

# US AND CHINA: NEW COLD WAR OR AN OVERDUE NEGOTIATION

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## ABSTRACT

The worrying trajectory of US economic strength relative to China signals a need to reassess the US' rules of engagement on trade and investment with our principal economic rival. China is turning more authoritarian, more focused on self-sufficiency, challenging US dominance in critical technologies, and selectively honoring 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. This paper examines the nature of these shifts and the need for and scope of a more muscular US trade and industrial policies to deal with China, and state capitalism generally; ideally not as adversaries but as economic partners.

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The worrying trajectory of US economic strength relative to China signals a need to reassess the US' rules of engagement on trade and investment with our principal economic rival. China is turning more authoritarian, massively funding a challenge to US dominance in critical technologies and continuing to honor the market-based rules of the international trade order only selectively. Moreover, deep structural features of the Chinese economy and its management blunt the effectiveness of international rules-based trade policy tools. China may be on an immutable path toward tightly controlled state capitalism. It may still become a constructive part of the Bretton Woods rule-based system that has evolved over the past 75 years. Either way, maintaining a solid and peace-supporting US-China economic partnership is more important than ever. To this end, the US needs a new, more muscular second track of trade and industrial policy to work more effectively with China and other authoritarians.

### The China Challenge

China's unique size, economic features, and industrial policies present a unique problem to the US, to which it has yet come up with an answer.

- The US is a principal architect and defender of the neo-liberal, market-based system of trade rules, and has long invested in convincing China to move toward these rules while China strategically moves away from them, giving China space and time to gain competitive advantage.
- Much of China's mercantilist industrial policy is unwritten, ad hoc, and embedded in broader management practice of the Communist Party-State, which has made redress through formal, document-based WTO dispute settlement channels difficult.
- The structural features of China's economy-- State-driven, high investment, suppressed consumption, limited market access for imports, managed currency, and low production costs—are the polar opposite of the US. As a result, when these two economies were directly connected by China's entry into the WTO in 2001, a strong flow of production, supply chains, jobs and savings (from factory payroll) from the US to China was inexorable.
- China needs US technology and successfully enlists the support of powerful US multinationals in providing it, which continues to upgrade China's industrial capability. This has strengthened and enriched both China and these multinationals. But now China has gained leadership in some tech-based products and invests huge amounts to reduce US leverage over it.
- China's production cost advantage, on average 30-35% below US, is systemic and will continue to pull supply chains from the US as China learns how to manufacture products of increasing degree of difficulty. This is how China moves up the value ladder of industries into those where the US has been advantaged. This dynamic will continue until the US acts with determination to block it.

We first consider how trading with China is increasingly problematic and a growing policy dilemma for the US, then outline new, assertive measures needed to deal with it.

## The Rules-based World Trade Order

Daniel Rosen of the Rhodium Group summarized the China problem in his 2019 testimony before the US-China Economic Security Review Commission: “There are myriad pieces of a liberal market foundation, but the three that are paramount are the financial system, rules-based competitive regimes, and private intellectual property protection”, and Western economies “depend for our vitality on these structural conditions that China’s current policy choices disrupt.” He added that nations that do not share the same principles of market behavior “cannot be as engaged and interoperable as nations that do.”

China’s economic system features a large, protected state-owned sector and government-directed resource allocation: much of its financial sector off-limits to foreign investment; capital accounts closely controlled; ubiquitous subsidies to manufacturers from national, provincial, and local government entities; uneven intellectual property protection; barriers to imports ranging from local content requirements to government-approved supplier lists; and a long list of targeted trade actions to punish trading partners for political and personal slights.

As a result, the US must confront the growing duality in trade regimes: a section of the global economy that operates largely within the rules-based, market-driven order and a section that does not. The WTO is fully capable of dealing with a degree of state capitalism, but China presents a new level of disruption. It has not signed on to the public procurement anti-discriminatory provisions of the WTO which protects from foreign competition its huge state sector which is estimated to be 15-20% of its GDP. Further, China’s state-owned enterprises pose a legal problem for enforcement because the state superstructure that owns and controls them is exempt under WTO rules which target stand-alone traditional, stand-alone state-owned companies common in most economies. Further, recent disputes within the WTO itself have weakened safeguards against assertive state capitalism.

