The future of US-China relations

Many experienced policy observers have recently considered how the Trump presidency will impact Europe, China and the global economy. Until now, "China Compass" has examined this multifaceted issue almost exclusively from the European or Chinese perspective. Our China expert and Strategy& colleague John Jullens adopts a different vantage point, thereby shedding new light on the current situation and its complexities. He begins his article by recalling a rivalry from ancient Greece, one that, according to a recent Harvard study, serves as a cautionary tale for US-Chinese relations.

Topics discussed in this article
- Thucydides's Trap and its implications for global tensions today
- The three strategic responses the US must choose from
- How foreign multinationals in China can protect themselves from low- and high-probability events

A recurring dilemma

In part due to its legendary military prowess and ascetic values, oligarchic Sparta had become the dominant power in ancient Greece by the fifth century BCE as well as the chief historical source for the authoritarian ideals of Plato's Republic. It was the unquestioned – land-based – superpower in its day, until the rise of another city-state, Athens, which had developed a formidable – sea-based – military of its own, but under a very different system of governance: democracy.

Athens' democratic dynamism created a thriving economy, and briefly made it the philosophical centre of the Western world, but its prosperity and influence dismayed Sparta, which felt its own leadership position was being undermined. Tragically, in 431 BCE, the Peloponnesian War broke out. It not only ruined Athens, but also led to the demise of Sparta, which, although victorious, never fully recovered and was eventually defeated by Thebes in 371 BCE at the Battle of Leuctra. In fact, as the bilateral conflict between Athens and Sparta spilled over into all-out warfare between other Greek city-states, the Peloponnesian War effectively marked the end of Greece's golden age.

The likelihood of a rising power, such as Athens, getting into a destructive military conflict with an established power, such as Sparta, has since become known as Thucydides's Trap, after the Athenian historian and arguably the world's first great strategist. Thucydides, who actually fought in the Peloponnesian War himself, subsequently penned a brilliantly insightful analysis of the war's inevitability due to "the growth of the power of Athens and the alarm which this inspired in Sparta". In fact, a recent study from Harvard University's Belfer Center found that when a major rising power threatens to displace a major ruling one, the most likely outcome is war. According to the study, no less than 12 of 16 cases from the last 500 years ended violently, including the mid-20th century conflict between the US and Japan.

There has been much hand-wringing of late about the similar rise of a resurgent China and the threat this poses to today's incumbent superpower, the United States. There certainly seem to be plenty of issues that could potentially trigger a conflict, including the North Korean nuclear threat, the Taiwan Relations Act, maritime disputes, cyber issues and various trade, currency and other economic issues. Until recently, most pundits thought China's rise would be peaceful, but, as Graham Allison, who led the Harvard study, has written: "China and the United States are currently on a collision course for war – unless both parties take difficult and painful steps to avoid it." Fortunately, as Allison acknowledges, falling into Thucydides's Trap is by no means inevitable, especially in the nuclear age. The potential repercussions are simply too great. In fact, the most recent cases examined by Allison and his team did not end in war. For example, while the US and the Soviet Union did engage in a hyper-tense Cold War from 1945 until the 1990s (and arguably until today), their conflict never resulted in outright war. And while the growing tensions since the 1990s between the UK and France, on the one side, and Germany, on the other, have culminated in the UK's dramatic decision to leave the European Union altogether, they have never come even remotely close to a military conflict.

New conditions, changing views

While a full-blown war between the US and China, which are both nuclear powers, seems highly unlikely at this time, it is nevertheless important to recognise that US-China relations have arrived at an important inflection point, since the status quo that has largely served both countries well over the last 20 years has become unsustainable; at the same time, the future direction of the relationship remains unclear. In fact, there exists a wide range of potential future scenarios, from mutual accommodation to something approaching a full-blown trade war, and perhaps even limited military conflict. As usual, the truth will lie somewhere in between those two bookend scenarios, but not necessarily in the middle. Most importantly, fundamental structural factors are putting stress on the status quo. In other words, the root causes are primarily a function of domestic political and economic developments in both countries, even though the eventual outcome will likely also be a function of the individual personalities and styles of the leaders of each country: President Donald Trump of the US and President Xi Jinping of China.

