



US-China Economic Statecraft: Turning Cold War into Negotiation

Original Paper

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Abstract

The trajectory of US economic strength relative to China has driven a reassessment of the US' rules of engagement on trade and investment. China is turning more authoritarian, more focused on self-sufficiency, challenging US dominance in international institutions, global markets, and critical technologies. It selectively honors the market-based rules of the international trade order. Structural features of the Chinese economy and its management blunt the effectiveness of international rules-based trade policy tools. The US, in response, is becoming more aggressive, with protective trade measures and proactive industrial policy. A new cold war is emerging, confounding the broad foundation of collaborative interdependence that vastly accelerating world economic growth for the past 35 years. This paper examines the nature of these shifts and the need for and scope of more constructive economic statecraft by both the US and China in order to build a workable, new rules-based framework for managing international competition and trade that is acceptable to both countries. It contributes a path toward more constructive long-term negotiation as an alternative to an economic cold war.

Keywords

economic statecraft • diplomacy • trade • negotiation • geoeconomics • supply chains • international competition • economic warfare • trade war • global manufacturing

1 Introduction

China's remarkable rise to Great Power status—the first nation to achieve this based on economic strength rather than military power—sets the global stage for two conflicting paths. The first is the path of productive wealth generation and technological advance from collaborative interdependence.¹ The second is an economic and technology cold war. In particular, the dual paths will become a 21st century version of Huntington's clash of civilizations:² two fundamentally different political systems, each believing itself to be “exceptional,” each economically dependent upon the other, yet caught in a modern Thucydides Trap. It is clear that both paths are being trod. Which prevails will depend on the quality of the economic diplomacy.

The two largest economies are balancing between collaborative partnership and a schism based on how their economies are organized. The US is a founder of the post-War Bretton Woods system—liberal democracy, free-market capitalism, rules-based trading regime. China, a member of the WTO since 2001, is turning more authoritarian. It honors the market-based rules of the international trade order only selectively. Growing state management of the Chinese economy blunts the effectiveness of the international rules-based trade system even as Beijing massively funds a challenge to US dominance in critical technologies.³ China has in some ways been a solid citizen of the WTO. It has been the subject of many WTO disputes and it offers a strong record of compliance with the decisions of panels and the Appellate Body. China may yet become a constructive part of the Bretton Woods rule-based system that has evolved over the past 75 years, but its current actions suggest a shift toward tightly controlled state capitalism incompatible with a market-oriented, rules-based order. Either way, maintaining a solid and peaceful

¹ From 2001 to 2016, China's exports rose from US\$266.1bn to US\$2097.64bn, while imports climbed from US\$243.55bn to US\$1587.92bn. In 2016, China's share in world exports hit 13.18 percent, up from 4.34 percent in 2001, and China's share in world imports hit 9.9 percent, up from 3.84 percent in 2001. During the same period, China's GDP grew dramatically from US\$1.339tn to 11.199tn. See, Siqi Li, Xinquan Tu Impact of Chinese Characteristics on the World Trade Organization: Challenges and Strategies, *China & World Economy* / 107–126, Vol. 26, No. 2, 2018 At: <http://ciwto.uibe.edu.cn/english/docs/2022-11/e7689f36153d4c26aafb4cab0ae0715f.pdf>

² Samuel Huntington, “The Clash of Civilizations,” *Foreign Affairs*, (1993).

³ Mark Wu, “The ‘China, Inc.’ Challenge to Global Trade Governance,” *Harvard International Law J.*, Vo. 57, No.2, Spring 2016.

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US-China economic partnership is more important than ever.⁴ To this end, the US needs a new and more far-sighted and strategic economic statecraft comprising trade, financial and industrial policies that can more effectively deal with China, and in turn the growing number of authoritarian governments.

Our position on what has to happen is simple and straightforward. The US and China must acknowledge their different economic interests and development priorities. Both must recognize multilateral dominion over the system of international economic rules. At the same time, the US must defend its market-based principles that underpin global trade among all countries. This means, on the one hand, working to disrupt and contain China's (and others') strategic initiatives to dominate particular critical industries and defending forcefully its own competitive position in key industries. On the other hand, the US must work with China diplomatically to develop a set of rules acceptable to both. This is a tall order and a tightrope task, but nothing will better serve US' or China's essential interests. Nothing other than American strength and resolve will persuade China to negotiate a new workable, rules-based framework. The US needs to convince China it is both accepting of China's rise and determined to retain the best of the current order that broadly serves the world economy so well.

This paper explores the complexity of current US-China relations and offers a path away from conflict and toward negotiation and goal-oriented diplomacy. The first section reviews the nature of economic statecraft needed to bind the relationship. The second section focuses on the growing tensions between China and the US. The language of war is becoming dominant and commercial policy discussions increasingly highlight separation and rivalry over cooperation and collaboration. The third section explores, in considerable industry detail, the deep integration of and the current industrial battleground between China and the US, and the worrisome drift of competitive advantage toward China from a US point of view. Fourth, we consider potential openings for effective diplomacy in China's continued engagement with trading partners. The final step is to consider the most realistic scenario of US-China economic relations and from that, finally, construct a roadmap for effective statecraft.

2 Economic statecraft

Economic statecraft has many faces. Some see it as the economic issues that provide its content: matters relating to production, trade, investments, development assistance, money, information, and their regulation.⁵ Baldwin, in his classic 1985 *Economic Statecraft*, and many analysts since then, define it more broadly, as the application of positive and negative economic measures in the pursuit of geopolitical goals, including punitive actions such as sanctions.⁶ This definition puts economic statecraft at the heart of national 'grand strategy.' President Harry Truman recognized that 'relations, foreign and economic, are indivisible.' This is consistent with Thomas Schelling's view of economic statecraft as the practice of *compellence*-- coercive economic measures to get others to do something they would not otherwise do-- and *deterrence*-- to force them to stop doing something you do not want them to do. Ideal, of course, is a nuanced mix of coercive and cajoling measures to achieve one's desired outcome.

Secretary of State Hillary Clinton, in a series of policy speeches in 2010 put economics and market forces at the heart of U.S. foreign policy. "Economic statecraft," she stated, "harnesses global economic forces to advance America's foreign policy and employs the tools of foreign policy to shore up U.S. economic strength."⁷ Economic statecraft, in this view, is directed at building the economic strength that will provide both the *power* to implement strategic foreign policy goals and the *freedom from* coercion by others.⁸ Effective modern statecraft builds strength by nurturing both a strong domestic economy and advantageous economic alliances.

Economic statecraft is best understood as the use of any and all tools available to policymakers to achieve the goals of the modern state. The primary goal of every nation is to develop the economic strength to finance the national and economic security that can secure its economic growth. History shows again and again that states are willing to use any and all tools available to this end; both the positive economic tools of collaboration and integration, and the negative tools of deterrence and compellence.

