporate privacy and open access to the Chinese market start to sound more dangerous, given what is happening in the U.S. itself.

There are important reasons for Chinese government foot-dragging on many disputed issues, including the inability of the central government to enforce its will on every local authority and Chinese officials' own insecurity about potential spying and subversion. One need not sympathize with these concerns to recognize that many of the major issues under dispute are not easy for Beijing to concede. Trump may push hard for major concessions, but China may also resist most of what he wants. The result might very well be a trade war that will injure both countries.

By Focusing on Trade, Trump is Badly Missing the Target on China

By turning inward and prioritizing a few domestic factories over the larger dynamics at play between the U.S. and China, President Trump seems to be fighting the small battles and conceding the bigger ones.

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Earth Institute China Initiative of Columbia University

Like China's today, Japan's economic rise since World War II was export driven. It used a range of industrial policies to aid its exports and tried everything it could to obtain U.S. technology. One crucial difference is that Japan depended on the U.S. for security. When in 1987, the Reagan Administration exploited Section 301 of the U.S. Trade Act of 1974, the same tool the Trump Administration is using against China today, to levy a 100% tariff on select Japanese goods, not only did Japan not retaliate, it did not even threaten to retaliate. Robert Lighthizer, the current U.S. Trade Representative was a midlevel trade official in the Reagan Administration. The ultimate effects of the Reagan era tariff are debatable.

China is a country that, not so long ago, endured the hardship of the cancellation of aid from the former Soviet Union in the midst of the Great Famine. Most Chinese today would be willing to fight a trade war with the United States and are determined not to repeat Japan's mistakes. To win a war, you have to know your enemy. It's not smart for President Donald Trump and his advisers to ignore the national sentiment in China. The playbook on Japan will not easily work on China.

China is a country that, not so long ago, endured the hardship of the cancellation of aid from the former Soviet Union in the midst of the Great Famine.

After joining the WTO in 2001, China pledged to gradually adjust its exchange rate regime which pegged the RMB to the USD. As China's current account surplus soared in the following years, China initially resisted international calls to revalue its currency, and pointed to how a revaluation of the Japanese Yen by more than 50% from 1985 to 1987 irreversibly changed the upward trajectory of the Japanese economy.

Lawrence Kudlow, President Trump's

The playbook on Japan will not easily work on China.

National Economic Council Director, has been eager to remind people how China has not been playing by the WTO's rules, how it has forced the transfer of U.S. technology, and how China is no longer a "third world" country.

Of course, there is truth to these arguments. China has become the world's second largest economy. However, China will argue that it's still not developed because its living standard is only 15% of that of the U.S., as measured by per capita GDP. China will also argue that since its entry into the WTO, it has significantly liberalized its economy. The average tariff has gone down to less than 10%. The opening and liberalization of the Chinese market has benefited American companies and consumers with cheap products, which more than offset the loss in manufacturing jobs due to supply chain relocation to China. The RMB has also risen against the USD, by no less than 20%. More recently, China spent one trillion dollars of its foreign exchange reserves to prevent the RMB from devaluing, which would surely have irritated the Trump administration.

However, U.S. officials are not satisfied by the gradualist approach China has taken in liberalizing its economy, claiming it's always been "too little, too late". China is likely to make concessions and speed up its reforms but is expected to resist U.S. pressure for radical change, adhering to its gradualist approach of "crossing the river by feeling the stones."

It seems that President Trump's number one goal is to revitalize U.S. manufacturing. A trade war with China may bring back jobs. But if bringing back manufacturing jobs is the goal, China can simply pledge to import more cars and semiconductors from the U.S. and make additional investments in U.S. industries. China will find it harder to address the other U.S. demands to drastically broaden market access and lower subsidies to certain sectors, as it runs counter to Chinese gradualism. Ultimately, the Trump administration may settle for China's incremental changes because multinationals are not Trump's main support base and disrupting the global economy for them would be counterproductive.

When dealing with China, the U.S. is wrong to prioritize bilateral trade. While the U.S. uses a 30-year-old playbook to challenge China, China is shifting its attention to Southeast Asia, Latin America, Africa, and even the Middle East through its "One Belt One Road" initiative. The math is simple for China. In order to continue its high-powered growth, China needs to expand the economic pie by cultivating emerging markets. Growing its already large economy through domestic consumption is already proving difficult. Another way would be to take a bigger slice from the existing pie, which would surely further antagonize the U.S. and others.

For the U.S. to maintain its position and continue its technological dominance, it has to compete with China in far corners of the world. Aware of the U.S.'s power, President Xi proposed to work with it on the world stage in a "new power relationship" and was ready to make concessions. Former President Obama balked, and countered instead with multilateral trade agreements, a pivot to Asia, and deepened engagement in Latin America.

By turning inward and prioritizing a few domestic factories over the larger dynamics at play between the U.S. and China, President Trump seems to be fighting the small battles and conceding the bigger ones. In time, trade friction with China may subside, not because of his successful tactics, but because trade will have gone elsewhere.

> If bringing back manufacturing jobs is the goal, China can simply pledge to import more cars and semiconductors from the U.S.

While globalization improves economic efficiency, its distributional impact has been less satisfactory. Recent U.S. administrations have failed to convince the American people of the merits of globalization. President Trump, whose goal is to "Make America Great Again," is antagonizing the developing world, while China goes in and snatches its support.

> The Trump administration may settle for China's incremental changes because multinationals are not Trump's main support base.

The U.S. Move on ZTE Was Short-Sighted

China's long-term focus on the direction of its tech market gives it a clear edge over the United States in the latest tech tussle between the two countries: a ban announced by the U.S. government earlier this month forbidding any U.S. companies from selling any parts or software to Chinese telecom company ZTE.

The U.S. tech industry has typically moved into new areas in sudden spurts, following the trendiest high-tech flavor of the month: mobile, cloud, big data, block chain. The trajectory and focus of China's tech industry, by contrast, is carefully planned several years into the future according to the government's perception of what the biggest sectors of the market will be in coming years. China's long-term focus on the direction of its tech market gives it a clear edge over the United States in the latest tech tussle between the two countries: a ban announced by the U.S. government earlier this month forbidding any U.S. companies from selling any parts or software to Chinese telecom company ZTE Corp. for seven years.

In the short term, of course, that ban is bad news for ZTE, and the Chinese economy more generally. Without access to the U.S. semiconductor market, ZTE will struggle to manufacture smartphones and other telecommunications equipment since the company currently relies on U.S. firms to supply roughly one-third of the crucial components for its products, according to Reuters.

But in the long term, such a ban would only serve to strengthen the Chinese tech industry by forcing the country to shift its focus to producing more of its own semiconductors domestically,

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as well as other device parts that it currently purchases from U.S. firms. Semiconductors are an obvious area for China to expand its domestic market, especially in the face of a hostile U.S. government: last year, China imported $11 billion in semiconductors and related products from the United States.

If Chinese firms were able to produce those products themselves, not only would U.S. firms lose out on that export business— they would also probably find themselves competing directly with Chinese firms in every other market around the world where they do business. That won't happen overnight, of course. Building up its semiconductor manufacturing capabilities will almost certainly take China years and, in the meantime, some U.S. firms may well benefit from ZTE's woes since ZTE is currently the fourth most popular smartphone manufacturer in the United States. But long term, the United States and many of its semiconductor firms will very likely regret having pushed China into such a lucrative and successful segment of its tech economy.

> Semiconductors are an obvious area for China to expand its domestic market.

There is still a possibility that the ban may not remain in place. The ban apparently stems from ZTE's disregarding an agreement in which it had promised not to ship U.S. technology to Iran. In March 2017, the company paid an $890 million fine after admitting to exporting U.S. technologies to banned countries and also promised to dismiss four senior employees and discipline at least 35 others. According to the U.S. government, however, ZTE never carried out all of those promised provisions and repeatedly lied about having done so, prompting the ban.

But ZTE has been granted an opportunity to provide more evidence of its compliance to the U.S. Commerce Department, presumably in the hope of reversing the ban. The company also announced that it had established a new compliance management committee to oversee its efforts to meet crucial legal requirements. Additionally, Reuters reported, ZTE's chief compliance and legal officer Cheng Gang was removed from his post in March, well before the U.S. government announced the ban in April.

It remains to be seen whether these measures will satisfy the U.S. government and persuade them to lift the ban. But it may not matter much, in the long term, whether they do or not.

China has already received the message loud and clear that it is dangerous to be as reliant as it currently is on U.S. semiconductors for fear of similar actions being taken against their other firms. Regardless of whether the United States follows through on its seven-year ban of sales to ZTE, the Chinese government will push for increased domestic production of semiconductors in the years to come.

The United States and many of its semiconductor firms will very likely regret having pushed China into such a lucrative and successful segment of its tech economy.

Already, even prior to the ban, China had established the ¥140 billion China Integrated Circuit Industry Investment Fund to provide support to Chinese semiconductor companies. Many of those companies saw their stocks increase significantly in the aftermath of the ZTE ban as Chinese newspapers issued urgent calls for the nation to strengthen its domestic semiconductor chip industry. China's goal, as laid out in a 2015 State Council plan, is to supply 40% of its own chips by 2020, and 50% by 2025.