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With US-China trade volume at \$657 billion in 2021 and China selling four times as much to the US as the US sells back, the imbalance is acute. But the real issue is not the size of the bilateral deficit, it is that China is on track to strip the US of its international economic strengths through trade denial. Beijing’s *Made in China 2025* is a heavily subsidized 10-year program to develop home-grown technology to reduce dependence on foreign sources and to substitute Chinese-made semiconductors, jet engines, advanced robots, biopharmaceuticals, etc. for those currently imported from the US and its peer economies of the EU and Japan. China understandably wants less critical technology dependence on its main geopolitical rival, but in US eyes this initiative seeks to nullify the principle of comparative advantage on which sustainable trade relations between major powers depends. Without the restraint of a rules-based trade regime, a zero-sum mercantilist war for share of production takes root.

Two industries—wind turbines, and electric cars and batteries—illustrate how Beijing uses many levers to pull production out of advanced economies into China.

In 2005, as renewable energy became important, China decided to contain the growth of foreign wind turbine producers whose superior products had given it a 75% share of China's young market. It increased the local content requirement from 40% to 70%—informally communicated to the big energy utilities because the WTO prohibits formal local content requirements of that size—and substantially raised the tariff on imported components, then urged the two most promising Chinese producers—state-owned Sinovel and publicly-owned Goldwind—to compete. Foreign producers now had to bring more production into China, building onshore operating scale and knowledge. Goldwind progressed faster than Sinovel and became China's market leader as state-owned utilities favored domestic suppliers, and it rode China's high market growth and large scale to become a global player, joining Denmark's Vestas, the EU's Siemens-Gamesa, and the US' GE as world leaders. Vestas has its largest production facility in the world in China and exports advantageously based on its low costs there, and Beijing has the supply chain on its turf and inside its jurisdiction—a good deal for both sides.

Beijing was ahead of the US and its peers in promoting electric vehicles, and in 2018, impatient with the slow technological progress Chinese EV manufacturers were making, offered Tesla unprecedented 100% ownership in Shanghai's free-trade zone. Tesla Shanghai now claims 90% of its supply chain is in China. Tesla has launched a compact sports utility model for \$47,000, low enough to qualify for buyer subsidies in China. (The comparable model in the US starts at \$59,000.) Tesla Shanghai is already exporting electric cars to Europe. In batteries, Japanese and South Korean batteries were originally better and lower cost, so Chinese authorities kept them off the approved supplier list to state-owned electric auto companies, and limited buyer subsidies to EV vehicles with batteries made by Chinese companies, giving tremendous growth to China's promising competitor CATL which is now the global volume leader.

These two industries demonstrate how China combines nimble, aggressive economic statecraft with the competitive energy of both Chinese and foreign corporations and the competitor-sorting and volume-concentrating power of market forces to strengthen manufacturing operations and supply chains in China. China, unlike Japan, which kept foreign companies out of its industries, smartly has invited them in. In the process, Beijing builds a tense but profitable partnership with powerful foreign multinationals who have no interest in decoupling from China but also who can become hostage to the Party-state's demands for acquiescence on other issues dividing it and the US, ranging from Uyghurs to obligatory technology transfer.

### Economic Gravity and Cost Advantage

China's economic structure and policy are designed to direct resources disproportionately to manufacturing and export. Its industrial policies, financial policies, and industrial economics combine to have this effect. Investment remains roughly 40% of GDP, funded by high rates of household saving. Capital controls and a non-convertible currency have enabled China to manage the value of the yuan. It has been undervalued for trade purposes (i.e.. comparative costs and prices with other countries), first for decades by Central Bank design and later de facto by inadequate international and domestic demand to hold yuan. Today's dollar/yuan exchange rate

