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THE U.S. – CHINA ECONOMIC CONFRONTATION: THE PARADOXICAL RESULT

Ekonomska konfrontacija SAD i Kine – paradoksalni rezultat

Abstract

The paper analyzes the confrontation between the United States and China in the recent trade war that resulted in the new trade deal between the two countries at the beginning of this year. After giving a short background, the paper gives an overview of the U.S. – China economic relations, the trade war and the results of the new trade deal. The general conclusion is that the trade war initiated by the United States through the introduction and raising of tariffs was ineffective with the U.S. bearing the costs. The overambitious quantitative goals of the new trade deal are unrealistic and will probably not be achieved. The trade war also undermined the international order of which the rules of conduct of international trade are a significant part. The trade war as well as the U.S. opposition to the appointments of appellate judges in the WTO have undermined this organization as the institutional foundation of international trade. Paradoxically, in order to oppose what are perceived as unfair trade practices within the system of free trade by China, the U.S. has adopted state-managed trade. The new trade deal with China will only strengthen the U.S. interdependence with China as well as the Chinese system of "state capitalism" that in the U.S. view was seen as the root of the problem in its trade with China. In short, the trade war and the resulting deal were self-defeating in terms of the goals that they were supposed to achieve.

Keywords: *United States, China, international trade, trade war.*

Sažetak

Rad analizira konfronatciju između SAD i Kine u okviru nedavnog trgovinskog rata koji je rezultirao novim trgovinskim sporazumom koji je potpisan početkom ove godine. Posle kratkog osvrta na nedavnu istoriju dve zemlje, rad daje pregled ekonomskih odnosa između SAD i Kine, trgovinskog rata i rezultata novog trgovinskog sporazuma. Opšti zaključak je da je trgovinski rat koji su započele SAD kroz uvođenje i podizanje carina bio neefikasan uz snošenje njegovih troškova od strane SAD. Novi trgovinski sporazum između SAD i Kine ima preambiciozne kvantitativne ciljeve koji verovatno neće biti ostvareni. Trgovinski rat je podrio međunarodni poredak u okviru koga su pravila međunarodne trgovine značajan deo. Trgovinski rat, kao i protivljenje SAD da se postave apelacione sudije u okviru STO su podrile ovu organizaciju koja je institucionalni temelj međunarodne trgovine. Paradoksalno, kako bi se suprotstavile onome što vide kao nedozvoljene radnje u okviru sistema slobodne međunarodne trgovine od strane Kine, SAD su prihvatile državno upravljanje međunarodnom trgovinom. Novi trgovinski sporazum sa Kinom samo će ojačati međuzavisnost između SAD i Kine kao i sistem kineskog „državnog kapitalizma" koji je po mišljenju administracije SAD bio koren problema u trgovini sa Kinom. Ukratko, trgovinski rat i rezultirajući novi trgovinski sporazum su samoporažavajući sa aspekta zadatih ciljeva.

Ključne reči: *Sjedinjene Američke Države, Kina, međunarodna trgovina, trgovinski rat.*

Introduction

The current trade war between the United States and China did not come to an end with the new trade deal that was signed this January. Rather than as a "peace treaty" it should be seen as a "truce". It will certainly be spun as a triumph for the U.S. by president Trump in the year in which he is seeking reelection. It will probably be portrayed as a constructive diplomatic triumph by Xi Jinping as well, by projecting China as a responsible international player dedicated to both globalization and compromise. However, the really hard questions concerning why and how the U.S. and China got into a trade war will remain unanswered or rather answered in such a radically different way by the participants as to render answers that can be discussed rationally among them and based on facts close to impossible. Worse yet, radically different answers may lead to further feuds and confrontations leading to de-globalization, fragmentation of the world economy and the beginning of a new "Cold War". Given the circumstances, the true major challenge is how to avoid this type of confrontation. A very brief view of the major developments affecting the U.S. and China during the last two decades, as well as their interaction should shed some light on the background of the trade war that brought so much uncertainty to the rest of the world.

Two decades ago, the U.S. was the sole superpower and undisputed leader of NATO, the largest economy, a champion of free trade, multilateral institutions (IMF, World Bank, WTO) and globalization based on the vision of an ever expanding liberal world order. True, in some cases international rules were breached, some stretched and some trampled on, but overall there was a belief that the liberal order had no true alternative and that the U.S. was the prime shaper of that order. American preoccupations were preserving that order by dealing with the Asian Crisis (1997), by keeping Russia afloat (backing Yeltsin, backing Russia up in the Russian financial crisis through the IMF, 1998) and expanding it by bringing China into the WTO (2001). The establishment of NAFTA was a sure sign of commitment to globalization since it was created to enhance competitiveness of its three members on the world market. On top of that, the U.S. economy was booming for the longest time, achieving budget surpluses and drawing down public debt with low inflation and high employment. Indeed, the collapse of communism in Europe and the dissolution of the Soviet Union brought not only a relative tranquility, but also a peace dividend by allowing for a drop in military spending in relation to GDP.