4 Farrell and Newman, "Weaponized Interdependence," *International Security*, June 2019.

5 *The New Economic Diplomacy: Decisions Making and Negotiation in International Economic Relationships*, N. Bayne and S. Woolcock, Ashgate Press, 4th edition 2017

6 Baldwin, D. A. 1985. *Economic Statecraft*. Princeton: Princeton University Press, and J. Blanchard and N. Ripsman. "A Political Theory of Economic Statecraft." *Foreign Policy Analysis*, (2008)

7 Hillary Clinton, "Economic Statecraft," at: <https://2009-2017.state.gov/secretary/20092013clinton/rm/2011/10/175552.htm>

8 Conversely, to gain commanding influence over another state, a nation will seek to foster economic dependence. Paraguay, for example, recently cut diplomatic ties with Taiwan. China has invested approximately \$130 billion in Latin America between 2005 and 2020. It specifically refuses ties with any country that recognizes Taiwan. Taiwan has invested heavily in its few remaining allies in areas like technology, transportation, and health care, but as in Paraguay, it is simply outspent by China. See, e.g., "Taiwan or China? Paraguay's dilemma puts election race in the spotlight," *Reuters*, April 24, 2023; at: <https://www.reuters.com/world/americas/taiwan-or-china-paraguays-dilemma-puts-election-race-spotlight-2023-04-24/>

Most nations, especially emerging markets, have economics at the center of their foreign policy. And for good reason. A favorable economic balance is increasingly the basis for a favorable strategic balance. Wealth can fund armies and navies. But power in the 21st century comes from building strong economies through policies that spur growth, create jobs, nurture innovation, foster value-adding networks, and engender commercial alliances.⁹ Another source of power—notably soft power—can be to create an environment of liberty and choice with free markets that open opportunities for individuals and businesses to succeed. “If sanctions are among our more powerful sticks,” Secretary Clinton said, “our culture of entrepreneurship is one of our most effective carrots, an often-overlooked element of our economic statecraft and a source of American power.” Smart power is a careful blend of soft and hard power. Hard power is increasingly defined not by weapons, but by assertive economic tools such as sanctions, export restrictions and retaliatory trade remedy actions, occasionally accentuated by a few major powers with threats of tailored military intervention. Economic growth allows countries both to use these tools and to protect themselves from them.

Alan Dobson documents America’s long record of using forceful economic diplomacy to achieve foreign policy goals, often at greater cost to America than to the targets.¹⁰ Thomas Jefferson imposed an embargo on British goods. America’s first trade deal with Japan was negotiated in 1853 under the guns of the Black Ships in Tokyo harbor. Aggressive trade sanctions in 1940-41 pushed Japan to invade Pearl Harbor. President Carter imposed a grain embargo to protest Russia’s invasion of Afghanistan at great cost to American farmers. Reagan arm-twisted trading partners to control trade flows and then outspent the USSR into bankruptcy. More recently, a tariff war on China. Biden has continued and expanded it with aggressive buy-America, industry subsidies and friend-shoring policies.

China, for centuries aloof from international affairs, has risen rapidly to a dominating presence on the global scene—as the world’s largest exporter, linchpin to manufacturing supply chain, world’s largest energy importer and developer of mineral resources, and the builder new islands in the South China Sea. It employs a wide range of both positive interventions, from huge public sector investments and industrial subsidies to international outreach agencies such as the China International Development Cooperation Agency (CIDCA)¹¹ as well as punishments—such as withholding access to its rare earths; embargo of Norwegian salmon; embargoes of South Korean products; limiting Google’s access to markets, etc.—to shoulder its way into the club of Great Powers. Even the growing tensions in the South China Sea are more than simply historical or security claims to territory; they rest firmly on economic interests: fishing, drilling, and shipping.

Effective application of economic measures for foreign policy ends confronts multilayered public policy pressures that requires increasingly sophisticated political skill. Bayne and Woolcock¹² point out the conflicting pressures: between economic imperatives and politic goals, between international and domestic interests, and between governments and other forces such as civil society and non-state actors empowered by social media. Economic statecraft must be practiced in policy space crowded with a growing set of energized stakeholders: sophisticated advocates for business, labor, and finance; literally thousands of interconnected international NGOs pushing a rich assortment of agendas; as well as the growing array of international institutions, such as the UN, World Bank, IMF, OECD, ILO, WHO, WIPO, and UNCTAD.¹³ At the same time, statecraft must blend with commercial diplomacy dedicated to trade liberalization, trade promotion, investment agreements, standard setting, data privacy and security, regulatory compliance, and WTO affairs.

Statecraft, to be done well, require intricate collaboration among all domestic stakeholders—supportive and opposed—and many transnational interests—friendly and unfriendly—to form a coherent and compelling national front, which then must artfully be put forward as national economic diplomacy supporting a national grand strategy in coordination with many and varied policy agendas. US-China relations, and the statecraft to make it work productively, collaboratively, and peacefully, must manage all the components of public policy at play in the relationship and all the stakeholders and special interests that affected by and will affect the process in both countries and there respective allies.

9 Farrell and Newman, “Weaponized Interdependence,” *International Security*, June 2019; at: https://www.mitpressjournals.org/doi/full/10.1162/isec_a_00351

10 Alan Dobson, *US Economic Statecraft for Survival: 1933-1991*, Routledge, NY (2002)

11 Cheng Cheng, “The Logic behind China’s Foreign Aid Agency,” *Carnegie Endowment*, May 2019; at: <https://carnegieendowment.org/2019/05/21/logic-behind-china-s-foreign-aid-agency-pub-79154>

12 Nicholas Bayne and Stephen Woolcock, eds. *The New Economic Diplomacy: Decision-Making and Negotiation in International Economic Relations*, Ashgate Press, 2011

13 It is easy to see why large international firms develop their own strategic foreign policies to coordinate business diplomacy with state economic diplomacy, and even more to help design and manage it Colin Reed, “Developing a ‘Corporate Foreign Policy’: The Urgent Need for Boardroom Geopolitics Strategies,” *Encyclopedia Britannica*, (November 2022); at: <https://encycopediageopolitica.com/2022/11/03/developing-a-corporate-foreign-policy-the-urgent-need-for-boardroom-geopolitics-strategies/> and, John Chipman, *Why your Company Needs a Foreign Policy*, (2016). (A corporate foreign policy has two components. “Geopolitical due diligence” involves the assessment of local, regional, and transnational risks facing a company. “Corporate diplomacy” aims to enhance a company’s ability to operate internationally and to ensure its success in each particular country with which it is engaged. Successful execution can be a new source of competitive advantage for multinational businesses in a time of increased geopolitical volatility.)

3 The Looming Thucydides Trap

The U.S-China relationship is moving distinctly on two paths—integrating deeply and dividing belligerently.¹⁴ Both are happening rapidly and in direct confrontation with each other. As McMaster and Scheinmann report it,¹⁵

“In the growing partnership, the United States felt comfortable reducing its defense spending to the lowest share of GDP since 1940. Meanwhile, Russia and China embarked on greatly expanded and strategic economic statecraft complemented with the largest military modernization and expansion programs their countries had seen in generations. Most notably, China launched the Belt and Road Initiative (BRI) and its funding arm, the Asia Infrastructure Investment Bank (AIIB) with the explicit aim of building a trade and development alternative to the U.S-dominated Bretton Wood system. They increasingly flexed their growing economic influence, and in Russia’s case attacked and occupied countries or part of countries. They determinedly increased their influence in the institutions they joined. They progressively increased measures to manage domestic order by adding an expanding range of constraints on their own citizens. US restraint was interpreted as weakness.”

US job losses tied to the massive and decades long US trade deficit tops the long list of US complaints about Chinese trade practices.¹⁶ Along with investment restrictions, forced-tech transfer and intellectual property theft, President Trump revealed deep underlying concerns in Washington and the broader US business community that things were not right in China. Trump’s Trade War against China, continued in the Biden Administration, defined the divide. It continues to widen as the US takes more openly defensive measures and China more openly challenges the existing ruling order.