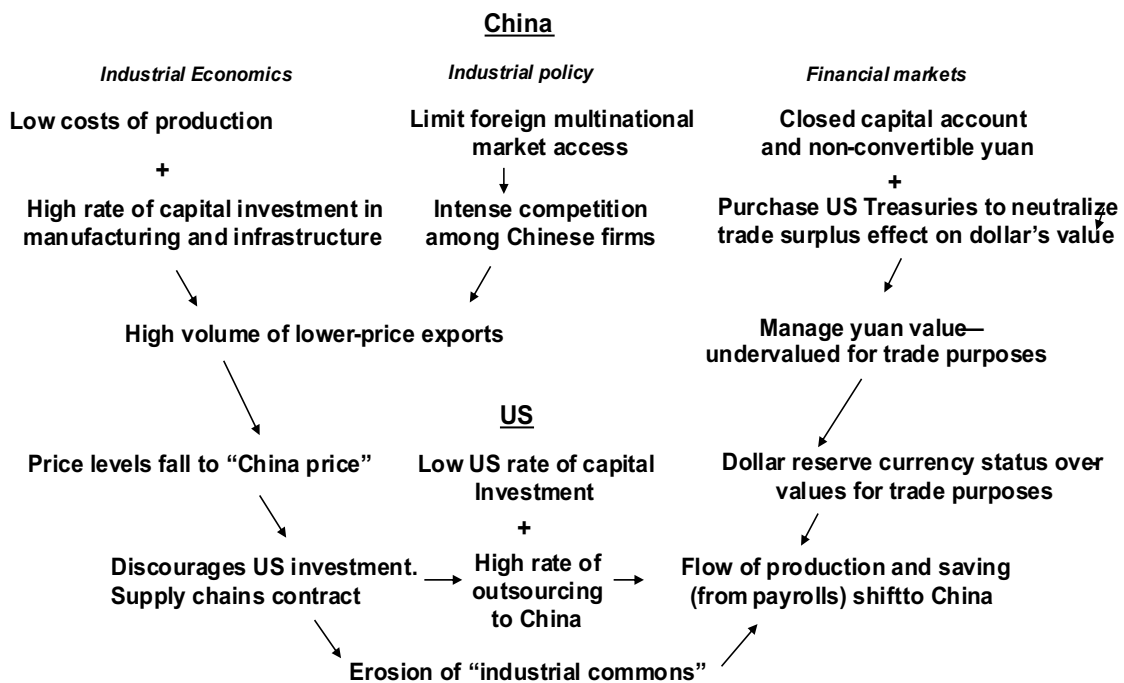
is essentially where it was ten years ago and only 20% higher than twenty years ago when China's level of industrial ability was rudimentary. China's rate of increase in industrial capability, cost efficiency, and range of exportable products has far outpaced the rise in value of the yuan.

Exhibit 1 traces the cause-and-effect linkage from macroeconomic enablers to microeconomic outcomes once China's economy was directly connected to US goods markets, multinational corporations, and financial markets twenty years ago. US economic features of low investment, high consumption, open markets, technology rich multinationals, higher production costs, and a reserve currency role that over-values the dollar for trade purposes form the other half of this interactive system. The result is simply economic physics—manufactured product flowed from China to the US, and dollar payments, payroll, and technology flowed in the reverse direction.

Exhibit 1

## Effects of China's Macroeconomic Profile on US Economy

*Dynamics of the Two Economies' Interaction Once Connected in 2001*



China's cost advantage allows Chinese companies to land manufactured product in the US on average 30-35% lower than costs of US producers. Exhibit 2 describes the structure of this cost difference. It applies across a great range of manufactured products, allowing China to displace US production once it is able to make a product to developed economy quality standards. The sources of this cost advantage are many: lower wages and salaries, longer working hours, larger production scales, higher rates of new capital investment, simplified manufacturing processes, lower land and construction costs, lower safety and environmental standards and costs of compliance, modern logistics infrastructure, and intense domestic competition among Chinese manufacturers for market share. This will not change. Modern

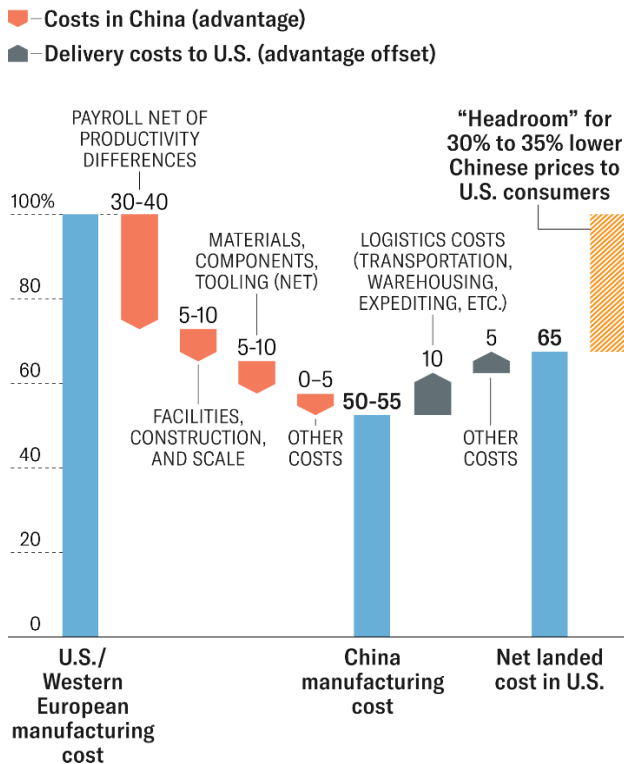
advances like 3D printing, robotics, etc. will not neutralize this advantage, as both China and the US seriously pursue them.