These are ambitious goals for a country with a relatively small semiconductor industry, and they may yet turn out to be impossible for China to meet, at least on such a short time table. But long-term planning and growth is precisely where China's tech industry excels and the ZTE ban will help push China to make good on its plan to achieve greater independence from the U.S. semiconductor market, even if not by 2020.

At a moment when the United States is so deeply protective of its semiconductor industry, and so profoundly mistrustful of Chinese tech companies, it's astonishing that they should be so short-sighted as to spur the development of a host of Chinese competitors in that market. It's a decision the U.S. government and tech firms may well find themselves regretting at some point in the future that they are not yet planning for, but that China certainly is.

The World's Two Biggest Economies

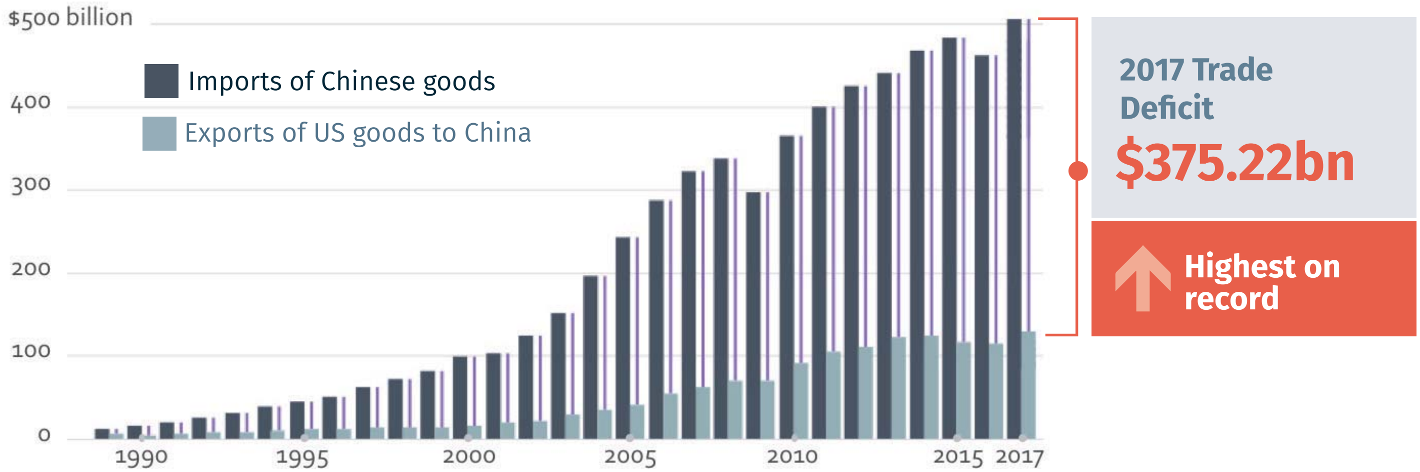
You can visit US-China Economic Relationship website.

Accusations of unfair trade practices have led to the threat of tariffs between the US and China. As fears of a trade war between the world's two biggest economies grow, what's at stake in this important relationship?

US		China
No.1	**Economy** Rank	No.2
$ 20.41 trillions	GDP (April 2018)	$ 14.09 trillions
2.9%	Growth Rate (2018 est.)	6.6%
$ 62,150	GDP/Capita (2018 est.)	$ 10,900
327~ millions	Population	1.4~ billions
No.3	Population Rank	No.1
9.83 millions	Area (sq km)	9.60 millions

Source: IMF; Statisticstimes

2017 Record Trade Deficit



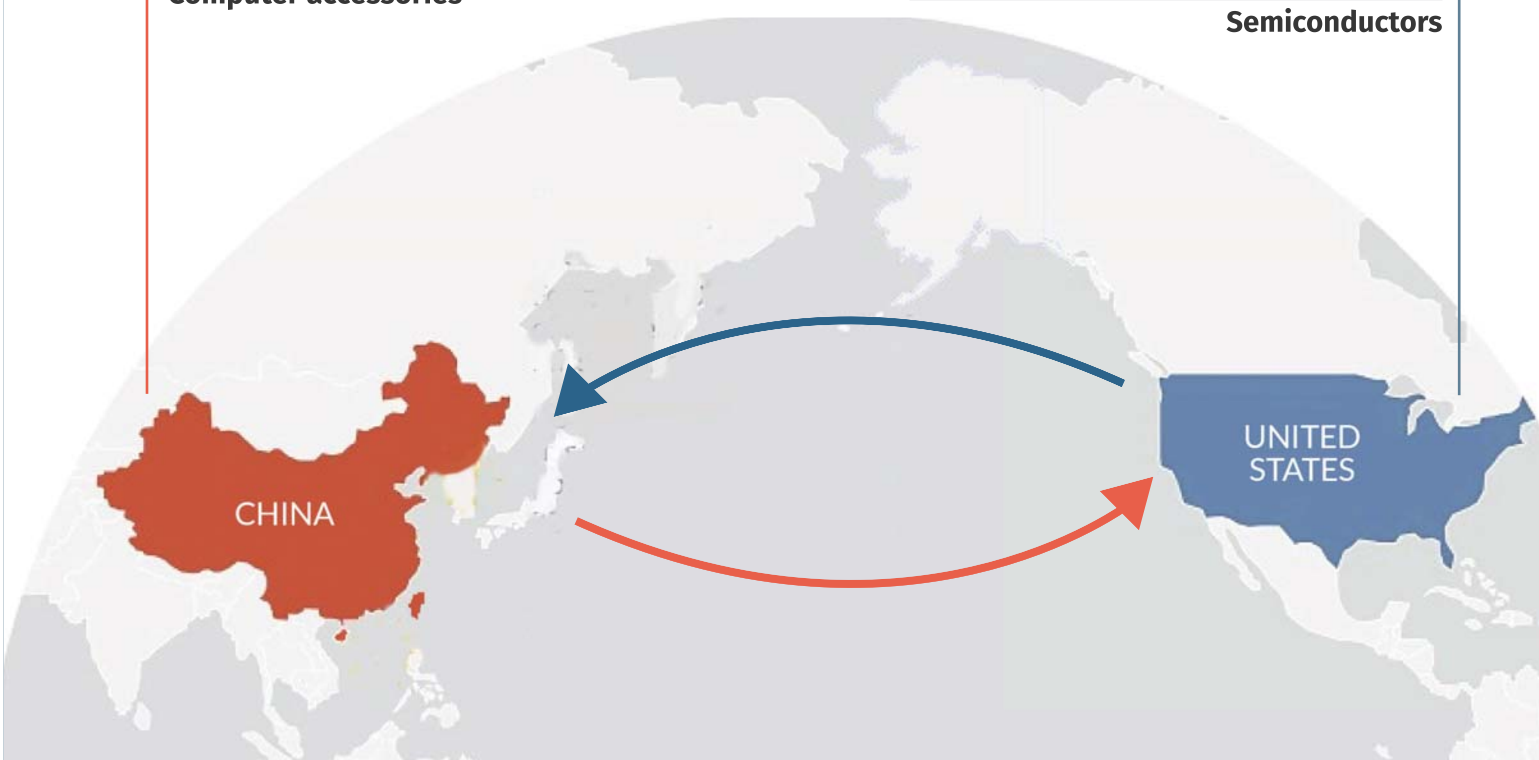
Source: www.census.gov

Major Chinese **Exports to US**

- Cellphones and household goods, n.e.c.
- Computers
- Telcomm. equipment
- Computer accessories

Major US **Exports to China**

- Airplanes
- Soy beans
- Cars
- Electronics, equipment and machines
- Semiconductors



On balance, U.S. trade with China benefits Americans

In 2016, US exports **$169 billion** and created 910,000 US jobs

By 2030 , exports are expected to total **$525 billion**

With a US-China bilateral investment treaty, annual US exports would increase by **$400 billion** , creating 170,000 new US jobs

Chinese investment projects cover **98%** congressional districts, across 46 states, creating 140,000 American jobs

The US could receive **$300 billion** in investments from China, 1 million American workers would be employed by Chinese-owned firms by 2020

In 2016, a total of **3 million** Chinese tourists and travelers visited the US, supporting 554,000 local jobs

In 2016, more than 353,000 Chinese students studying in the US and contributing **$15.9 billion** to the US economy.