Donald Trump opened the door to uncharacteristically blunt dialogue and policies. In addition to punitive tariffs, the number of Chinese firms identified on the Commerce Department’s Entity List restricting US exports quadrupled. Huawei was singled out for special exclusion. Congress and the Trump administration tightened screening on Chinese investments and restricted the use of Chinese equipment by federal agencies, contractors and grantees. Chinese students and researchers found it harder to get visas; some faced criminal investigation and prosecution for downplaying ties to Beijing. An array of governmental institutions focused emphatically on the threat of China.¹⁷ Numerous official reports address the China threat.¹⁸

Language from the U.S. side has become correspondingly abrasive. A new Special Committee in the House of Representatives dedicated to countering China was launched in 2023, featuring primetime hearings in which the panel’s chairman called on lawmakers to act with urgency and framed the competition between the US and China as “an existential struggle over what life will look like in the 21st-century.”¹⁹ The vast American think-tank industry has shifted precipitously toward the China threat. The prestigious Center for Strategic and International Studies published a report entitled “Deny, Deflect, Deter: Countering China’s Economic Coercion,”²⁰ The Rand Corporation, one of America’s premier think tanks, has proposed that “the United States could create a civilian equivalent to the Joint Chiefs of Staff with a mandate to effectively and efficiently manage the expanding role of U.S. civilian departments in geopolitical and economic competition.”²¹

14 Graham Allyson, *Destined for War* (2017). H.R. McMaster and Gabriel Scheinmann, “Too Soft Power,” *Hoover Digest*, Winter, 2023., (“From the World Bank and IMF to the World Trade Organization to the Paris Agreement, to the International Space Station Washington welcomed Moscow and Beijing into growing network of Western institutions as a partnership in pursuit of global peace and prosperity. Global prosperity grew and the number of democracies. As the rules-based economic order set forth at Bretton Woods spread a form of economic order and global wealth steadily rose, so did the conviction that adversaries had been transformed partners. US support for inclusion—notably pulling China and Russia into the WTO—seemed the right choice.”)

15 H.R. McMaster and Gabriel Scheinmann, “Too Soft Power,” *Hoover Digest*, Winter, 2023.

16 “Section 301 Tariffs on Goods from China: International and Domestic Legal Challenges,” *Legal Sidebar*, Congressional Research Service, April 2022; at: <https://crsreports.congress.gov/product/pdf/LSB/LSB10553>

17 For instance, the U.S.- China Economic and Security Review Commission’s latest hearings on “China’s Global Influence and Interference Activities,” at: <https://www.uscc.gov/>

18 For instance, USTR, 2022 USTR Report to Congress on China’s WTO Compliance at 6, 15, 22 (February 2023), available at [https://ustr.gov/sites/default/files/2023-02/2022 USTR Report to Congress on China’s WTO Compliance - Final.pdf](https://ustr.gov/sites/default/files/2023-02/2022%20USTR%20Report%20to%20Congress%20on%20China%20s%20WTO%20Compliance%20-%20Final.pdf) [hereinafter WTO Report; report prepared pursuant to section 421 of the US-China Relations Act of 2000, which requires the USTR to submit an annual report to Congress on China’s compliance with commitments made in connection with its accession to the World Trade Organization (WTO)]

19 “New China committee debuts, warns of ‘existential struggle,’” *AP*, February 2023; at: <https://apnews.com/article/politics-united-states-government-mike-gallagher-china-business-e9e4d4c5617bb1cd2ab237fd86f2fc6b>

20 For instance, M. Reynolds and M. Goodman, “Deny, Deflect, Deter: Countering China’s Economic Coercion,” CSIS, March 2023; at: <https://www.csis.org/analysis/deny-deflect-deter-countering-chinas-economic-coercion>

21 Barry Pavel and Daniel Egel, A Civilian U.S. ‘Joint Chiefs’ for Economic Competition with China?, April 24, 2023, at: https://www.rand.org/blog/2023/04/a-civilian-us-joint-chiefs-for-economic-competition.html?utm_source=AdaptiveMailer&utm_medium=email&utm_campaign=7014N000001SnmQAC&utm_term=00v4N00000hxdcGQAQ&org=1674&lvl=100&ite=275385&lea=1453723&ctr=0&par=1&trk=a0w4N000009kadYQAQ

Kevin Rudd, former Prime Minister to Australia, highlights China's similar substantive and rhetorical shift:²²

"During the 20th National Congress of the Chinese Communist Party (CCP) last month, Chinese leader Xi Jinping brought the Deng era of Chinese politics to a definitive close. In many respects, it was clear that "reform and opening" was on its way out at the 19th Party Congress in 2017, when Xi proclaimed "a new era" in which the party would rectify the ideological, political, and policy "imbalances" left over from his predecessors. But it was the 20th Party Congress that gave Xi an unprecedented third term as leader and removed pro-market officials from the CCP's leadership. It even removed Xi's predecessor from the proceedings. After nearly 44 years, history will record that it was this congress that administered the last rites to Deng's reformist era. The brave new statist world of Xi Jinping is now in full force."

Xi is making clear, Rudd notes, that the CCP under his leadership has both the audacity and the capacity to translate this bold new vision into reality-- what Xi calls "Chinese-style modernization."²³ It is not entirely clear what the Xi style of modernization is or what the new alternative to the rules-based trading system would look like. It does appear to many that it will be more firmly focused on domestic security measures to ensure CCP preservation, strongly supportive of national sovereignty, and openness to working with the governments in power without judgment of their domestic policies, notably labor rights, human rights, environmental impact, and internal domestic security measures.

In 2019, China put in place national security review procedures for the acquisition by foreign investors of domestic enterprises and for the outbound transfer of intellectual property in the context of exporting technologies. In 2021, China's new Regulation on the Unreliable Entity List established a framework of restrictions or penalties on foreign entities deemed to endanger China's national sovereignty, security or development interests. Furthermore, the country strengthened its national security review of foreign investment by mandating pre-closing filings and authorizing the Government to review foreign investments in various sectors, including military, agriculture, energy, transportation and information technology.²⁴ In May 2023 on security grounds Beijing banned imports from a major US semiconductor producer.

Similarly, the US, like all its western allies, has put in place increasingly tight mechanisms for controlling investment into the US, strategic controls of exports containing technology, and outbound investment. All aimed at China. The Chips and Science Act, signed into law by President Biden in 2022, focuses explicitly and directly on defending America's leadership in advanced semiconductor technology by holding back China's advance. The Act prohibits "significant transactions involving the material expansion" of manufacturing capacity for leading-edge and advanced semiconductors in foreign countries of concern—including China. The proposed rules define "significant transactions" as those costing as little as \$100,000 and "material expansion" as increasing a facility's capacity by 5%.²⁵ The Commerce Department has bluntly stated its reasoning: "These thresholds are intended to capture even modest transactions attempting to expand manufacturing capacity" in China.

The exclusionary policies are working. The divide is growing, with economic consequence. Reva Goujon, director of China corporate advisory at Rhodium Group, stated that "This is essentially the U.S. utilizing industrial policy to steer supply chains for semiconductors in the direction that it wants, and that direction is clearly away from China." As a result, Samsung, SK Hynix, and most significantly TSMC are now all building major semiconductor manufacturing facilities in the US. The policy, she said, sends to companies a "clear signal that it's not going to be sustainable to produce semiconductors at the leading edge in China." John Bateman at the Carnegie Institute bluntly describes the phenomenon as America embarking "on one of its most difficult and dangerous international challenges since the Cold War. The task: reversing decades of economic and technological integration with its chief rival, China."²⁶

Language matters. Diplomacy is the art of communicating in ways to ease tensions and permit progress by smoothing over conflict. Aggressive and abrasive language does the opposite. It is well recognized in law enforcement and negotiation that if you approach a suspect or an adversary as a dangerous threat, they are much more likely to fulfill that expectation. Feverish public debate about the 'other' as a threat and a danger can only increase the likelihood of real danger.