## Exhibit 2

### China's Cost Advantage over the U.S.

Manufacturers in China enjoy a 30% to 35% cost advantage in the U.S. over U.S. domestic producers.

#### Composite of the costs of manufacturers of industrial and consumer products



Source: Thomas Hout's analysis of Boston Consulting Group data HBR

Findings based on years of data collection around these products—capital goods (rail systems, telecom equipment, and construction equipment); consumer and business durables (home appliances, autos, air compressors, and medical equipment and devices); components and intermediate products (solar panels, auto parts, electric motors, and pharmaceutical ingredients).

### China's Capability Escalator

The combination of China's large cost advantage and its steady movement up the industry ladder means continued erosion of US production and value chains. The entire industrial landscape can be seen as a spectrum of products and production processes ranging from low entry barrier, low-degree-of difficulty to high entry barrier, high-degree of difficulty. Exhibit 3 organizes a representative sample of products of interest in today's China-US trade, with required capability to compete increasing from left to right. Each column is divided into

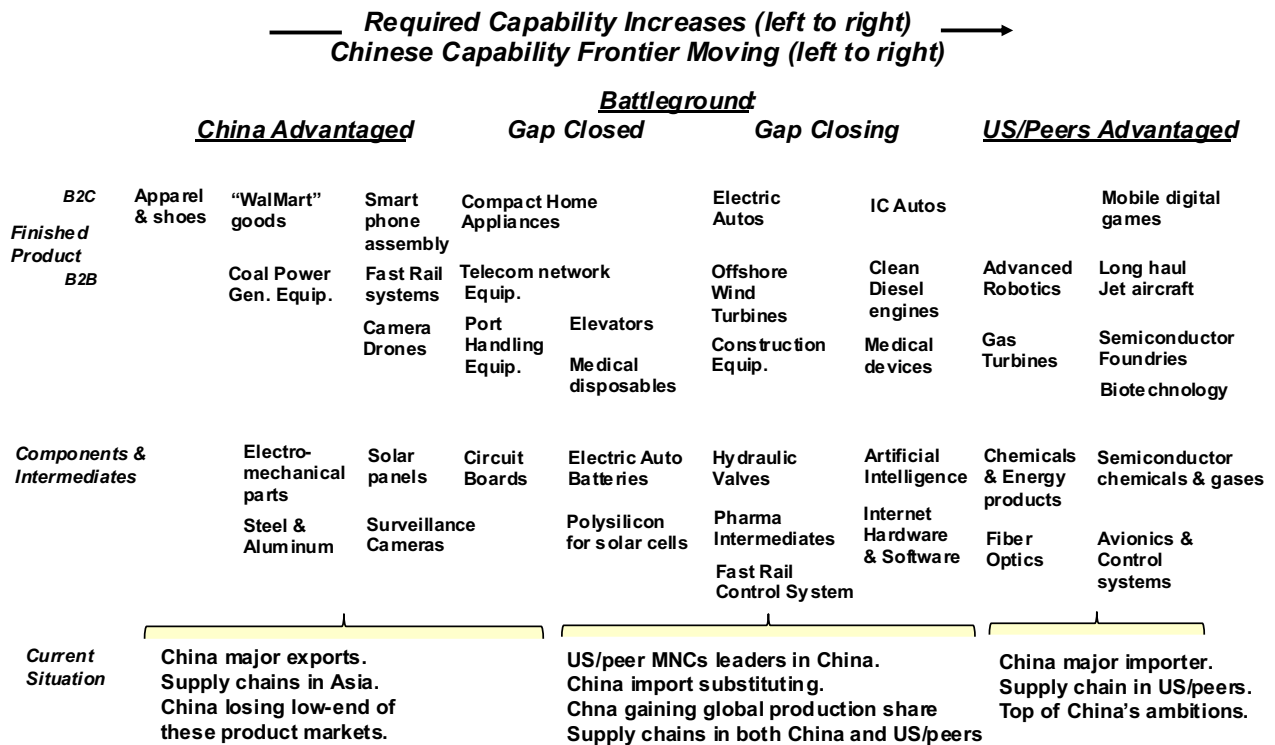
three levels—consumer products (B2C), industrial end products (B2B), and prominent intermediates/components.