Until recently, China was still a minor economic power with limited geopolitical ambitions. Beijing was preoccupied with domestic economic development and growth while trying to maintain domestic political stability. Chinese leaders viewed the US largely in aspirational terms, especially economically. At the same time, the US had become the world's sole superpower after the collapse of the Soviet Union in the early 1990s. Unlike China, Washington was primarily outwardly focused on actively spreading America's ideology of democracy, free trade and other Western values. Indeed, the US clearly saw itself as the political and economic model for all other countries to look up to and emulate, and even helped China enter the WTO in 2000.

Since that time, however, US economic growth has not only slowed significantly, but the distribution of economic gains has changed substantially as well, in part due to post-WTO trade with China. The latter may account for as much as 40% of the decline in American manufacturing jobs since 2000 and has put downward pressure on real wages for semi-skilled labour, devastating some communities dependent on low-end manufacturing jobs. In addition, the US no longer views itself as an unambiguous economic success story due to the global financial crisis it inadvertently triggered in 2008, and the anti-establishment movements that have gained strength on both ends of the political spectrum: the Sanders / Occupy Wall Street factions on the left and the Trump / Tea Party factions on the right. Finally, the US has experienced significant geopolitical and military challenges in, for example, Afghanistan, Iraq, Libya and Syria. The resulting social and economic pressures have made the US increasingly self-absorbed and inwardly focused, and undoubtedly played an important role in Donald Trump's victory in the recent presidential election.

At the same time, China has now become a major geopolitical and economic power and is increasingly starting to behave as one. It is now the world's second-largest economy, with an enormous trade surplus and massive US Treasury holdings. It has significantly increased its defence budget and become much more assertive geopolitically, especially close to home in East and South-East Asia. Most importantly, China's spectacular rise was consciously based on a very different political system and economic development strategy than the so-called Washington Consensus policies that were advocated by the US. In addition, those emerging markets that did embrace Washington's policy prescriptions, including many South American and South-East Asian countries, have not been nearly as successful and seen their economic development fall far behind China's. As a result, China is becoming increasingly confident and outwardly focused, and simply no longer looks up to the US to the same degree it did before.

Given their divergent political and economic objectives, strategies and influence – and the resulting potential for misinterpretation and mistrust – it is crucial for the US to fully understand China's motivations (and vice versa, of course). Most importantly, China's new-found assertiveness is actually only in part due to its growing economic and geopolitical power (i.e., strength) and much more a function of its having arrived at a crucial inflection point in its economic development, now that it is a middle income country trying to become a high income country (i.e., weakness). In fact, much of China's behaviour, both domestically and internationally, can be explained as being the steps Beijing feels are necessary to successfully transition towards a new phase in the country's economic development.

The "Chinese Dream"

China's primary challenge is that the economic engine that drove its spectacular growth over the last 30 years has run its natural course and needs to be replaced. This is often described in terms of a rebalancing away from exports and labour-intensive, low-skilled light manufacturing to a more market-based economy driven by domestic consumption and services. That is technically correct but also somewhat misleading; what China really needs to do is upgrade its industrial base from producing the world's garments, toys and so on to becoming a world-class producer of higher value added goods, such as cars, planes and medical equipment. That is very difficult to do and goes far beyond simply correcting market failures and further opening up trade and financial markets. In fact, opening up domestic markets too early to foreign competition could wipe out nascent local players, which is precisely what China is trying to avoid. Similarly, liberalising financial markets too soon can be destabilising, as the experience of South-East Asian countries during the 1997 financial crisis showed.

In this context, President Xi Jinping came to power in 2012 with a strong mandate and real sense of urgency to develop and implement the required structural adjustments. Xi's economic development plan was underpinned by three important guiding principles: the need for urgent and significant economic reform, the belief that implementing reform requires absolute political stability, and an attempt to wrap the required changes into an aspirational, Kennedy-esque "Chinese Dream".

Each of these pillars, or imperatives, makes sense from the perspective of Beijing, but less so from the perspective of Washington. For example, the need for upgrading China's industrial base has involved protectionist policies in industries that Beijing considers strategic, such as automotive, transportation and telecommunications. Similarly, the perceived need for political stability spawned a major effort to stamp out government corruption and increase control over, for example, social media, especially with an eye on recent events in the Middle East (i.e., the Arab Spring) and in the context of a slowing economy burdened by high debt levels and accelerating capital flight.