22 Kevin Rudd, "The Return of Red China: Xi Jinping Brings Back Marxism," *Foreign Affairs*, November 9, 2022; at: <https://www.foreignaffairs.com/china/return-red-china>

23 *Ibid*, Rudd notes, that in 1992, the term "national security" appeared once, and it was used just four times in 2012. But at the 19th Party Congress in 2017, Xi's first as leader, the term was used 18 times. In 2023 it was mentioned 27 times. Meanwhile, the Chinese term for powerful state, *qiangguo*, appeared 23 times, compared with 19 in 2017 and only two in 2002. Rudd suggests that the party is now focused on Chinese nationalism and national security, a sharp break from previous regimes, which were preoccupied with economic development.

24 "BRICS Development Report, 2023: at: https://unctad.org/system/files/official-document/diae2023d1_en.pdf

25 "Chips Act Will Test Whether U.S. Can Reverse Semiconductor Exodus," *WSJ*, February 2023; at: https://www.wsj.com/articles/chips-act-will-test-whether-u-s-can-reverse-semiconductor-exodus-f7c5a324?mod=article_inline (The rules cover a 10-year period, which would allow companies to make adjustments in their long-term China strategy.)

26 John Bateman, "The Fevered Anti-China Attitude in Washington Is Going to Backfire," *Politico*, December 2022; At: <https://www.politico.com/news/magazine/2022/12/15/china-tech-decoupling-sanctions-00071723>

4 The Avoidable War: Building on a Foundation of Collaborative Interdependence

The highly charged political and economic relationship between the US and China has been severely tested by years of trade war, pandemic-driven supply disruption, and technology decoupling. US multinationals, however, with few exceptions have not moved operations out of China or given up their Chinese suppliers. In fact, foreign direct investment into China continues.²⁷ Chinese exports to the US, despite high tariffs, continue to grow in tech-driven products like medical equipment and industrial machinery. As Presidents Biden and Xi were announcing their respective defensive economic policies, Ford announced that it will invest \$4.5 billion in a partnership with nickel miner Vale Indonesia and China's Zhenjiang Huayou Cobalt to produce in Sulawesi Indonesia up to 120 kg of contained nickel per year. The US automaker continues to build a sophisticated network of partners to directly source materials for its electric vehicle production.²⁸ This comes barely a week after Ford made a major capital pledge for investments in Michigan and a battery plant in Turkey.²⁹

China's manufacturing sector continues a steady march up the product ladder, claiming larger portions of supply chains. American and other foreign multinationals continue to bring more production to China. Neither US policy nor industry have yet come up with an answer to China's unique combination of cost advantage, flexible production capability, huge scale, and high growth, supported by state subsidies, protection, and a new generation of aggressive manufacturers. The high level of interdependence and mutual benefit between the two economies—integrated cross-border supply chains, high US corporate profits earned in China, high Chinese royalty payments for US technology, China's dependence on the US as its largest export market—is both a source of conflict and a strong reason to avoid a costly reversal in the form of a permanent economic war.

The US-China Manufacturing Battleground

Most US-China trade is driven by givens, such as natural endowments or wage rates, beyond the reach of government policy or companies' ability to win back supply chains. Where US-China geopolitics seems like two tectonic plates crashing, US-China geoeconomics has been more like two rivers meeting and blending into a single force. The economic imperative clashes with and will potentially dominate the geopolitics. It will be difficult for Washington—and even harder for Beijing—to dam the Chinese tributary in the long run. Productive statecraft will depend on understanding thoroughly this highly interdependent trade dynamic.

Exhibit 1 shows in four categories China's total exports to the US—recently reaching record levels. Forty percent are traditional consumer products, largely sold through big box retailers, whose supply chains long ago left the US and are gradually leaving China to lower-cost labor countries. Twenty-five percent is personal computers, cell phones and related products that, while assembled and finished in China, actually contain more American content—design, software, and semiconductors—than Chinese. Another 10% of US imports from China are processed materials and low-tech intermediates, from steel and metal parts to processed fish, where the much talked-about resilience-seeking movement away from Chinese suppliers by American B2B buyers is underway.

The remaining 25% of Chinese exports—machinery and equipment of all kinds and tech-based products—is where major US manufacturers directly compete with China. Exhibit 2 compares the volume growth of China's exports to the US relative to the volume growth of US exports to China, industry-by-industry, from 2012 to 2021. The circle sizes represent the gain (in green) or decline (in red) in each country's exports to the other over the period. The sobering result is, excluding the big computer and cell phone volume that artificially inflate China's export strength, China's gain in annual export volume to the US in tech-based manufacturing was nearly four times that of US's exports to China over the period. The main reasons are twofold—China-based manufacturers are in general growing in capability faster than the US is creating new, advanced products that need US supply chains for their manufacture, and China remains the only lower-cost economy that can engineer and make these products to demanding buyers' specification in the volumes required.

The patterns of strength and volume gain/loss differ by industry, including those few where either China or the US dominates. China controls computers & cell phones assembly and telecom equipment, and the US in aircraft & jet engines and semiconductors. Then come the big, segmented industries, where both economies show strong export growth, each with different strengths. In medical equipment, for example, the US keeps developing new, more advanced products to sell to China, which in turn comes

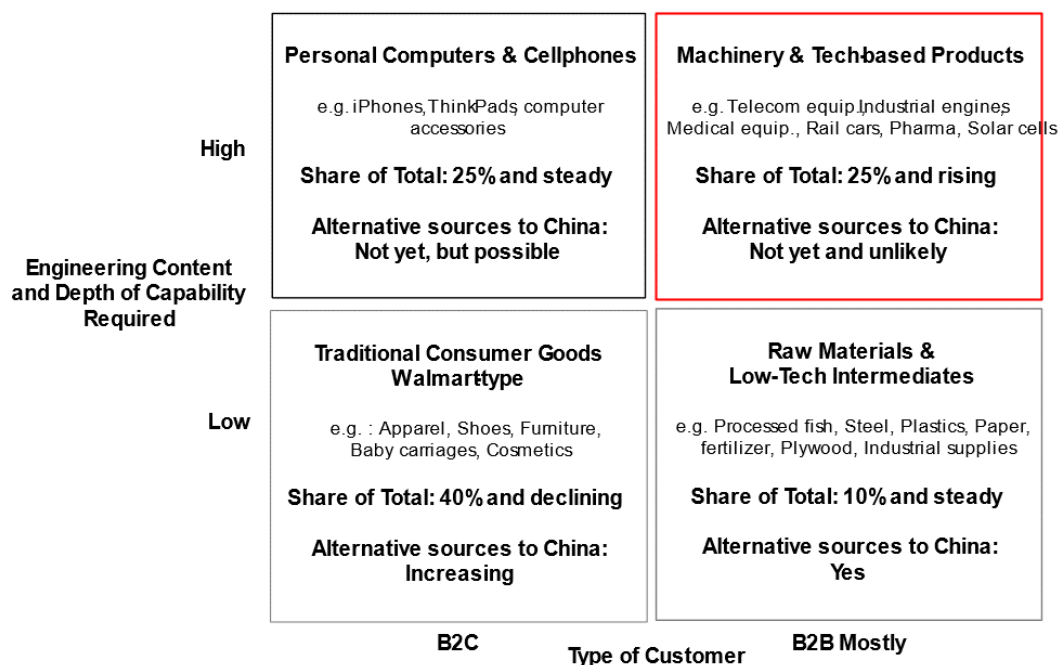
27 Actual flows are uncertain as Chinese Govt data tends to overstates FDI. <https://rhg.com/research/cutting-through-the-fog/>. Chinese manufacturing is highly integrated into global value chains, using global standards 90 percent of the time, while importing many advanced components. Multinational firms have greater penetration into Chinese consumer markets than they do in the United States. Woetzel and Seong, "The Value of Global China," *Projectsyndicate*, at: <https://www.project-syndicate.org/commentary/china-global-integration-trade-investment-liberalization-by-jonathan-woetzel-and-jeongmin-seong-2019-07>.