Industries where China holds advantage and dominates trade—i.e. easier entry, cost advantage drives outcomes—are on the left. Supply chains of these products reside in China or elsewhere in Asia. Only the upstream big-ticket machinery that make these products would still be in the US and its developed economy peers. Products where US holds advantage and currently dominates trade—i.e., hard to enter, deep capability required—are on the right, and their supply chains of critical components similarly reside in the US or its peers. American corporations in US-advantaged industries do not stand still, and in semiconductors, advanced robotics, and others their rate of product advances outruns China’s rate of capability advance. Only in industries like chemicals and energy products where US is cost-advantaged are American producers safe.

In the middle of the spectrum are the Battleground industries where China is steadily closing or has closed the capability gap. These are relatively fast-growing industries of great importance to US industrial health and employment.

Exhibit 3

### China’s Moving Escalator Where China’s Ability To Engineer and Manufacture Acceptable Quality Product Relative To US Today



## Tipping Points

China's capability frontier has been moving from left to right—based on both foreign technology and its own. As operations expand in China—whether foreign or Chinese owned—they can successfully engineer and manufacture a product at lower cost that will pull production from the US.

This shift typically goes in phases, with the low-end, lower degree-of-difficulty products or stages of the production process going first. The Chinese facility gains experience and scale, increasing its ability to handle the next degree-of-difficulty. GE in medical devices and Cummins in diesel engines illustrate here. Both create and produce their most advanced products in the US, but have big multinational production footprints, and over time China's share of their total global production volume increases, in part because China's market has grown faster than others they serve (i.e. more products designed for China and made in China) and in part because an onshore China operation, once fully capable, begins to supply lower-cost piece parts and/or less-advanced finished goods to the US and peer developed markets. This is how multinational corporations create advantage against direct competitors, including Chinese.

Further, Chinese supply chains in recent years are steadily import-substituting more expensive key components and intermediates from the US and its peers such as hydraulic valves (for construction equipment), control systems (for fast rail) or polysilicon (for solar panels). Comparative advantage is effectively nullified by a creeping absolute advantage.

The Battleground columns are of urgent US policy interest as the US risks losing these supply chains and the “industrial commons” (knowledge clusters, tool makers, raw materials sources, sub-suppliers, research efforts, etc.) behind them. Tipping points here are happening earlier in a product's life cycle, and Chinese companies have quickly moved to dominate global production scale in several relatively new tech-based products such as Huawei (5G telecom network equipment), HIKVision (surveillance cameras), DJI (drones), CATL (EV batteries) and Longi Green Energy (solar panels). All these companies devote roughly the same percentage of revenues to R&D as their Western competitors. Four of these five are non-state owned and founded in the 21<sup>st</sup> century.

## How This Bilateral Trade Imbalance Matters

In market-driven, rules-based trade where equilibration mechanisms (e.g, real exchange rate movements) can operate, comparative advantage allocates shares of production. Bilateral trade imbalances matter little or not at all. Bilateral deficits and surpluses can offset each other, and even chronic overall deficits or surpluses can be sustained by capital movements and national borrowing capacity. But bilateral trade imbalances matter where one partner is taking production share away from the other through non-market, non-rules-based means; where comparative advantage is being suppressed; where equilibration mechanisms are not available to



offset structural absolute advantages; and where geopolitical power stakes are high and the balance of geopolitical relative advantage is based in part on what is traded between the two.

China's exports are increasingly Battleground products. The share of total Chinese exports that are high-value, knowledge-intensive products—specifically, machinery and equipment of all kinds including big-ticket capital goods, precision instruments and medical devices, vehicles, and pharmaceuticals, etc.—has risen from 40% in 2001 to 56% today and is still rising directly into sectors of US comparative advantage. The US faces costly consequences if they are lost.

### US Policy Objectives and Options

The context for new policy thinking toward China is this: The US-China economic relationship is too big to be allowed to fail, but if it is not re-structured, it is not sustainable. Such a re-structuring must both serve US interests and ultimately, if it itself is to be sustainable, be tolerable to China.