Further reading
- Allison, Graham. *Destined for War: Can America and China Escape Thucydides's Trap?*, Houghton Mifflin Harcourt.
- Autor, David, David Dorn and Gordon Hanson. *The China Shock: Learning from Labor Market Adjustment to Large Changes in Trade*, National Bureau of Labor Statistics.
- Dollar, David. *The Future of US-China Trade Ties*, Brookings.
- Gordon, Philip. *A Vision of Trump at War*, Foreign Affairs.
- Harvard Kennedy School, Belfer Center. *Thucydides's Trap*.
- Jin, Keyu. *China's Weapons of Trade War*, Project Syndicate.
- Jullens, John. *China: The Mother of All Black Swans*, Strategy+Business.
- Jullens, John. *Lessons from the East Asian Development Model*, Strategy+Business.
- Jullens, John. *Rethinking China's Economic Growth Challenges*, All China Review.
- Thucydides. *History of the Peloponnesian War*, Wikisource.

Finally, Xi has embarked on a nationalist campaign to inspire the Chinese people and inoculate the leadership from the pain of its restructuring efforts while making the proverbial medicine of economic reform go down a little easier. In fact, Xi's promulgation of the "great rejuvenation of the Chinese nation" is remarkably similar to Donald Trump's "Make America Great Again" campaign slogan, albeit with the important Thucydian difference that Xi is trying to reclaim what China once had, while Trump is trying to hold on to what the US already has.

All of this is playing out in a context where the US must deal with an unusual number of significant geopolitical and economic challenges, including the denuclearisation of North Korea, the resolution of several Asia-Pacific maritime disputes, global climate change and the impact of digitisation, automation and other elements of the fourth Industrial Revolution on the US economy and society in general. The key question is which course of action the new Trump administration will decide to pursue and whether it will be able to successfully tackle concerns about China's recent actions without compromising potential cooperation in areas of mutual benefit.

The administration will have to choose one of three potential strategic postures: accommodation, containment/confrontation, or some combination of sticks and carrots. Accommodation would be the preferred option, if the administration believes that China's rise is more or less inevitable and that any attempt by the US to stop it is doomed to fail and will only lead to a lose-lose outcome for everyone. From this perspective, the US should try to get along and live side-by-side with China. This is analogous to the approach taken by the British Empire towards the US after World War II. On the other hand, those favouring confrontation tend to see China as a hostile actor that can be, and should be, contained. This option is similar to the US's strategy towards the Soviet Union during the Cold War, but, importantly, is taking place in a far more interconnected world, especially economically. The third option is to view China as the proverbial "frenemy" and adopt a sticks-and-carrots approach to manage US-China relations. For example, this could include cooperating to resolve the North Korea issue, while using targeted trade sanctions to encourage China to play by the rules of the international community. (It is necessary to keep in mind, of course, that China views these rules as designed by, and favouring, the US itself, and not universally applicable international norms).

Many roads lead to Beijing

As of this writing, it is not yet clear which approach the new Trump administration will ultimately decide to adopt. On the one hand, Trump's campaign rhetoric was unusually tough on China, including calling for a 45% tariff on Chinese imports, designating China a currency manipulator and questioning the US's longstanding "One China" policy. In addition, the new administration withdrew from the Trans-Pacific Partnership trade agreement within one week of taking office. On the other hand, President Trump has since adopted a more conciliatory posture and his first in-person meeting with President Xi at his Mar-A-Lago resort in Florida seems to have gone well. Nevertheless, the new administration has not yet articulated its China policy, and the underlying issues and accompanying scope for mistrust and conflict have, of course, remained.

Given the size and importance of the Chinese market in many industries, many US firms will have no choice but to continue to find ways to be successful and win in China. For example, as much as 40% of automotive sales volume growth during the next few years will come from China, according to PwC Autofacts. The key for foreign multinationals (MNCs) is to try to be as nimble as possible in light of the significant irreducible uncertainty that will likely exist for the foreseeable future. They should start with some scenario-planning to better understand the implications of the various potential outcomes, ranging from benign changes to the status quo to more disruptive changes, and what they should do in response to each. At a minimum, MNCs should anticipate some modifications to existing trade policy and tax regulations, given that the US has already opted out of TPP, which is currently being reconstituted, but this time with China as a leading member. In addition, the new administration is considering various changes to, for example, border tax adjustments on imports and exports, corporate tax rates, import duties and other free trade agreements (e.g., NAFTA), which will materially impact global supply chains and the operations of MNCs in China in terms of optimal manufacturing footprint, best country sourcing, research and development activities and future investments. MNCs need to carefully consider and model the potential profit, tax and transfer pricing implications of each scenario. In addition, they may want to adopt a real options approach to their investment strategies, making smaller incremental investments each time until the future becomes clearer again.