28 Alex Irwin-Hunt, "FDI round-up: Ford's \$4.5bn EV nickel deal, Campari's \$161m Kentucky refinery," *FDI Intelligence*, March 31, 2023; at: https://www.fdiintelligence.com/content/news/fdi-roundup-fords-45bn-ev-nickel-deal-camparis-161m-kentucky-refinery-ebd-backs-antalya-airport-82305?xnpe_tifc=OFzdHkU.xD4NxubXhIB_h9psafeWaeiWhFWZbMPvhdijVdA8nkJWRMxchfQJrFY7hFH8xdop4dH7huQ.4DYT&utm_source=exponea&utm_campaign=fDi%20Picks%20of%20the%20Week%2031.03.23&utm_medium=email

29 Ford plans Turkish battery plant, *fdiintelligence*, February 22, 2023; at: <https://www.fdiintelligence.com/content/locations/global/asia-pacific/south-korea/fdi-round-up-3bn-boost-for-oman-uae-railway-ford-plans-turkish-battery-plant-iberblue-wind-boosts-portugal-s-renewables-82124>

Exhibit 1

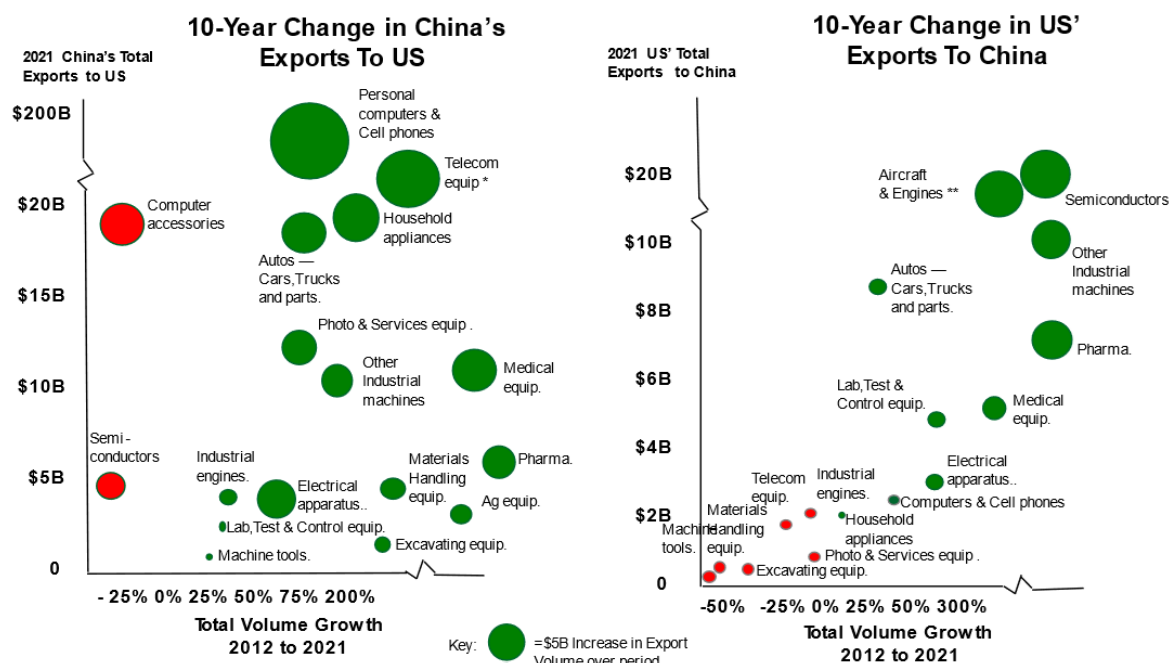
Four Categories of China's Exports To US



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Exhibit 2

Volume Gains and Losses in US -China Machinery & Tech Products Trade 2012-2021



Source: US Census Bureau international trade data; authors' analysis

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*China telecom equip. data runs from 2012-2018 to adjust for subsequent US bans to Huawei and ZTE

*US aircraft data runs from 2012-2018 to adjust for the Boeing 737 Max shipment pause since 2018

up with slimmed-down versions of basic machines to ship to the US. Pharma has a similar flavor, as does Other Industrial Machines, with the US much stronger in robotics, gas turbines, etc. where multiple disciplines, materials science, and software are critical, while China dominates in somewhat less complex, more standard-design, high manufacturing volume areas like silicon-based solar panels and drones.

In the remaining industry sectors, however, China's bilateral export volume growth is far healthier than the US'— household appliances, industrial engines, photographic equip. including cameras, materials handling equipment, agricultural equipment, excavating equipment, machine tools, auto parts, etc. This is traditional turf of big, important American manufacturers. In addition, China's import substitution proceeds in areas like telecom electronics, hydraulic valves, diesel engines, and excavating equipment, where US export volume to China actually declined over the last ten years. As a result, supply chains have consistently concentrated in China.

The Chinese competitive dynamic here is familiar to most, but its growing force is under-recognized. It starts with two big advantages—the world's largest market and an average 30-35% lower production cost—both leveraged by a government that reinforces market forces with subsidies and protections aimed at a tipping point where China's leading producers can match the foreign multinationals' product features and production quality, at which point production and supply chains migrate in earnest to China. Multinationals operating in China can drive this shift, but increasingly it's led by China's own better companies—mostly non-state-owned, founded since 2000, with R&D spending levels comparable to American competitors. Examples include Huawei (telecom), Goldwind (wind turbines), DJI (drones), HIKVision (surveillance cameras), Sany (excavating equipment), Longi Green Energy (solar panels), CATL (electric vehicle batteries), and Midea (home appliances),

China's scale, growth, and cost advantages are easily underestimated. The common reference to China as “the world's second largest economy” is illusory, as China has 15 million new housing starts per year (8 times' the US') and one billion internet users (over 3 times the US') and supplies the majority of equipment and construction to the Belt and Road Initiative, estimated at \$1trillion over ten years. And because Chinese industry was long fragmented by inter-provincial protections, the strongest competitors grow far faster than the national market as market share concentrates.

Cost advantage over US producers is driven not just by lower wages and salaries, lower construction and facilities costs, lower regulatory compliance standards, etc., but also by larger production capacity additions, manufacturing process refinements made possible by employing many more (affordable) factory-floor technicians and engineers, and a formidable Darwin effect from intense competition for market share.