Let us acknowledge the US has a foundational competitiveness problem independent of China. It needs to build modern infrastructure, increase skilled immigration, better educate and develop its work force, reduce its cost structure, including health care, invest more in critical technology areas, de-polarize its politics, etc. All these positive developmental actions are necessary to remain competitive even in the market-driven, rules-based trading world in which the US operates with most trading partners. But competing with China's state capitalism and dynamic non-state-owned companies demands, in addition, more targeted, more assertive policies—both positive developmental ones and defensive, protective ones—that are carried out earlier in the game. Further, any new policies will work best if the US brings its rules-based allies along in the effort.

The industry categories in exhibit 3—China-advantaged, Battleground, and US-advantaged—are a useful framework for considering both the positive and defensive policies needed vis-à-vis China.

#### *China-advantaged category:*

Little in the way of new China-specific policy will be useful here, and the US should continue to use standard defensive tools within the WTO process. Supply chains in the great majority of these goods (except specialty, high end versions) long ago left the US and low Chinese prices on consumer goods raise US real incomes. In many cases, like intermediates from coated wire to heavy forgings, they help keep US finished goods producers stay competitive. Tariffs here simply raise these costs. The great majority of Chinese value-added imported into the US is in this category. Dropping or lowering trade war tariffs here will be a useful concession to China to offset new, more assertive US measures in battleground and US-advantaged products. Some exceptions, however, might be for critical medical items or scarce materials or where fledgling US suppliers show promise of leapfrogging the Chinese with new technology.

A variety of positive tools, however, will help here. More trade and investment agreements with allies and emerging markets—the US making it easier for their imports into currently China-advantaged areas in return for greater access for US products in battleground and US-advantaged products. More use of enterprise zones near US ports offering tax and tariff concessions would make it easier for foreign companies to finish production of goods now entering for the US market and exports. This creates jobs and more supply chain resilience. Also, more incentives for US finished goods producers and their supply chains to take advantage of the North American platform (USMCA economies) would be useful, especially now that Chinese and Mexican wages are similar. The more intermediates sourced from Mexico, the greater the chance finished goods production is viable and secure in North America. Targeted economic supports for Central American countries (CAFTA countries) could extend the North American platform, create a larger and more wage competitive industrial base, and address dramatically the developmental needs of central America that contribute heavily to the politically sensitive immigration “flooding” concerns in the US.

*Supply-chain Battleground category:*

This territory—from EV batteries to medical devices to wind turbines—is where policy toward China needs to be more strategic, organized, and proactive. The policy purpose must be to prevent tipping points. China’s entrepreneurial energy, mercantilist practices, cost advantage, and high market growth, together means that more supply chains will over time migrate to China unless the US counteracts them. The key is to keep US supply chains intact, keeping finished product and critical upstream intermediates and services in the US while allowing lower-priced non-critical intermediates into the US.

Existing US laws enable a broad range of unilateral actions against Chinese imports. Section 301 of the 1974 Trade Act is a tool for promoting reciprocity, authorizing the President to respond to foreign practices that block US exports and foreign investments. Section 232 of the 1962 Trade Expansion Act authorizes actions where US national security is threatened by foreign trade practices. With China both a risky supply source of critical goods and a geopolitical adversary, it is clear that the US has a national economic security interest in many battleground products. Finally, the most China-specific and potentially most powerful tool would be revival of a Section 421-like trade remedy. Section 421, replacing Sec 406 of the 1974 Trade Act that targeted safeguard actions against non-market non-WTO members, was added in year 2000 as part of China’s WTO accession agreement. Section 421 enables tariff relief and restrictions on Chinese imports that “disrupt” the market, a less demanding standard than the “serious injury” requirement needed for the seldom used Section 201 safeguard measures. Perhaps more importantly, Section 421 requires that the US International Trade Commission both determine injury and explain the short- and long-term effects both of taking and of not taking its remedy recommendation before the President decides on the final action.

To key to properly implement a strategy built around these tools, the US must establish a decision-making entity; we suggest one headed by the Office of the US Trade Representative (conveniently positioned within the Executive office of the President) and with participation from Departments of Treasury, Commerce, Energy, and Defense, at least. Prioritization of

product sectors for would depend on merit including importance to national economic security and competitive viability of the supply chain.