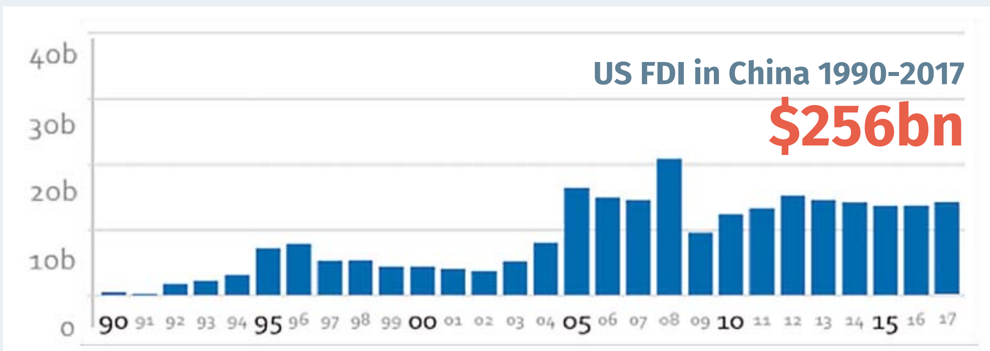
Trade with China saves American families about **$850 per year.**

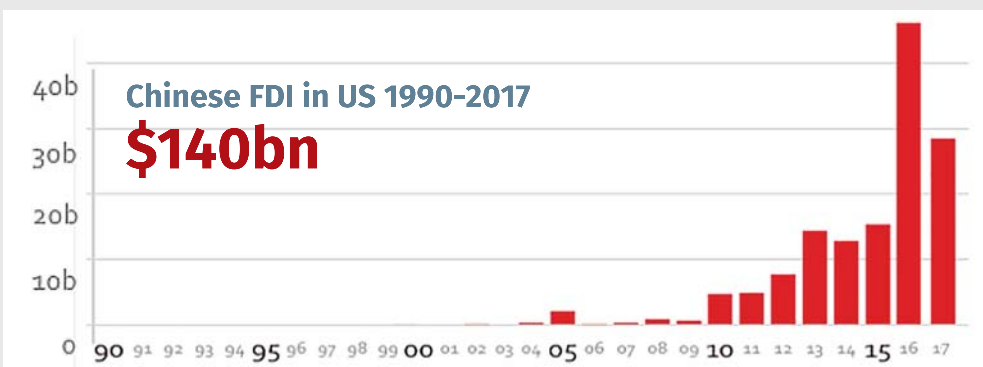
Typical US household income	**$56,500**
Trade relationship's effect on consumer prices	**x .015**
Yearly savings for typical American family	**= $850**

Chinese FDI in U.S. surging, but facing restrictions

Major Chinese **Purchases** in US in past 2 years

- HNA ▶ CIT's aircraft leasing unit **$10 billion**
- HNA ▶ Hilton Hotels **$6.5 billion**
- HNA ▶ Ingram Micro **$6 billion**
- Qingdao Haier ▶ General Electric appliances business **$5.6 billion**
- Anbang ▶ Strategic Hotels properties **$5.5 billion**
- Apex Technology ▶ Lexmark **$3.6 billion**
- Wanda ▶ Legendary Entertainment **$3.5 billion**





Major Chinese deals **Blocked**

2017

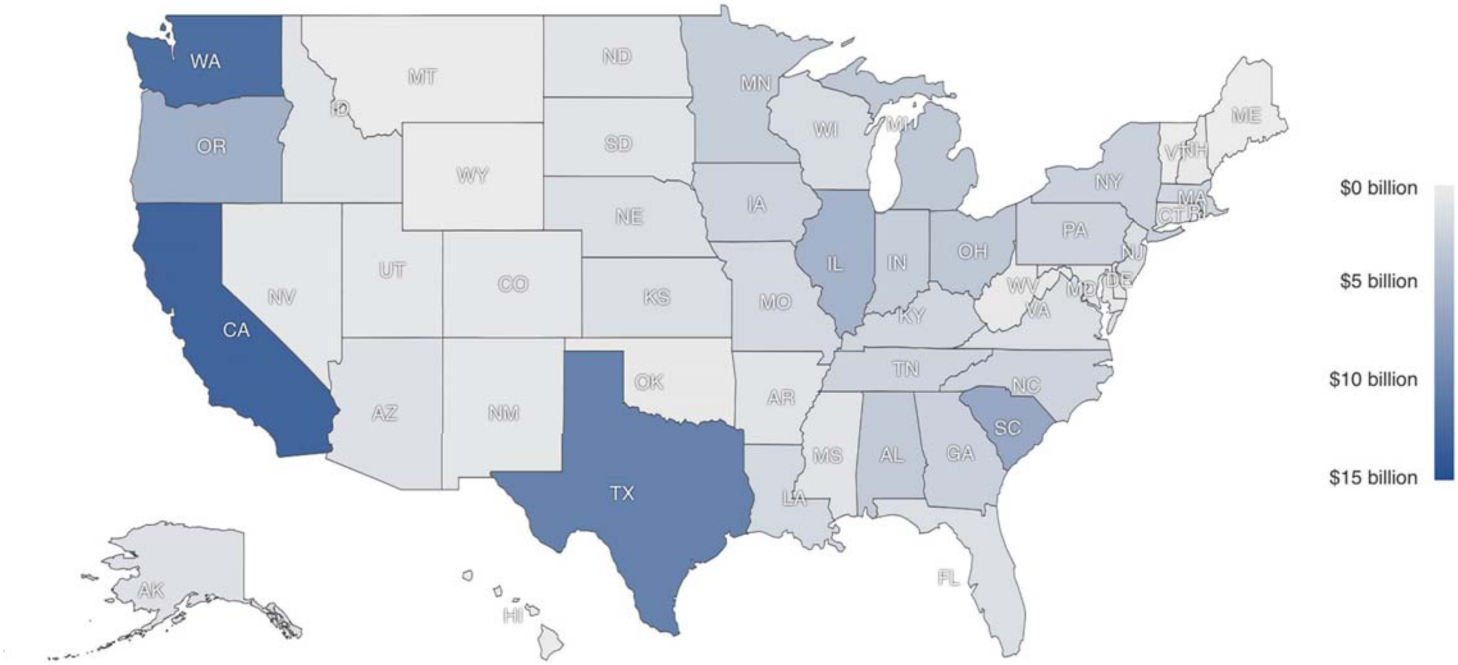
- Canyon Bridge Capital Partners ▶ Lattice Semiconductor **$1.3 billion**
- Orient Hontai Capital ▶ AppLovin **$1.4 billion**
- China Zhongwang Holdings ▶ Aleris **$2.3 billion**

2018

- Broadcom ▶ Qualcomm **$117 billion**
- Ant Financial ▶ MoneyGram **$1.2 billion**
- HNA ▶ Skybridge Financial* **$180 million**

Source: Rhodium Group, New York Times

How do the different states benefit from economic exchange with China?



No.	State	Goods Export to China in 2017/ billion	Services Export to China in 2016/ million	U.S. Jobs supported in 2016	Chinese Investment	local jobs by FDI
1	Alabama	3.6	383	17,400	$1 billion since 2000	2,250
2	Alaska	1.3	136	6,100	$10 million since 2000	/
3	Arizona	1.2	1,011	13,400	$1.6 billion since 2000	1,350
4	Arkansas	0.9	175	8,600	$70 million since 2000	170
5	California	16	9100	121,600	$21 billion since 2000	16,000
6	Colorado	0.647	952	10,900	$605 million since 2000	1,000
7	Connecticut	0.762	639	7,700	$50 million since 2000	480
8	Delaware	0.38	186	2,900	/	180
9	Florida	1.9	3,400	31,000	$1.8 billion since 2000	2,500
10	Georgia	3	1,300	23,400	$1.9 billion since 2000	4,300
11	Hawaii	0.121	414	3,600	$800 million since 2000	100
12	Idaho	0.468	128	5,200	/	90
13	Illinois	5.7	2,300	53,800	$5.6 billion since 2000	6,700
14	Indiana	3.1	856	26,300	$590 million since 2000	1,950
15	Iowa	2.1	338	23,600	$1.1 billion since 2000	4,600
16	Kansas	1.2	278	13,300	$2.4 billion since 2000	2,220

No.	State	Goods Export to China in 2017/ billion	Services Export to China in 2016/ million	U.S. Jobs supported in 2016	Chinese Investment	local jobs by FDI
17	Kentucky	3.2	453	15,300	$4.3 billion since 2000	10,000
18	Louisiana	2.5	772	15,500	$1 billion since 2000	400
19	Maine	0.241	126	2,200	/	/
20	Maryland	0.675	952	9,700	$170 million since 2000	740
21	Massachusetts	2.3	2,300	27,200	$4.3 billion since 2000	1,900
22	Michigan	4	1,100	29,200	$2.8 billion since 2000	10,000
23	Minnesota	3	712	25,800	$1 billion since 2000	2,800
24	Mississippi	1	208	9,300	/	/
25	Missouri	1.7	829	19,900	$1.1 billion since 2000	4,700
26	Montana	0.245	95	2,600	$70 million since 2000	/
27	Nebraska	1.4	182	15,100	$480 million since 2000	3,000
28	Nevada	0.804	932	10,500	$200 million since 2000	170
29	New Hampshire	0.424	211	3,300	$320 million since 2000	450
30	New Jersey	1.6	1,400	15,700	$1 billion since 2000	1,880
31	New Mexico	1.019	192	3,900	/	/
32	New York	3.1	5,300	49,800	$17 billion since 2000	6,440
33	North Carolina	2.6	1,300	24,700	$5.9 billion since 2000	16,000
34	North Dakota	0.765	76	9,000	/	/
35	Ohio	4	1,200	30,900	$1.7 billion since 2000	5,000
36	Oklahoma	0.287	381	4,700	$1.9 billion since 2000	1,220
37	Oregon	3.8	681	31,200	$330 million since 2000	660
38	Pennsylvania	2.7	1,700	26,500	$930 million since 2000	2,170
39	Rhode Island	0.166	189	2,100	less than $10 million between 2000 and 2016	/
40	South Carolina	6.3	526	34,800	$1.6 billion since 2000	2,760
41	South Dakota	0.804	95	9,600	/	3,500
42	Tennessee	2.7	819	20,400	$870 milion since 2000	2,150
43	Texas	16	4,300	74,700	$8 billion since 2000	4,800
44	Utah	0.704	395	6,000	$240 million since 2000	1,600
45	Vermont	0.204	93	1,700	/	/
46	Virginia	1.5	1,100	15,300	$2.5 billion since 2000	5,400
47	Washington	14	1,500	64,500	$1 billion since 2000	1,460
48	West Virginia	0.538	171	3,800	/	/
49	Wisconsin	1.9	491	14,100	$660 million since 2000	2,200
50	Wyoming	0.058	60	900	$1.3 billion	/

"THE ANNUAL US-CHINA TRADE DEFICIT AMOUNTS TO $367.4" BILLION."