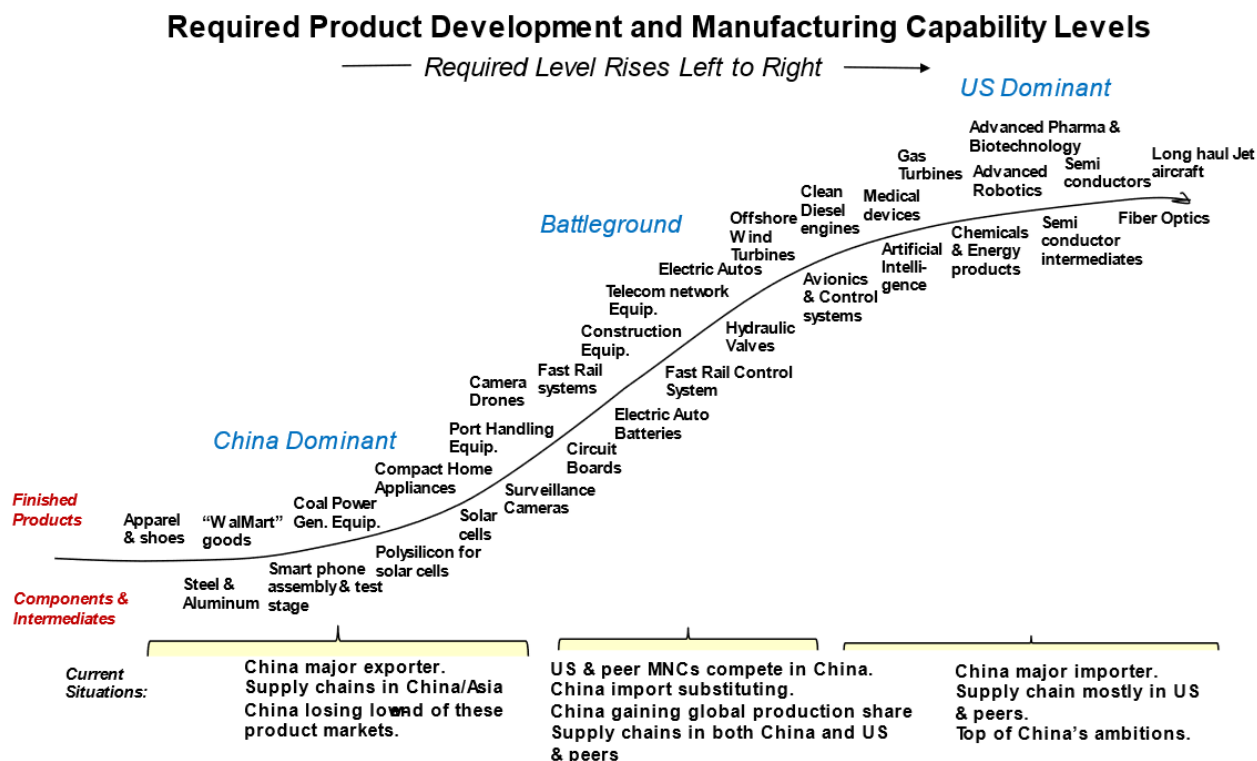
The tipping point is reached at different times depending on the industry, based on the American technology edge and the rate of product advancement relative to China's rate of technology and production improvement coming from behind. In a typical industry, finished goods production in China begins using critical imported components and intermediates behind a protective wall limiting foreign finished goods imports. China then attracts onshore the critical upstream supply chain that begins this layer of import substitution. Once China catches up to advanced countries' product standards in a portion of the industry's finished goods product line, production of that portion can begin moving from the US to China, which then commences exports. This catch-up traditionally is first accomplished by a foreign multinational's operation in China, followed by domestic producers. More portions of the product line follow until Chinese operations—either foreign or domestic owned—can produce most of the line, completing the cycle. The entire cycle can take decades, but increasingly progresses much faster. The technology and business know-how needed to drive this cycle in some cases arrives by obligatory technology transfer as a condition of market access for the foreign multinational or by pirating. Increasingly it is generated by Chinese domestic companies themselves. We call this dynamic China's supply chain gravity.

Exhibit 3 is a snapshot of the state of play today in select product lines and sorts them into three categories: 1) where China has the capability to develop and produce new products and is now dominant; 2) where the US remains dominant; and 3) the current battleground space between them. It is termed China's Moving Escalator because China continues to move up the curve.

Three battleground industries—wind turbines, medical devices, and electric autos—illustrate current early-stage movement up the curve through a powerful combination of China's growing corporate capability and government support. All three are *Made in China 2025* targets.

- *Wind turbines.* China began containing foreign producers' (GE, EU's Siemens-Gamesa, and Denmark's Vestas) domination in 2005 by raising tariffs on imported components and raising local content requirements from 40% to 70%, communicated informally to state-owned electric utilities to skirt WTO prohibitions. All three multinationals then brought operations to China. Vestas's largest and lowest cost factory is now in Tianjin, and China got a world-class supply chain to migrate—a good deal for both sides. Non-state-owned Goldwind and Envision grew rapidly, overtook state-owned Sinovel, and are now leaders in China, easily the world's largest market. Exports from China of the less-demanding onshore turbine-driven generator sets shot up starting in 2019, with the US their second largest destination. Both the multinationals and domestic suppliers are exporting. GE, Vestas, and Siemens-Gamesa remain leaders in the more-demanding offshore wind turbines.
- *Medical equipment.* Medical devices are a major US strength, with 25% of total global production. High-tech imaging,

Exhibit 3 China's Moving Escalator



Source: Authors' analysis; Bernstein Research

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biochemical diagnostics, and surgical replacement parts in China are dominated by innovative product streams from Johnson & Johnson, GE, Danaher, and European peers, while lower-cost products such as ultra-sound, stents, and defibrillators are developed and produced in China for export to the US by fast-growing Chinese non-state-owned Mindray, Neusoft Medical and others as well as by these multinationals. Chinese provincial health authorities order their state-run hospitals to use only China-made devices when available, and insurance re-imbursement can penalize imported stents. China remains a non-signatory to WTOs Agreement on Government Procurement. Not surprisingly, domestic producers are moving up the product ladder, with these products increasingly present in US hospitals. US imports from China are rising faster than US exports.

- *Electric vehicles (EVs) and batteries.* China's EV market moves faster than the US', thanks to government policy. Beijing in 2018 grew impatient with domestic auto producers' poor progress in EV new product development and invited Tesla, as a prod, into an unprecedented deal—100% ownership in Shanghai's Free Trade Zone. Further, it acted to keep superior Japanese and Korean batteries off the approved suppliers list for state-owned auto makers, allowing CATL and its Chinese rivals to capture the growth and move down the experience curve. Today, Tesla Shanghai's supply chain from casting machines to batteries is now nearly all in China, which now is the company's export hub for Europe. CATL refined the lower-cost lithium iron phosphate battery and is now the world's largest battery producer. GM, VW, etc. which dominate internal combustion engine cars in China, are well behind there in EVs.

All three industries will see Chinese supply chains grow in strength and volume relative to the US', and China's markets will continue to grow in strategic importance for American multinationals relative to the US market. Who owns the companies—foreign or domestic—matters less to China than getting strong players onshore. Beijing's thinking over the years hasn't changed—get the supply chain to China, and the dynamics of cost, growth, scale, and capability will enlarge China's competitively advantaged space relative to the US, despite current US deeper and broader innovation ability. In economic terms, China tends to deny access in US comparative advantage, importing only where the US has absolute advantage. All this is working well for China and unlikely to change. The question for US policymakers is what can or should be done about it?

5 Progress in China on Economic International Policy

Progress on reform in China is being made on some fronts. For instance, China's FDI Restrictiveness Index in manufacturing decreased from nearly 0.6 in 1997 to 0.21 in 2021—compared to an OECD average of 0.06.³⁰ In 2021, China further reduced the number of sectors restricted or prohibited for foreign investors, but only from 33 to 31. It abolished restrictions on foreign shareholding in joint-venture life insurance companies and encouraged foreign investors to establish regional headquarters in China for fund management, procurement and sales. China continues to explore liberalization with pilot programs opening 12 services sectors to FDI in the Tianjin, Shanghai and Chongqing municipalities and in Hainan Province.

China's recent Comprehensive Agreement on Investment (CAI) with the EU may signal a productive path for US-China relations as it lays out specific steppingstones. First, along with China's closing some doors in the economy, it is important to understand where it is opening other doors. Foreign firms wanting to invest in China have always needed to obey the country's prevailing Foreign Investment Law (FIL), which sets out the general principles applicable to foreign investment: FDI restrictions in certain sectors, limits on foreign ownership, requirements for joint ventures (JV) with local partners, controls on capacity expansion, etc. The FIL was revised in January 2020 to mandate that Chinese government procurement at all levels of government shall not discriminate between foreign and domestic firms. The FIL officially forbids forced technology transfer. Importantly, provisions in joint venture contracts that mandate transfers cannot be legally enforced.