Defensive measures need to target specific Chinese practices and product areas *early* and take the form of some combination of quantitative restrictions, local content requirements, and targeted tariffs or sanctions. Quantitative restrictions could be either product-specific or the issuance of a limited number of licenses to import across pools of designated products, which reduces the management burden on USTR. Local content rules encourage both foreign and domestic investment in the US and can pinpoint portions of the value chain most critical to defend. China of course is very familiar with these measures, having used them on foreign multinationals for years. (Severe penalties for falsification of country-of-origin or product description documents are needed to reduce fraud.) Disruption of current sourcing patterns will be significant, as the Battleground sector has many intertwined supply chains involving China.

Positive developmental policies can start with public procurement preferences for domestic producers but need to include expanded financial incentives to export for Battleground companies. ARPA-E and National Institute of Health fund energy and medical promising startups, but ARPA equivalents for other targeted Battleground product areas are needed, especially where otherwise strong US supply chains are coming under Chinese fire. (Tesla got a \$465M loan from ARPA-E in 2009.) ARPA equivalents should coordinate grants and loans with the quantitative defensive measures outlined above through the USTR. States play a more ground level role from incentivizing foreign direct investment to hosting partnerships across corporations, universities and community colleges, foundations, and government aimed at improving overall competitiveness. The Central Indiana Corporate Partnership (CICP) is a model. It is not accidental that Indiana leads the US in percentage of work force employed in manufacturing.

The ultimate goal vis-à-vis China of all this may well be a comprehensive negotiated settlement. China much prefers a marketplace with orderly and predictable economic policies to one governed by episodic measures subject to politically driven change. It has thrived in the rules-based system since joining the WTO in 2001. It does especially well if everyone else follows the rules while it picks and chooses—its own form of free-rider advantage. The price to China of a negotiated settlement would be a new set of rules of engagement that might hinder its Battleground exports. The price to the US will be giving up most of the US tariffs covering two-thirds of China's exports, which are mostly China-advantaged industries where US supply chains are long gone.

*US-advantaged category:*

The most comprehensive set of US actions is required in this sector, which lies at the core of national security and economic growth, represents the US' strongest exports and intellectual property assets and constitutes a unique industrial and technology commons. This category is highly visible to Congress so it tends to get what it needs, once the case is made.

Recent changes to American policy and law aimed at China include: heightened controls on the export of US technology; broader screening of incoming foreign direct and portfolio investment (the Foreign Investment Risk Review Modernization Act), and possible scrutiny of outgoing foreign direct investment by US firms; exclusionary entity lists of Chinese companies; etc. More positive policy is on the way, including large subsidies to US-located semiconductor capital spending, STEM education, clean energy, supply chain resilience in scarce raw materials, etc. worth roughly \$200 billion.

To prevent tipping points, positive policies beyond money are necessary if the US wants to compete effectively with big-ticket systems against China Inc. This means US government proactively orchestrating projects involving federal Departments, US and allies' foreign corporations, and financial institutions around US technology standards and systems architectures. (The Defense and State Departments do this effectively in military systems and aerospace.) An example is the Trump Administration's Operation Clean Networks that blunted Huawei's drive to sell its 5G wireless network systems worldwide. Operation Clean Networks was a late scramble to avoid disaster. The model going forward needs to be to get the US ahead of the curve, leveraging trading partners' growing concerns about China geopolitically, and leading the way in developing alternatives.

The defensive unilateral measures and enabling laws outlined above for the Battleground apply here as well, even more so because leverage is greater in the US-advantaged sector for many reasons. US technology is stronger and its sanctions would hit harder because China remains dependent on US technology and US soft power around the world is far greater. The US is learning to use its tools more purposefully and strategically but would need to get key peer economies aboard on these measures. The US will incur short-term costs in all this, experiencing what economists call "second-best solutions" when trade is managed. Fair enough. And we recognize the problem of bureaucratic creep as administrative agencies dabble in private business. But the longer-term costs of not doing enough to match your biggest competitor when they follow different and more favorable rules are greater and largely irreversible.

## Conclusion

China, the first nation to become a Great Power based solely on economic power, was able to do so because of the free-market, rules-based trade order anchored by stable, consensus-based international institutions. China uses this order well; indeed, depends on it. 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 helping keep peace. China must blend into this system in order for it to survive. If it does not survive, a new, more clearly divided system will *per force* have to arrive. 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 hard negotiation that cannot and should not be avoided.