Statistics used to measure trade flow usually pin the entire trade value of a product to thee last place it was exported from, even if its components come from other countries.

For example, in the case of the iPhone, Apple handles its design, software, and marketing in the US. High-value components come from a variety of countries: processors from the US, barometric pressure sensors from Germany, displays from South Korea and Japan, touch ID sensors from Taiwan. Only the final assembly takes place in China, and the wages paid to Chinese workers for this are a comparatively small part of the total manufacturing cost.

However, when a completed iPhone is then exported to the US, the entire import cost is attributed to China in US trade statistics. Since many companies use China as the final assembly point, this is the case with many other products, too. A more accurate figure, taking into account value added, is around $132.7 billion.

"MOST AMERICANS DON'T BENEFIT FROM TRADE WITH CHINA."

Chinese products lower prices for US consumers by 1-1.5%. The benefits from Chinese trade allowed the average American household to save $850 in 2015, when median household income was $56,500.

Trade with China also allows Americans to enjoy benefits to their environment and their quality of life. Lower-end manufacturing operations generate substantial pollution and pay low wages. Since a lot of that manufacturing has migrated to China, the US has effectively exported a lot of this pollution. Furthermore, by outsourcing lower-end manufacturing jobs, the US has been able to specialize in higher-end operations, which pay higher wages. Many Americans enjoy cleaner air and water and a higher standard of living as a result.

Both Sides of the Story

China is often blamed for its trade imbalance with the US. But what's the other side of the story?

"AMERICA DOESN'T BENEFIT MUCH FROM EXCHANGES WITH CHINA."

The US runs a large trade surplus with China in services. Although small compared to the trade deficit in goods, this surplus is rapidly growing, increasing from an annual average of less than $2 billion from 2000-2008 to $37.4 billion in 2016.

In 2016, more than 353,000 Chinese students went to America to study, contributing $15.9 billion to the economy.

"THE US-CHINA TRADE IMBALANCE IS DELIBERATELY CAUSED BY THE CHINESE."

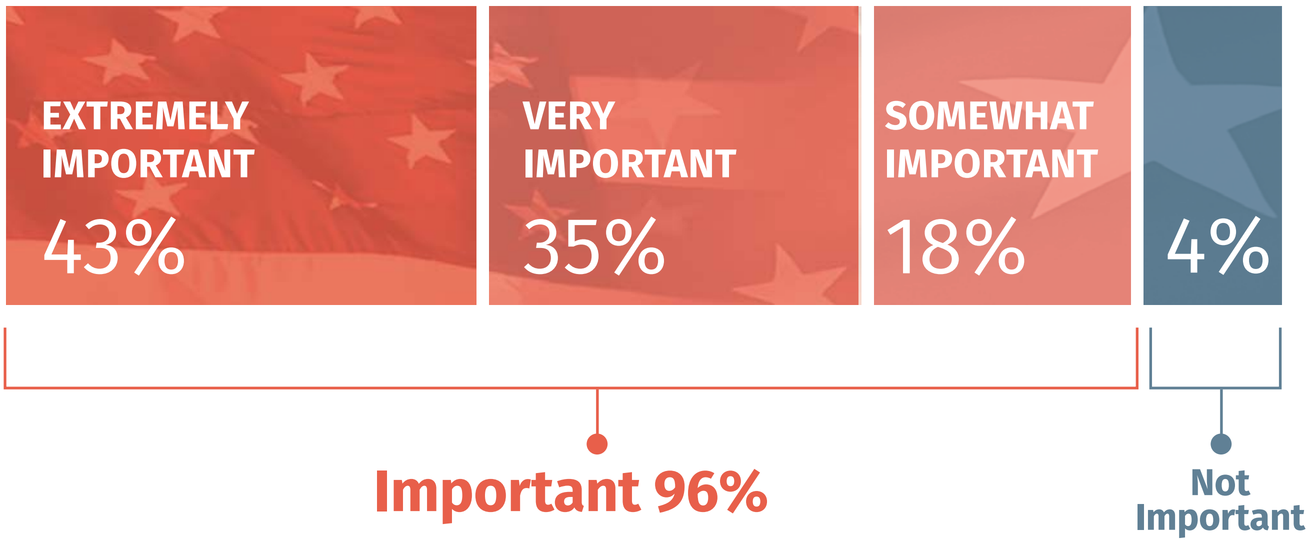
The US-China trade imbalance is not deliberately caused by the Chinese. It's due to divisions in the global value chain and structural differences between the industries in the two countries. For example, Americans are large consumers of electronic products. But because wages in America are high, it has no competitive advantage in manufacturing. Because wages in China are low, it has this advantage.

"CHINA IS A CURRENCY MANIPULATOR THAT ACTIVELY DEVALUES THE YUAN TO BOOST ITS OWN EXPORTS."

In the past year, if there was any manipulation of the yuan by China, it was to prevent it from devaluing against the US dollar – the opposite of what it would need to do to boost its exports.

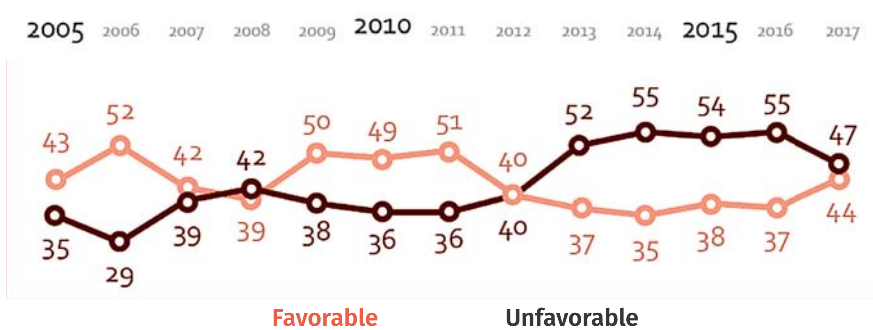
Love-hate relationship, but an important one

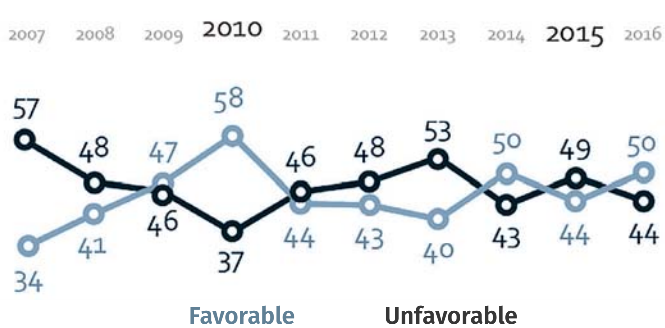
How important are positive bilateral relations between China and US to your business growth in China (2017)



Source: AmCham China Business Climate Survey 2018

U.S. views of China





Chinese views about the U.S.

Source: Pew Research Center

Recent Developments 2017-2018

U.S. ACTION | CHINESE ACTION

2017

U.S. ACTION

Aug.
U.S. initiates Section 301 investigation of “Chinese theft of intellectual property”.

Oct.
U.S. imposes anti-dumping duties on Chinese aluminum foil.

CHINESE ACTION

Nov.
Xi hosts Trump for state visit - $250 billion of “deals” signed.

U.S. ACTION

Dec.
U.S. labels China a “revisionist power” in National Security Strategy.

2018

U.S. ACTION

Jan. 17
U.S. imposes countervailing duties on imports of stainless steel flanges from China and India.

Jan. 22
U.S. imposes safeguard tariffs on washing machine and solar-cell imports.

CHINESE ACTION

Feb. 4
China starts a one-year anti-subsidy investigation into grain sorghum imported from the U.S.

U.S. ACTION

Feb. 14
U.S. imposes anti-dumping duties on cast-iron pipe fittings from China.

Feb. 27
U.S. imposes anti-dumping and countervailing duties on aluminum foil from China.

CHINESE ACTION

Feb. 27 – Mar. 3
China’s Vice Premier Liu He meets with U.S. economic officials.

Feb. 28
China’s commerce ministry says it’s “strongly dissatisfied” with the duties on aluminum foil.

U.S. ACTION

Mar. 8
U.S. imposes countervailing duties on forged steel fittings from China.

President Trump signs off on stiff tariffs on imported steel and aluminum.

Mar.20
U.S. imposes anti-dumping duties on stainless steel flanges from China and India.

Mar. 22
U.S. imposes anti-dumping duties on carton-closing staples from China.

U.S. Trade Representative proposes 25 percent duties on Chinese products under section 301.

Mar.23
U.S. complains to the WTO about protection of intellectual property.

CHINESE ACTION

Mar. 23
China unveils tariffs on $3 billion of U.S. imports in response to the steel and aluminum duties.

Apr. 2
China says it will start levying tariffs on $3 billion of U.S. imports including fresh fruits, nuts, wine and pork.