Equally important, the new FIL specifies that when China signs an international agreement with provisions more favorable to the admission of foreign investors, those provisions will override the domestic regulations. International agreements already signed by China with investment provisions include the WTO agreements (China's schedule of commitments under the General Agreement for Trade in Services (GATS); the Regional Comprehensive Economic Partnership (RCEP) agreement among 15 Asia-Pacific countries; the Phase One US-China agreement; and the demands of the CPTPP, to which China has applied.

The EU-China CAI includes new rules on subsidies, state-owned enterprises (SOEs), technology transfer³¹ and transparency.³² In addition, the CAI establishes a commitment to allow each party's firms to participate in the development of standards (at least by the central government bodies) and join working groups and technical committees at all levels, as equals to domestic firms. The CAI offers possible progress toward resolving a major area of conflict between the US and China—how to handle SOEs. The CAI sets out criteria to define them, specifically to expand it from full ownership to the power of the state to appoint directors and to control the decisions of the enterprise through “any other ownership interest” or even without “any ownership stakes.”³³ The CAI also established a procedure through which a party can demand information about specific subsidies, similar to those of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).

In signing onto the CAI, China took an important step towards promoting ‘competitive neutrality’ between state-owned (or state-influenced) and private firms. It signals China's willingness to begin to deal with the major concerns raised about Chinese firms both at home and abroad. The CAI, combined with RCEP and the CPTPP application, suggests that China recognizes the need to integrate into global markets in the face of growing US adversity.

The CAI was concluded in principle in December 2020, but by March 2021 fell victim to dueling sanctions over forced labor in Xinjiang province.³⁴ China seems eager, however, to get it signed; the EU seems to have grown skeptical of China's commitment to the reforms. Nonetheless, the CAI offers indications of China's bargaining position for future negotiation with the US and, in turn, in the WTO. As important for the WTO are the CAI's sustainable investment provisions covering labor and environmental standards. These are now defining provisions in bilateral or regional agreements of the US and EU. The CAI is the China's first commitment to these standards and an important transformation by one of the most adamant leaders of the developing world's resistance.

30 OECD FDI Restrictiveness Index; at: https://www.oecd-ilibrary.org/finance-and-investment/fdi-restrictiveness/indicator/english_c176b7fa-en

31 Under CAI, parties cannot “impose or enforce any requirement or enforce any commitment or undertaking ... to transfer technology, a production process, or other proprietary knowledge to a natural person or an enterprise in its territory”. A tight reading of this language means that a local partner—it applies to production of goods and services—will not be able to enforce any commitment for tech transfer that it may have extracted from the foreign partner as a condition for a joint venture. That is, even when joint-venture requirements continue to apply, companies will no longer be able to enforce unwanted technology transfer. If enforced properly, this measure will be a major advance for EU firms investing in China.

32 Uri Dadush and André Sapir, “Is the European Union's investment agreement with China underrated?” *CEPR Policy Contribution Issue* no. 9/21, April 2021 (CAI's important progress in extending the CAI to subsidies in certain services, even if the enforceable provisions relate only to transparency (notification) and consultation. The subsidizing party is not required to remove the subsidy or to accept the complainant's countervailing measures, only to use its best effort to find a solution.)

33 Uri Dadush and André Sapir, “Is the European Union's investment agreement with China underrated?” *CEPR Policy Contribution Issue* no. 9/21, April 2021 (Firms granted monopolies by the state are also defined as SOEs. The definition applies at “all levels of government”, which includes the operation of SOEs owned by local and regional government. Under Section 2 Article 3 of the CAI, covered entities must “act in accordance with commercial considerations in the purchases and sales of goods or services in the territory of the Party ...” and not discriminate. Subsidies to SOEs are covered by a new notification requirement in the Article on Transparency of Subsidies, which applies to all enterprises)

34 Lily McWee, “The Rise and Demise of the EU-China Investment Agreement,” CSIS, March 20, 2023; at: <https://www.csis.org/analysis/rise-and-demise-eu-china-investment-agreement-takeaways-future-german-debate-china>

6 What's next: crashing plates or merging rivers?

The possibility of a deep economic rupture, even military intervention between the US and China, which would cut off supply chains and jeopardize the more than \$700 billion in U.S. assets in China, will remain for the foreseeable future. The increasingly harsh language dominating official dialogue defines the relationship. But the best place to begin thinking about US corporate and government options toward China is not a worst-case scenario but rather to consider the most likely scenario going forward. Here we lay out what we consider the most probable state of affairs, beginning with the near term and moving beyond.

-China's economic priorities going forward will remain much the same as before. Economic growth and manufacturing are the core of the Chinese Communist Party's legitimacy, hence will remain the main objectives. The CCP's 40-year track record since Mao has been to learn and smartly pivot. Growth will be slower. As government policy de-emphasizes the volatile property and construction sector as a growth engine, Beijing will depend even more on manufacturing and trade, avoiding moves that jeopardize exports and international confidence in its supply chains. Mr. Xi's controversial tech crackdowns have spared industrial tech giants, hitting media, fintech and services that have stepped on the Party's sensitive feet, but the key machinery and tech-rich sectors will get from Beijing what they need to succeed—which means taking aim at American competitors.

-Ongoing trade confrontation but limited economic warfare. Both Beijing and Washington have layers of economic weapons that can be used against each other. Fully employed they would be devastating. For that reason, a mutually assured economic destruction-type deterrent is likely to prevail, suggesting that defensive tools will be highly-pinpointed—applied to particular product markets for specific reasons. They are likely to continue to be employed aggressively but carefully, and largely under WTO governed rules of engagement. Decoupling will surely continue, but will be focused narrowly on national-security and strategic technology areas and not extending into overall trade and technology. If neither side feels it will gain more than it loses in an escalated economic war, there will be a strong impetus to limited actions and negotiated agreements. Invasion of Taiwan or China militarily supporting Russia's invasion of Ukraine would of course derail such moderation. While invasion is the default focus of media and increasingly of policymakers in both capitals, it is not the default planning assumption of companies.

-US Multinationals' continued investment in China. Foreign multinationals see beyond current disruptions and the risk of war to the long-run necessity and gains of building capability in China, which is why foreign direct investment in China by multinationals in battleground industries continues to rise, even as incoming FDI in cheap labor-seeking contract manufacturing and short-term portfolio investment falls. Portfolio investment is a game of many options and second chances, unlike direct investment, which is about long-term building of organizations and market positions. "China + 1" is a sensible business sourcing strategy for supply chain resilience, but not a new one. Foreign manufacturers are simply doing some de-risking by sourcing from other Asian economies but not de-globalizing or abandoning China. China's harder line toward foreign companies' China operations doesn't diminish the need to develop products for global distribution in China, which remains unique in its fast pace of generating manufacturing solutions. Examples are Honeywell in smart systems, Thermo Fisher in science lab equipment, and Toyota in green transportation. All are undeterred by China's economic nationalism.

-China's Durable Cost advantage. The 30-35% average production cost advantage over the US applies over a great product range from consumer goods to heavy equipment to high-tech devices, and increasingly stems from leaner designs and problem-solving in production processes. For example, LONGi Green Energy's raw material-conserving mono-crystalline silicon wafer production; Huawei's dense core signal processing units in 5G; and CATL's lighter, safer lithium iron phosphate batteries. Cost-reduction offsets rising wages. China skeptics emphasize its coming shortage of workers, but the impact of this on the scale and dynamism of China's market is many years' off. Meanwhile, scarce labor stimulates automation in digital payments systems, no-staff retail stores, and modular-based construction techniques. China is the most reliable, innovation-capable, high-volume, low-cost machinery and tech goods producer at this time.