More seriously, it is possible that a more significant trade conflict will break out between the US and China. In this case, US firms should be prepared for much tougher tit-for-tat actions, as China has plenty of its own trade weapons at its disposal. For example, China could decide to cancel orders for airplanes and other products and shift its purchases to non-US suppliers. Similarly, it could discourage Chinese companies and consumers from buying American products and services, as recently happened to South Korean firms. In addition, it could decide to dump some of its massive holdings of US Treasury securities and other financial assets, significantly raising US interest rates and making the new administration's planned tax cuts and infrastructure investments much more difficult to fund. A major trade conflict could also significantly impact global supply chains and production networks, resulting in inflation – i.e., much higher consumer prices in the US.

US firms should actively engage with the Trump administration to make sure the consequences of any decision it is contemplating is fully understood in terms of the actual impact on employment, inflation, interest rates and the economy in general. It is especially important to assess the impact on employment, as the low- and middle-skilled jobs that have been lost to China since 2000 are unlikely to come back to the US under any scenario. At the same time, US firms should engage in similar lobbying activities in China, either directly to those national, regional and local authorities and companies that favour foreign trade and investment, or indirectly through the American diplomatic corps and various chambers of commerce. Some MNCs may also want to rethink their partnership strategies with local Chinese firms to further inoculate themselves from potential retaliatory actions.

Finally, MNCs would be wise to consider the unthinkable and also plan for true low-probability/high-impact black swan events, such as another war on the Korean peninsula, a domestic financial crisis or major social unrest. They should map their geographic footprint and operations, including supply chains, channel partners, and customers, and try to identify all events that could result in major demand shocks or supply chain interruptions. Detailed contingency plans should be developed for each event and prioritised based on their risk exposure, ease of implementation and cost. Simulations and war games are often useful tools for

Towards a new type of power relationship

Commentary from Katja Banik

In terms of their own preparations for the future, both the US and China – but also the EU – should rethink their internationalisation strategies: they must find a more effective and wiser way to use globalisation as a means of managing their respective countries and regions. Regardless of China's rising military spending, the US is still – and will be for a long time – the only global military power. A war between the US and China is unlikely as a result.

Ultimately, it is all about geopolitics – the relation between power and space. All trade agreements and multinational cooperative ventures are embedded in a multitude of political and diplomatic partnerships. Being part of the rule-making process for global trade therefore means being part of world leadership.

Considering the US's re-balancing strategy in Asia, it has always considered China both a friend and a enemy to some degree especially under the Obama administration with its "Pivot to Asia" policy. The US's apparent withdrawal from Eurasia and Trump's "America First" policy seem to be supporting China's geopolitical ambitions. The recently launched Belt and Road Initiative (BRI) is part of China's new grand strategy, which aims at securing major trade roads between source and production sites. In fact, this is clearly a "China First" strategy.

Thus, both China and the US are adopting a "country first" approach. This does not necessarily make their separate approaches conflicting scenarios; they could be seen as complementary narratives instead. These narratives aim at ensuring each country's economic, social and political development, thus increasing national outcomes. Consequently, it seems that both nations are in the process of defining a new type of "great power" relationship.

Complementary instead of conflicting applies to all the relevant stakeholders – nation-states and transnational players such as the EU. Everyone is in the same boat and has different objectives but is facing the same challenges. Embracing universal values is therefore of critical importance – and is something all stakeholders should do.

assessing the potential impact of each event and, equally important, training senior executives to deal with such crises.

Thus, US-China relations have entered an important new phase. While certainly no one in Washington or Beijing is interested in engaging the other in a serious conflict, Thucydian history and fundamentally different interests, objectives and styles suggest such a conflict is possible, perhaps even likely. MNCs would be wise to hope for the best but prepare for the worst.

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