U.S. ACTION

Apr. 3
The U.S. releases a list of targets for proposed tariffs on $50 billion worth of imports. The list is dominated by high-tech industrial products.

Apr. 4
U.S. responds to China’s WTO complaint, calling it baseless.

CHINESE ACTION

Apr. 4
China says it will levy an additional 25 percent tariff on imports of 106 U.S. products including soybeans, automobiles, chemicals and aircraft.

China complains to the WTO about the Section 301 tariff action by the U.S.

U.S. ACTION

Apr. 5
Trump says he’s instructed the USTR to consider $100 billion of additional tariffs.

CHINESE ACTION

Apr. 6
China’s commerce ministry says the nation will fight to the end and at any cost.

U.S. ACTION

May 3-4
U.S. delegation led by Treasury Secretary Steven Mnuchin has trade talks with China’s Vice Premier Liu He in Beijing.

May 8
Trump and President Xi talk over phone on trade and North Korea.

CHINESE ACTION

May 9
Liu He is confirmed to go to the U.S. to continue trade talks.

(Source: Bloomberg and agencies)

Calm Down, China and the US Have Always Been 'Strategic Competitors'

Fears of serious conflict between China and the U.S. are the result of hasty conclusions, superficiality, one-sidedness, and claptrap.

Yin Chengde
Research Fellow
China Foundation for International Studies

In its recent National Security Strategy Report, the US announced a shift of its strategic focus from fighting terrorism to responding to global power competition, while characterizing China as the primary national security threat and a main strategic competitor. This was quickly followed by a series of moves to ramp up military and economic pressure on China, moves that indicated a shift of America's China policy towards one of containment. Such a development certainly gives rise to concerns among the Chinese.

But to me, some remarks on the latest US policy changes, as well as their negative impact, have gone a little too far. For example, one described the US shift as a reversal of its long-standing China policy, with the period of relative stability based on coordination and cooperation between the two countries being replaced by a period of sustained adversarial confrontation. Another argued that the two countries will fall into the "Thucydides trap" and end up fighting a cold war, perhaps even a hot war in the South China Sea or Taiwan Straits. A China-US trade war is also said to be on the cards. These remarks are totally untenable, for they fail to see the wood for the trees, mistake things' appearance for their essence, jump to hasty conclusions, and are guilty of superficiality, one-sidedness, and claptrap.

In fact, it is nothing that special for the US to adjust its foreign policy and strategies from time to time. During the first decade after the end of the Cold War and just before the War on Terror started, the US had made geopolitical power rivalry the focus of its

> It is nothing that special to characterize China as a threat or strategic competitor to the U.S.

national security strategy. When President Barack Obama ended the Iraq War, he in fact reinstated global power competition as the focus of US national security strategy, which caused no conflict or confrontation between the US and other global powers. By the same token, it is nothing that special to characterize China as a threat or strategic competitor to the US. Ever since China overtook Japan in 2010 as the world's second largest economy, the US has gone out of its way to call China a threat and regarded it as a major challenger to its hegemonic power. The Obama administration's ensuing "rebalancing" strategy in the Asia-Pacific was aimed at preventing and containing China's rise. But facts are more powerful than wishful thinking. Proceeding from its overall national interests, the US has consistently made engagement its priority in its relations with China while keeping containment on the backburner. Taking an extreme view on America's latest China policy, even to the point of seeing an imminent cold war between the two countries, therefore, is dead wrong, for it goes against both history and reality.

A China-U.S. relationship featuring both bickering and cooperation will not change.

What one must not overlook is the fact that the factors keeping China-US relations essentially positive all these years remain. First, America still needs a helping hand from China in a complex, fluid, and turbulent world. It is a world that is full of threats and challenges, such as the proliferation of nuclear weapons, climate change, international terrorism, financial crises, and sporadic outbreak of regional conflicts. No country can escape them unscathed, and as a country enjoying global presence and having interests all over the world, the US certainly bears the brunt of the pressure from them. Even a superpower cannot manage them all by itself. International cooperation is a must, and cooperation from China is essential. The US isn't in great shape right now, and things would only be harder without Chinese cooperation.

Second, China does not constitute a threat or a challenge to the US. China preaches and practices peaceful development, pursuing a foreign policy of peace and following a defensive policy. China has long since forsworn global hegemony and refrained from seeking domination of any region or the world at large. This is China's national policy, and its unshakable conviction, which makes it impossible for China to threaten or challenge the US or any other country. Though China has grown stronger thanks to 40 years of robust development, it still lags behind America economically with a GDP barely two thirds that of the US. The gap is even bigger when it comes to military capacity, science and technology, and overall national strength. China cannot possibly threaten or challenge the US. The "China threat" paranoia in the US is not based on facts, but is driven by anti-China prejudice and the selfish interests of America's military-industrial complex. The American government, which is by and large pragmatic towards China, is not expected to contain China as confronting China would bring grave and unpredictable risks.

Third, economic cooperation is still the stabilizer of China-US relations. After 40 years of rapid development of economic relations, China and the US have become each other's biggest trading partner and the largest source of foreign investment. What's more, China is America's largest creditor. Around 70% of China's huge foreign exchange reserve, or roughly $2 trillion, is in the form of US dollars, which is crucial for the US to balance its budget, avert financial risks, and maintain the Dollar's status as the world's base currency. In fact, economic relations between China and the US has become the ballast of their overall relationship, where a high degree of mutual interdependence has made them inseparable partners in the community of shared interests. Thus, an imminent trade war between the two countries is a fake proposition because none of them could afford the irreparable harm that will come with it.

Fourth, one year into the Trump administration, we can see that the two heads of state have laid a good foundation for the sound development of China-US relations. They have met three times in person and called each other eleven times on the hotline, and reached important agreements on major bilateral and international issues. In particular, President Xi's visit to Mar-a-Lago and President Trump's visit to China both brought historical achievements. The two presidents developed a cordial personal rapport and a sound working relationship, which will go a long way towards closer and steadier ties between the two countries.

> America's policy of engagement plus containment with engagement as the mainstay will not change.

In summary, we should look at the negative changes in America's China policy with objectively and calmly. These changes have certainly affected China-US relations. But they will not herald a fundamental turn for the worse, or a wholesale retrogression in the relationship. America's policy of engagement plus containment with engagement as the mainstay will not change. Their shared perspectives will continue to outweigh their differences. And a China-US relationship featuring both bickering and cooperation will not change. China-US relations will continue to go forward and upward, albeit with ups and downs and twists and turns.

The DPRK Nuclear Issue: Possible Outcomes

What policies will China and the U.S. adopt and how will they play their roles?

Zhang Tuosheng
Director
China Foundation for International Strategic Studies

How will the DPRK nuclear crisis develop after the success of the South-North Summit on 27 April? What policies will China and the US adopt and how will they play their roles? I will attempt some analysis based on four possible scenarios.

In the first scenario, actual progress will be made in the DPRK-US dialogue, and an agreement on freezing DPRK's nuclear program will be reached. This will open the gate to multilateral dialogues in line with the dual-track approach. In such a process, the US will be critical and China must also make a significant effort.

The US has critical roles to play: making sure that the summit with the DPRK goes smoothly with an agreement to start the denuclearization dialogue; resuming denuclearization dialogue with the DPRK as soon as possible, steering it towards gradual progress and avoiding easy interruption over major differences; and persuading the DPRK to accept inspections by giving reasonable rewards such as decreasing the scale and frequency of or even suspending joint military exercises with South Korea and removing some sanctions, whilst maintaining military and diplomatic pressure.

> In order to realize the freezing of the DPRK nuclear program, a critical question is whether there will be verification and how verification will be conducted.

China may also play important roles: actively supporting the US-DPRK summit and potential follow-up dialogues; supporting the US and the DPRK to first agree on targets for verifiably freezing its nuclear program and playing a positive role in the verification; supporting appropriate reduction of economic sanctions on the DPRK as a reward for freezing its nuclear program while keeping in place UN Security Council sanctions resolutions. China may also play a positive mediation role when the USA and the DPRK experience difficulty in dialogues.

President Moon Jae-in gave the North's leader Kim Jong-un a USB drive containing a "New Economic Map of the Korean Peninsula" at the fortified border village of Panmunjom on April 27, 2018. (Inter-Korean Summit Press Corps)

In order to realize the freezing of the DPRK nuclear program, a critical question is whether there will be verification and how verification will be conducted. China will support necessary verification and favor the IAEA instead of the US in playing the leading role in verification.

Generally speaking, in the course of striving for dialogue resumption and nuclear freezing, as China and the US have shared basic objectives, the two sides have much to collaborate on even though they have their differences. Since the dialogue will be mainly between the US and the DPRK, for it to be successful, the US will obviously play a bigger role than China.

In exchange for abandoning its nuclear program, the DPRK will demand that the US fundamentally change its policy of hostility, provide the DPRK with security assurances, undertake not to overthrow its regime, and replace the armistice with a peace treaty. The DPRK will ask the US to lift sanctions, withdraw troops fully or partially, cease providing a nuclear umbrella for its allies, and establish diplomatic ties with it. The DPRK may even propose engaging in reciprocal nuclear disarmament together with the US. In short, the DPRK will ask the US for very specific and practical measures instead of an oral security assurance. On the other hand, the US wants complete, verifiable, and irreversible disarmament, before which it will not be prepared to have diplomatic ties with the DPRK or withdraw troops from the peninsula. Withdrawing its nuclear umbrella will be unacceptable to the US even if the DPRK is denuclearized. Besides, the DPRK wants to denuclearize in a phased manner and through reciprocal measures, whereas the US wants denuclearization as soon as possible and will not allow the DPRK to drag out the process.