-Macro market mechanisms favor Chinese supply chains. Exchange rates can, if the change is large enough, re-direct trade flows. But they are not available in the US-China trade context. The yuan/dollar exchange rate is roughly where it was ten years' ago and only 20% higher than twenty years ago when modern China was just emerging, mainly because Chinese people and companies want to own other currencies, while the US cannot depreciate the dollar because it is heavily traded and held internationally. Moreover, the opposing macroeconomic profiles are so diametric: the US' low investment, low saving, open market, low growth, strong currency, etc. compared to China's high investment, high saving, semi-protected markets, higher growth, weak currency, etc. Once directly connected in 2001 by the WTO, the flow of production, payroll, and household saving from one to the other was simple economic physics.

US-China Economic Statecraft 2.0

Beijing holds substantial leverage in any negotiation with its economic success and wealth, its tight administrative decision structure, and its facility with the many economic instruments it has used so successfully over the years.³⁵ It can push hard on the US.

³⁵ William J Norris, *Chinese Economic Statecraft: Commercial Actors, Grand Strategy, and State Control*. Cornell University press, 2016; and Reynolds and Goodman, "Deny, Deflect, Deter: Countering China's Economic Coercion," CSIS (2023)

The US needs economic statecraft that is more like China's—strategic, tactically coherent, and comprehensive, aimed directly at building up American competitiveness. It needs to be clear, forceful, inclusive, and consistent. US actions toward China after its accession to the WTO in 2001 were mostly defensive, i.e., challenge China's mercantilist export surges on a product-by-product basis while keeping its own market open to China toward the neoliberal rules-based international trade regime.

After 2016, the US posture hardened, pulling up “national security” and “serious domestic injury” to justify stiff tariffs on two-thirds of Chinese imports. Recent US legislation enables much tighter scrutiny of Chinese incoming foreign direct investment and more severe export controls, including Entity Lists that cut off dozens of Chinese companies' access to critical American technology. These measures extended prohibitions to American-owned technology anywhere, even if licensed to third party companies. The State Department's Operation Clean Networks successfully convinced many allies to reject Huawei's 5G system. Oversight of Chinese financing of US university-based scientific research was stepped up. This was followed by a Biden imposed Executive Order (forthcoming) to restrict outbound investment into China.

The Biden Administration has added two important initiatives. The first, mentioned earlier, is the Chips and Science Act which aims at keeping production of semiconductors and renewable energy products in the US. The US is thus responding to *Made in China 2025* with its own plan for US industry, including subsidies for building facilities in the US and de facto local content requirements; strategic restrictions on certain Chinese imports; more efficient application of countervailing and safeguard measures in response to subsidies Chinese producers receive at home—all necessary to level the playing field and build leverage for negotiations to remove such restrictions. The US must aim to engage in constructive dialogue with Beijing by making clear its intention to defend its industrial base. Specifically, the two governments should be open to negotiate industry-by-industry remedies with metrics to monitor improvement. Where possible, encourage bi-national joint ventures companies in infrastructure such as power plants and bridge construction. Explore free-trade zones (such as the Shanghai Pilot Free Trade Zone) for each other's manufacturers interested in building operations.

The second is increased emphasis on joining with trade partners to set high trade and investment standards regarding labor, the environment, and intellectual property treatment that require China to upgrade in order to be eligible to participate. Stronger bonds with trade allies are needed; not just trade agreements but collaborative infrastructure deals for emerging markets that can compete with China's Belt and Road Initiative, leveraging allies' best technologies, and teaming to develop focused value networks and better balancing of the security bill among alliances. In trade deals, the US should give developing countries access to its domestic market in China-dominated products in return for greater access to theirs in US-China battleground industries. And the US could eliminate tariffs on Chinese imports in China-dominated markets—the US need not care whose imports serve these— and focus strategic measures on Chinese imports in the battleground sectors.

This effort at broad-based partnership builds on the initiatives China is taking to integrate into the existing trading system (e.g., reformed FTA, RCEP, CPTPP, and CAI)—even if they are only shallow commitments to the principle. The goal is to make China realize the long-run benefit of turning toward a more market-oriented, rules-based model of domestic economics and international competition. Since 1973 China has been pulled toward that model. Since 2012, it has moved actively toward a more assertively self-sufficient state-capitalism under a more authoritarian and geopolitically oriented state. Washington, with its allies, needs to return to its role of openly pulling China into the rules-based trading system with much more proactive commercial and business diplomacy aimed at Beijing and at the Chinese business community.

Aside from its relations with China, positive statecraft for the US must include long-overdue measures to improve US competitiveness at home: more modern infrastructure; strategic immigration reform to secure a larger supply of trainable, high-quality labor and the corresponding training; regulatory reform to promote investment and ease the cost of doing business; incentives to drive managed health care throughout the economy; expanded technical education to create a workforce geared to smart manufacturing; and federal support to reduce the investment cost of production in the US. For example, US equipment manufacturers in battleground industries, when competing with Chinese producers in export markets, could receive both financial and technological supports equivalent to the difference in US vs. China price indices of industry cost inputs or to adjust for exchange rate distortion.

The US and China should re-establish a new form of the Strategic and Economic Dialogue (S&ED) and the Joint Committee on Commerce & Trade (JCCT). Re-establish also the rich network of dialogues that underlay these two national projects: such as the Cyber Working Group, the Climate Change Working Group, the Joint Committee on Science and Technology, the Water Quality Action Plan, the Law enforcement Cooperation Dialogue, the US-China Innovation Dialogue, the US-China Investment Forum, the Eco-Partnership Dialogue, the Energy Policy Dialogue, and Agriculture Joint Working Group, among others. New ones might be even more appropriate: a Cybercrime Working Group, a Business Leaders Regulatory Analysis Dialogue, a Public-Private Antitrust and Competition Policy Working Group, a Development Bank Best Practices Dialogue, or a WTO Reform Working Group. Others can be imagined. Both parties can nurture this network of initiatives to bring the two societies—government, business, labor, and civil society—into discussion, all with the objective of channeling conflict into constructive cooperation and a collaborative path toward a world order appropriately less dominated by the US and more open to Chinese characteristics (along with, of course, EU, Japanese, Canadian, Nigerian, Indonesian, Brazilian, and many more, characteristics).

In this way, the US can make clear both the path it wants to take and the alternative path it is willing to take to defend current battleground and US-dominated sectors. The US, working with allies, must convince China what is at stake by abandoning the free market-oriented, rules-based system for centralized state-capitalism alternative. For leverage, it needs to show it can play this game effectively by stronger and more effective defensive actions that level the playing field. It must demonstrate its ability to mobilize allies to support the current system.

Of course, any major US- China agreement seems like a reach, but it is certain that the US and China need the same thing—national and economic security and a stable global trading system. We may define these differently, but that can only be clarified and resolved with a rich structure of dialogue and negotiation.

7 Conclusion

China's rise to a Great Power is built on the free-market, rules-based trade order anchored by stable, consensus-based international institutions. Following the World War, the dominant United States recognized the value to it of a rules-based free market trading system with an abundance of wealthy trading partners. The system has served America well. China has also used this system well; indeed, it depends on it. But an authoritarian state capitalism of China's size and ambition threatens the system. China must bend to the system just as the system must stretch to include China. In turn, disrupting it in a targeted fashion is likely the only way the US can create the leverage needed to make room for a negotiated settlement between the two super-powers. Such a settlement is the only way to preserve the rules-based order that for the past 75 years has evolved to integrate the world economy, grow wealth and keep peace. China must blend into this system in order for it to continue to prosper in the long run. In turn the US must help the system open to China and adapt to ineluctable changes from such a large new force. If the rules-based system does not survive, a new, more clearly divided system will evolve that will impose greater costs on all parties. Hard choices are needed to design and implement policies that create the right leverage required for the tough negotiation needed to preserve the system. One might label this a "new Cold War," but at its heart it is a long hard negotiation that cannot and should not be avoided.