With significant differences on how to denuclearize, it is rather predictable that freezing the DPRK nuclear program, even if possible, is still very far from North Korea abandoning nuclear weapons and establishing peninsular peace.

The American role will remain critical while the role of China will increase. As the multilateral dialogue unfolds, China will become a primary participant. If the Six-Party Talks are resumed, China may play an even greater role, including by coordinating policies of relevant parties, mitigating differences between the DPRK and the US, gradually reducing and ultimately ending sanctions against the DPRK together with the other relevant parties as denuclearization progresses, and participating in a joint security assurance for North Korea.

In the second scenario, the DPRK-US dialogue breaks up, North Korea conducts new nuclear or missile tests and the peninsular situation worsens. The US decides on limited military strikes, leading to military conflict or even war. If such a scenario unfolds, China and the US are likely to hold opposite positions but it's still possible for them to cooperate to an extent.

There are but two ways for the DPRK-US dialogue to break up. Either both parties are responsible, or just one of them is. Historically, both the US and the DPRK were to blame for previous failures. With deep mutual distrust and with the US administration very much pinned down in domestic politics, none of their previous agreements were truly implemented. As the US is the stronger party, it should probably shoulder a greater responsibility. We will see what happens this time.

> China always believes that the use of military means to resolve the nuclear issue or to interrupt the nuclear program contains enormous risks and may well lead to unbearable consequences for the Peninsula and Northeast Asia.

If the dialogue does break up and the US makes up its mind on using military force, differences between China and the US will quickly increase. China always believes that the use of military means to resolve the nuclear issue or to interrupt the nuclear program contains enormous risks and may well lead to unbearable consequences for the Peninsula and Northeast Asia. As such, China will firmly oppose unilateral American action to use force against the DPRK.

If the US carries out limited military attacks, such as intercepting the DPRK's missile launches, destroying the missile launcher, or engaging in cyber warfare, there may be several possibilities.

First, to avoid large-scale military conflict or war, the DPRK may refrain from immediate military counterattacks and the two countries may enter a quasi-war.

Second, the DPRK may choose to wage limited counter attacks on American military assets in the ROK or Japan and the two sides will engage in a limited military conflict.

Third, as the military conflict escalates and in the face of attacks on its main military facilities by the US and its allies, the DPRK may fight back desperately with attacks on more American and ally targets within its reach. In this situation, the military conflict will quickly develop into an all-out war or even a nuclear one, which may even lead to a China-US military conflict.

In the first two cases, China will make great effort to promote dialogue so as to avoid conflict escalation or war. But if and when a war breaks out on the Peninsula and its national interests are under serious threat, including from a severe nuclear security or refugee crisis, China will have to take necessary military action to safeguard its national security.

It is predictable that in a war on the Peninsula, both China and the US will work hard to avoid another direct collision as in the previous Korean War and strive for cooperation in preventing and dealing with a nuclear crisis. In this instance in the best case scenario, a direct Sino-American military conflict and a nuclear war will be avoided. Then the war's losses may be fewer and its duration shorter, and the post-war recovery may also be shorter. Nonetheless, military conflict or war will still bring great harm to peninsular security as well as to the lives and property of people there. The flames of war may well spread beyond the peninsula.

In the worst case scenario, a nuclear war on the Korean Peninsula will bring enormous and lasting disaster and destruction to Northeast Asia at large.

In the third scenario, as the risks of war are too huge, the US and the DPRK, after failed dialogue, may fall into an even more severe military standoff, but short of conflict. In that situation, China-US relations will become even more complex and uncertain.

In this scenario the DPRK will continue nuclear weaponization by inter alia conducting more nuclear and missile tests, building more nuclear weapons and ballistic missiles and deploying them for actual combat. Relaxation and improvement of DPRK-ROK relations will not last and hostility will intensify again. To safeguard its security and that of its allies, maintain the credibility of its bilateral military alliances in the region, and prevent Japan and the ROK from going nuclear, the US will spare no effort in strengthening military deterrence against and containment of the DPRK. As such, China will have to readjust policies to safeguard its own security.

Then, two factors will influence Chinese policy and actions.

The first is the reason for dialogue breakup. If both the DPRK and the US are to blame, the relevant Chinese policy may remain basically unchanged. If the dialogue breaks up mainly because of the US, China-US cooperation on denuclearization will certainly be negatively affected whereas China-DPRK relations may improve. On the other hand, if the DPRK is to blame, China-US cooperation may be further strengthened.

The second factor is the change in American military posture on the Peninsula and in Northeast Asia after the dialogue breakup. As the peninsular situation worsens, the US will strengthen deterrence against and containment of DPRK, its military presence in the region, its nuclear umbrella for allies, and the missile defense system in the region. These kinds of moves have causes serious concerns for China in recent years. China thinks these measures target it as well as the DPRK. Now the US has publicly announced that it regards China as a primary strategic rival. Changes in its military presence in Northeast Asia, particularly development of missile defense and changing its posture of the nuclear force, will only cause greater security concerns for China and force it to take measures to prepare against it. As a result, China-US cooperation on the DPRK nuclear issue may well be undermined and an arms race in Northeast Asia may commence.

Of course, even when the peninsular situation worsens, China and the US will still have a major common interest in the denuclearization of the Peninsula. If the two sides manage their increasing differences and establish effective crisis management mechanisms, they will still be able to cooperate on pressuring DPRK through sanctions and pushing it to the negotiating table.

In the fourth scenario, the DPRK may make limited compromises (such as stopping new missile or nuclear tests, in particular ICBM test launches) and the US may tacitly recognize the DPRK's status as a nuclear weapon state, similar to India and Pakistan.

This scenario seems rather unlikely, at least for now. However, if the US focuses on the so-called 'strategic competition' from China and Russia, fights a trade war with China, or triggers another crisis across the Taiwan Straits, leading to serious deterioration in relations with China, the DPRK may well seize the opportunity to improve its relations with the US. Then the prospect of a US-DPRK compromise may occur. There are of course people making just the opposite hypothesis. They believe the DPRK will move closer towards China.

No matter which possibility becomes a reality, the DPRK gaining a status similar to that of India and Pakistan will certainly damage international cooperation on denuclearization of the Peninsula and deal a heavy blow to the international nuclear non-proliferation regime. In that case, regional security will worsen. The arms race, especially between major countries will intensify.

China will do its best to avoid such a scenario. But it's uncertain what policy the Trump administration will pursue.

North Korea leader Kim Jong-un made his first ever foreign trip as leader to meet China's President Xi Jinping from March 25 to 28, vowing he is "committed to denuclearization" and willing to hold summits with the South and the U.S.

A New Beginning on the Korean Peninsula?

It will be up to President Trump to close the deal on denuclearization.

Troy Stangarone
Senior Director
Korea Economic Institute of America

After a year of rising tensions and concerns over the prospect of conflict over North Korea's nuclear program, tensions on the Korean Peninsula have momentarily eased. On April 27, Kim Jong-un and South Korean President Moon Jae-in met for the first time in the de-militarized zone (DMZ) surrounded by pageantry and symbolism. The meeting kicked off a new era of summit diplomacy and will soon be followed by a critical meeting between U.S. President Donald Trump and Kim Jong-un that may pave the way for a new beginning on the Korean Peninsula.

The recent inter-Korean summit was a success by many measures, even if some of the key details remain to be worked out. In a break with the past, Kim Jong-un agreed to meet South Korean President Moon Jae-in at the Peace House in the DMZ, making him the first North Korean leader to travel south of the DMZ. There was also a frankness in how Kim Jong-un spoke of the economic difficulties facing North Korea. Perhaps most significant for setting a new path on the Korean Peninsula, however, was the commitment by both Koreas to realizing denuclearization in the Panmunjom Declaration, the first direct reference to denuclearization in an inter-Korean summit document.

Designed to improve relations with North Korea and help ensure the success of the upcoming U.S.-North Korea summit, the inter-Korean summit should be viewed as the first of at least two interlocking summits. The Panmunjom Declaration helped to achieve these objectives by establishing a new framework for inter-Korean relations and beginning to address the security issues needed for talks between the

> The United States and North Korea have historically had different definitions of what denuclearization means.

United States and North Korea. The document focuses on three areas of inter-Korean cooperation: the development of co-prosperity, the reduction of military tensions, and the development of a permanent peace on the Korean peninsula.

One of the key elements of the Panmunjom Declaration regarding co-prosperity is the agreement to implement all prior inter-Korean declarations and agreements which would provide North Korea with clear economic benefits should it follow through with denuclearization. In the area of reducing tensions, the agreement reaffirms a non-aggression pact, calls for the end of hostile acts, and a phased disarmament. Both sides also agreed to seek a peace treaty to end the Korean War by the end of 2018. While denuclearization is the last element of the agreement, nominally, the adoption of all prior inter-Korean declarations and agreements should also commit North Korea to the 1992 Joint Declaration on the Denuclearization of the Korea Peninsula.

South Korean President Moon Jae-in (R) met with DPRK Leader Kim Jong Un in the truce village of Panmunjom inside the demilitarized zone separating the two Koreas, South Korea, April 27, 2018.

The United States should be pushing to include all of North Korea's weapons of mass destruction included in UN Security Council resolutions in an agreement.

While helping to create a framework for cooperation, details will still need to be worked out on the phased approach to disarmament agreed to in the declaration, but perhaps most important will be defining how the economic and social cooperation agreed upon will be conducted while sanctions are still in place.

If the summit with South Korean President Moon opened the door to a denuclearized North Korea, it will be up to President Trump to close the deal on denuclearization. But expectations should be managed. The Panmunjom Declaration is intentionally ambiguous in some regards and any agreement reached at the Trump-Kim summit will be about top down aspirations, rather than a detailed agreement. However, if the summit is successful, there are certain elements we should look for in any agreement.

The most important element will be how the two sides define denuclearization. The United States and North Korea have historically had different definitions of what denuclearization means. For the United States, denuclearization has meant the complete, verifiable, and irreversible dismantling of North Korea's nuclear program. In contrast, North Korea has often referred to the "denuclearization of the Korean Peninsula," by which it means the removal of the U.S. nuclear umbrella and U.S. troops from the Korean Peninsula as part of the process of denuclearization. An important first step will be arriving at a common definition of denuclearization.

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Timelines will also be important. The Panmunjom Declaration placed clear benchmarks, even if further details are still needed, for the end of hostile acts in the DMZ by May 1, military talks in May, family reunions on August 15, and the conclusion of a peace treaty by the end of the year. Any U.S.-North Korea agreement will need to clearly define when denuclearization will be concluded, when inspections can begin, and when sanctions relief can begin. The United States has suggested that denuclearization be relatively quick, as was the case with Libya, before sanctions relief can begin, while North Korea has suggested a phased approach that would provide some benefits before complete denuclearization is achieved. Details on denuclearization and other issues will need to be negotiated after the summit, but clear timelines should be established.

Any agreement should go beyond denuclearization. The United States should be pushing to include all of North Korea's weapons of mass destruction included in UN Security Council resolutions in an agreement. North Korea is known to have a chemical and biological weapons program. With the assassination of Kim Jong-nam with VX nerve gas last year and the UN Panel of Experts report on North Korea's dealings with Syria on chemical weapons, we know that the regime is willing to both sell and use other weapons of mass destruction.

While there are clear elements the

> Kim Jong-un noted disappointment at North Korea's failure to implement prior agreements.

United States should seek in any agreement, North Korea will have priorities as well. These are likely to include the conclusion of a peace treaty, security guarantees, and sanctions relief, but will also likely include a request for the United States to provide direct economic aid to North Korea as part of any agreement.

Reports have indicated that North Korea will not ask for the removal of U.S. troops, the end of the U.S. nuclear umbrella, or an end to U.S.-South Korea alliance, merely that military exercises be appropriate to the situation, the U.S. pledge not to attack North Korea, that strategic assets not be used or based in South Korea, and that the U.S. agree to a peace treaty. If this is truly the extent of North Korea's security requests, there could be real grounds for an agreement.

At the inter-Korean summit, Kim Jong-un noted disappointment at North Korea's failure to implement prior agreements, something the United States knows all too well from his time as leader and the short-lived 2012 Leap Day Agreement. While Kim was likely not referencing the Leap Day Agreement or even the 1992 joint declaration on denuclearization, if he genuinely understands the need for full implementation of the Panmunjom Declaration and any agreement reached with President Trump, there may be a chance to resolve the North Korean nuclear situation and achieve a new beginning on the Korean Peninsula. However, if he does not, we may end up back where we were before— with increasing pressure and the prospect of conflict.

The Petroyuan Shift: Eclipse of the Petrodollar Monopoly

As oil can now be traded with RMB-denominated contracts, the rise of the petroyuan will accelerate the internationalization of the Chinese currency as investors begin to increase their allocations into Chinese financial assets.

Dan Steinbock
Founder
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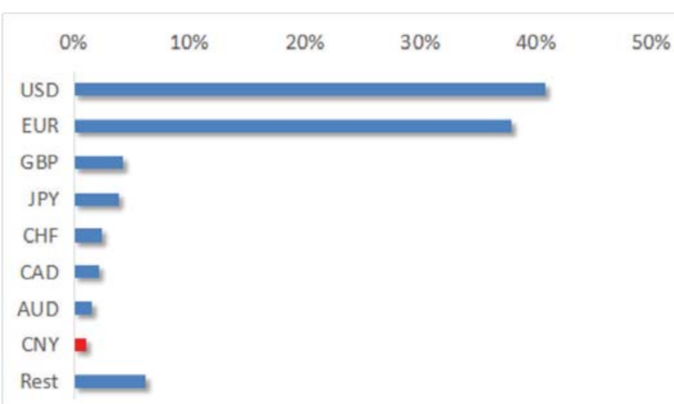
In late March, as international media focused on Trump's tariffs and the prospects of a trade war, renminbi-denominated oil contracts began trading in the Shanghai International Energy Exchange (INE) for the first time. This will foster the rise of the petroyuan, which may cause a dramatic shift in global asset allocations as institutional investors begin to diversify into China's onshore bond markets.

Today, the status quo is still very different. The U.S. dollar (USD) and the euro (EUR) still dominate more than 85% of international payments, followed by the English pound, Japanese yen, Swiss franc, Canadian dollar and Chinese yuan (which accounts for 1%) (Figure 1).

Figure 1. Major International Payments Currencies



Source: SWIFT, Feb 2018

Following its integration into the global economic and trading environment, China is now integrating into the global financial system. It is already the world's biggest trading country, has the largest foreign-exchange reserves, and the world's biggest consumer market. As China now also absorbs most of the world's commodities, dollar-denominated intermediaries are not warranted - if they ever were.

Rise and eclipse of petrodollar

After World War II, the U.S. dollar was the predominant world currency and America fueled almost half of the world economy. Today, the U.S. dollar accounts for barely 40% of international payments, while the share of the U.S. in the world economy is less than half of what it was in 1945. So why

As China now also absorbs most of the world's commodities, dollar-denominated intermediaries are not warranted - if they ever were.

does the U.S. still benefit from this "exorbitant privilege"? That has more to do with the petrodollar.

After the 1945 Yalta Conference which effectively divided Europe, the ailing President Franklin D. Roosevelt met Saudi Arabia's King Ibn Saud. Bypassing the Brits, the former "masters of the universe," FDR and Saud agreed to a secret deal which required Washington to provide Saudi Arabia military security in exchange for secure access to supplies of oil.

Despite periodic pressures, the pact survived until the 1971 "Nixon Shock." As dire U.S. economic prospects led President Nixon to the unilateral cancellation of the direct international convertibility of the U.S. dollar to gold, the postwar Bretton Woods system of international financial exchange was replaced by a regime based on freely floating flat currencies. The U.S. dollar was decoupled from gold. To deter the marginalization of the U.S. dollar, Nixon negotiated another deal which ensured that Saudi Arabia would denominate all future oil sales in dollars, in exchange for U.S. arms and protection. Led by Saud, other OPEC countries agreed to similar deals and global demand for U.S. petrodollars soared.

The U.S.-Saudi strategic partnership weathered another four decades of multiple regional wars. When the Fed began to pave the way for rate hikes in 2014, the value of the dollar started to climb, though slower than expected, and oil prices plunged since oil markets are dollar-denominated. To seal the old alliance, President Trump signed a historical $110 billion arms deal with King Salman.

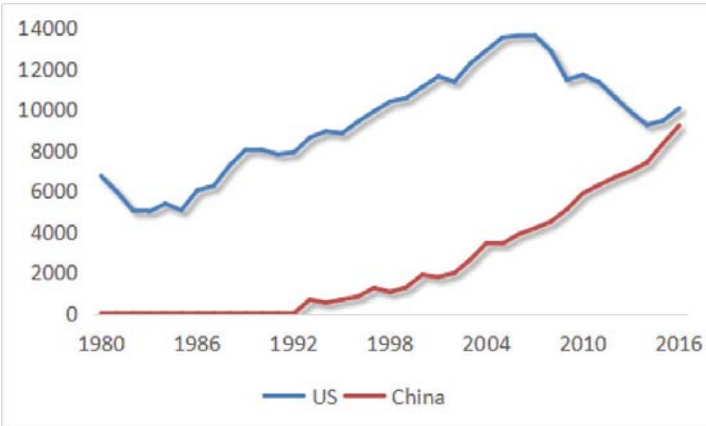
Yet, the U.S. dollar's coverage is slipping because structural conditions that supported its dominance have been softening since 1971.

How OBOR drives the rise of petroyuan

The internationalization of the Chinese renminbi accelerated significantly in 2016 when the RMB joined the IMF international reserve currency basket. Last October, China established a payment-versus-payment system for transactions involving Chinese yuan and the Russian ruble. The China Foreign Exchange Trade System (CFETS) hopes to launch similar systems with other currencies based on China's huge multi-decade, multi-trillion One Belt One Road

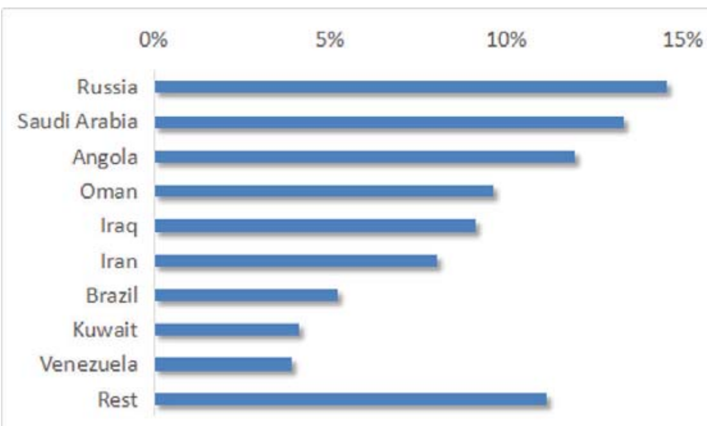
Today, the U.S. dollar accounts for barely 40% of international payments, while the share of the U.S. in the world economy is less than half of what it was in 1945.

Figure 2.
U.S. & China Crude Oil Imports (1,000 Barrels per Day), 1980-2016



Source: BP Statistical Review of World Energy 2017

Figure 3. China: Oil Suppliers (% of Total Imports), 2016



Source: World Top Exports, March 2018

(OBOR) initiative.

As the OBOR expands links between major economies in Asia, Africa, Europe, and Latin America, member countries are candidates for RMB-denominated payments. Last December, Iran, which has not deployed the U.S. dollar in foreign-trade transactions since the early 2010s, announced it would join the Russia-led Eurasian Economic Union (EEU), which will also have a central role in the OBOR, and thus in RMB-denominated payment systems. U.S. geopolitics is escalating these trends. When the White House suspended U.S. aid to Pakistan, Islamabad announced that the Chinese yuan could be used for bilateral trade and investment activities, which will support the China-Pakistan $57 billion economic corridor.

Recently, China has become the largest global oil consumer (Figure 2). With major oil exporters like Russia, Venezuela, Iraq, Iran, and Saudi Arabia, China's market means leverage, and many of these suppliers have either already agreed to price their sales to China in RMB, or are actively considering it (Figure 3). In turn, major commodity exporters, such as Indonesia, have joined in non-dollar trades.

The future is on China's side. By 2040, Chinese annual demand is expected to grow more than 30%, whereas the U.S. is likely to reduce its reliance on oil imports as it hopes to develop domestic shale oil capacity. U.S. economic interests in Saudi Arabia may erode, even if military interests prevail. If Saudi Arabia decides to adopt the yuan for some of its oil exports, that could unleash a broader shift.

Impending shift

As an increasing share of China's oil imports will be priced in RMB, that will result in large RMB reserves in oil exporting countries, which will be spent on Chinese exports, or recycled into China's financial markets. As demand for RMB assets will increase, the role of the USD

> The U.S. dollar's coverage is slipping because structural conditions that supported its dominance have been softening since 1971.

for trading purposes will lessen.

In the short-term, the Chinese system is unlikely to change the way oil is traded globally. Even with exchange convertibility, international investors and resource traders must have confidence in Shanghai INE as a trading hub.

In secular terms, the petroyuan will mean a paradigm shift in global asset allocations to China's financial markets, as long as China will continue to remove or significantly reduce capital controls for RMB-priced oil trading. Between 2014 and 2017, global institutional investors already tripled their China holdings of onshore bonds. In a year or two, when China's onshore bond markets are likely to be included in global bond benchmark indices, a major reallocation of capital will flow into China's onshore bond markets.

An important caveat: the progressive shift to petroyuan will speed up disruptively if investors one day lose faith in the U.S. dollar, due to a U.S. debt crisis, or a huge Trump policy blunder. The shift away from the U.S. dollar could accelerate dramatically.

China's economic rise is already a reality. The coming shift in global asset allocations is its rightful reflection in world finance.

China Looks to the Arctic

For China the Arctic represents a largely blank geoeconomic canvas outside of the United States' sphere of influence.

Malte Humpert
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The Arctic Institute

The Arctic represents a small but growing part of China's long-term quest to secure access to natural and energy resources and to gain and subsequently maintain greater control over the world's transportation highways. For China the Arctic represents a region of stability, devoid of conflict, and lacking the influence of a clear hegemon, i.e. the United States, in which it can expand its economic reach. To this end China is supportive of the region's existing security architecture, which allows it to integrate the Arctic into its own development agendas, e.g. the Belt and Road Initiative, largely unopposed.

China's interest in the Arctic is two-fold: access to the region's vast natural resources, including Russian gas and oil and the use of Arctic shipping routes, namely the Northern Sea Route (NSR) and Northwest Passage (NWP), to import said resources as well as export its own goods. Thus, the region's resources and shipping lanes offer an opportunity for geographic diversification of its energy imports specifically and its international trade more generally.

China's economic and geopolitical security depend on unimpeded access to a number of waterways, primarily along the Suez Canal Route, over which the country exerts little control. It has been a long-stated goal of the Chinese leadership to adopt measures to overcome this strategic vulnerability known as the "Malacca dilemma" and counteract the United States' control of vital shipping lanes. In this respect, China's efforts to expand its naval capacity, investments in ports along its main trade routes, and construction of airfields and related infrastructure on shallow reefs in the South China Sea are part of the country's attempt to gain greater control over its key waterways.

> For China the Arctic represents a region of stability, devoid of conflict, and lacking the influence of a clear hegemon.

Ukraine-built Chinese icebreaker Xue Long.

Similarly, access to the Arctic's resources and shipping lanes will allow for variegation of supply and in the not-too-distant future an alternative connection to China's most important market – the European Union – along routes outside the direct influence or control of the United States. As part of its newly released Arctic policy China aims for commercial and regularized operation of Arctic shipping routes with the goal to integrate a "Polar Silk Road" into its Belt and Road Initiative. Chinese investments into Arctic infrastructure such as the Belkomur railway line and the Arkhangelsk deep-water port foreshadow the growing importance of these trade routes.

For China the Arctic represents a largely blank geoeconomic canvas outside of the United States' sphere of influence in which it can lay the foundation today for significant economic and geopolitical rewards in the future. As such, China will continue to work within the existing structure of Arctic governance and utilize the region's exceptionalism – an apolitical space removed from traditional power dynamics – as a buffer against the United States' influence.

The European Union and United States' sanctions targeting Russian Arctic hydrocarbon development further accelerated China's engagement in the region. The country's financing and technical support was crucial to the development of Russia's Yamal LNG project, which upon completion was hailed as the first large-scale overseas project of the Belt and Road Initiative. Strategic cooperation agreements between the China Development Bank and the China National Petroleum Company, both already engaged in Yamal LNG, for the larger Arctic LNG 2 project were signed in late 2017. While the extent to which Russia will welcome additional Chinese investments – and influence – remains to be seen, the two countries understand the region's political stability and the absence of conflict as beneficial for the rapid development of its economic potential.

China's advance into the Arctic is abetted by the power vacuum created by the United States' absence from the region. The United States sees little economic benefits from a greater involvement in the Arctic's future. The United States' single ageing polar-class icebreaker is a symbol of its inability to commit the required investments to expand its role in the region. Paired with a shortage of political will and a lack of understanding of the importance of the region has left it, at least thus far, unable to counteract growing Chinese influence. As it stands China faces little sustained opposition by any of the Arctic states to incorporate aspects of the Arctic into its economy and make use of the region for strategic gains.

Due to the Arctic's unique environment, all economic activity, be it the exploitation of natural resources or increased shipping activity, comes with significant risk. Despite a reduction of ice coverage during the summer months navigation in ice-infested waters leaves little margin for error. A number of near-misses along the NSR, including collisions between two Russian oil tankers in 2010, indicate that the question of a major accident is not a matter of if but when.

While shipping traffic in the immediate future will be concentrated along the Russian coastline, primarily to export hydrocarbon resources, a full-fledged

The Chinese government released "China's Arctic Policy" on January 26, 2018, a white paper outlining how the BRI (Belt and Road Initiative) applies to the Arctic, also called "Polar Silk Road."

> The United States sees little economic benefits from a greater involvement in the Arctic's future.

future "Polar Silk Road" will undoubtedly make sustained use of the waters of the central Arctic Ocean and the NWP. Seasonal variability of ice conditions along these new routes, lack of accurate navigational charts and aids, and increased distance to search and rescue facilities will further enhance the risk of such operations.

The point here is that it is not China's economic ambitions for the Arctic per se which enhance environmental impacts, but economic activity in general. As with other highly frequented waterways – the Strait of Malacca sees more accidents than any other shipping channel – the setting of rules and their enforcement will be essential. In this regard the recently-adopted Polar Code can be but a first step to mitigating some of the risks associated with operating in the Arctic.

While the integration of the Arctic region into the global economy appears inevitable and great powers, like China, will undoubtedly seek to benefit from its material riches and strategic value, it will be the Arctic states' continued responsibility to exercise and enforce responsible stewardship over the region.

About China-United States Exchange Foundation

Based in Hong Kong, the China-US Exchange Foundation was established in 2008 by individuals who believe a positive relationship between the strongest developed nation and the most populous, fast-developing nation is essential for global wellbeing. The Foundation is a non-government, non-profit entity and is privately funded.

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China-US Focus, published by the China-United States Exchange Foundation, is built on the principle that China and the United States hold the most important bilateral relationship of the 21st century.

China-US Focus is the only open-platform where Chinese and American thought leaders can openly express their views on the myriad issues that face the two nations, thus promoting communication and understanding between the peoples of China and the United States.

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