The events of September 11, 2001, were the beginning of a string of events that fundamentally changed that reality as well as the image and perception of the U.S. abroad. While the world showed solidarity with the United States, with Russia among the first to extend a helping hand, the U.S. was already drawing plans for the war in Iraq. This war was based not only on false information, but also on a doctrine of establishing a democratic regime in the Middle East that would serve as an example to other nations. In other words, the idea of an ever expanding liberal order that its proponents saw as (almost) inevitable, regardless of multilateralism and rule-based collective action through the UN, caused the first rift with important traditional European allies (France, Germany). The expansion of NATO to the borders of Russia and the perceived intention of expanding further into post-Soviet space led to a much more serious rift with Russia after a short war and the establishment of a frozen conflict in Georgia (2008). The same perception of the U.S. motives along with the fear of the engineering of colored revolutions in post-Soviet space led to the intervention in Ukraine, bringing another frozen conflict and sanctions on Russia by the U.S. and the EU. The financial crisis of 2008 was seen as of U.S. making and led to a recession that also exposed the weaknesses of the EU in general and the euro zone in particular. Perhaps, most importantly, it led to the loss of faith in the Anglo-Saxon version of capitalism, a model that many countries in the world had tried to emulate. The Obama administration stayed out of further military engagements, but was unable to lead to favorable outcomes or disengage from either Iraq or Afghanistan. In foreign policy, the Obama administration announced its "pivot to Asia" and negotiated the Trans-Pacific Partnership (TPP) a regional trade agreement that would include countries that made up 40% of world GDP, but excluded China and India. The attempts at resetting relations with Russia failed, as they took a turn for the worse with the crisis in Ukraine. The Trump administration has brought a fundamental change promoting a transactional approach to international relations, showing disdain for international institutions (including NATO) and disregarding rules (WTO). With his presidency, the U.S. is beginning to be perceived as a factor of instability and uncertainty.

The last two decades have seen profound changes within China as well as profound effects of China's rise on the rest of the world. The combination of growth based on surplus-labor, foreign direct investment (FDI) and export-led growth could not have been possible without economic reforms. At first shy and creeping, these reforms led to the dominance of the market economy and a growing private sector. The unprecedented high growth rates of such a large country for so long could not but leave a big footprint on the global economy. The results of this growth record are many, the most important one being that it has made China the second largest world economy in nominal terms (the first in purchasing power parity terms), that it lifted 800 million people out of absolute poverty and that it has reduced the difference between the standard of living of the average American citizen and the average Chinese citizen to four to one in purchasing power parity (a tenfold decrease of this ratio). China has also become the world's leading manufacturer reaching 20% of total global manufacturing in 2015. It has also become the leading trade partner for most countries in the world along with the EU.

Certainly, large problems came to the fore during this time. In spite of claiming a Marxist ideology it has become a nation of extreme income inequality. Also, it has vast regional differences in income leading to high internal migration. China has also seen its first serious financial crisis in 2015. Furthermore, it faces potential ecological disasters, not to mention some long-term factors that could lead to grave difficulties, the most obvious one being demographic decline.

The U.S. - China economic relations till the trade war

During these two decades, the economic relationship between the U.S. and China has also been growing at an unprecedented rate. The first and most obvious is the rise of China as merchandise trading partner of the United States. In 1980, China was the 24th merchandise trading partner, ranked 16th in exports and 36th in imports. In 2017, China was the U.S. largest merchandise trading partner by far, ranking 3rd in U.S. exports and 1st in imports [7, p. 2]. This expansion in merchandise trade was marked by larger and larger U.S. trade deficits as presented in Table 1.

The top five U.S. goods exports to China in 2017 were (1) aerospace products (mainly civilian aircraft and parts); (2) oil seeds and grains (mainly soybeans); (3) motor vehicles; (4) semiconductors and electronic components and (5) waste and scrap. China was the second-largest U.S. agricultural export market in 2017, at $19.6 billion, 63% of which consisted of soybeans. The top five U.S. imports from China in 2017 were (1) communications equipment; (2) computer equipment; (3) miscellaneous manufactured commodities (such as toys and games); (4) apparel; and (5)

Table 1: U.S. merchandise trade with China: 1980-2017 ($ in billions)

Year	U.S. Exports	U.S. Imports	U.S. Trade Balance
1980	3.8	1.1	+2.7
1990	4.8	15.2	-10.4
2000	16.3	100.1	-83.8
2010	91.9	365.0	-273.0
2011	104.1	399.4	-295.3
2012	110.5	425.6	-315.1
2013	121.7	440.4	-318.7
2014	123.7	468.5	-344.8
2015	115.9	483.2	-367.3
2016	115.6	462.6	-347.0
2017	130.4	505.6	-375.2

Source: U.S. International Trade Commission (USITC) Data Web.

semiconductors and other electronic components. China was also the fourth-largest source of U.S. agricultural imports in 2017 at $4.5 billion [7, pp. 3-4].

The trade deficit had already been an issue of concern in the previous two administrations. However, the current U.S. obsession with the trade deficit seems to be founded on a huge misunderstanding of the economic meaning of the deficit as well as the extent to which globalization has created an intertwined world in which unilateral national action is of very limited scope and can even be counterproductive. This will be discussed in the following section.

The flow of U.S. multinational companies' direct investment to China as well as investment by Chinese companies in the U.S. economy has also raised controversy.

Chinese investment in the U.S. consists mainly of the holding of U.S. Treasury securities reaching $1,325 billion at the end of 2017. If we add U.S. government agencies (such as Freddie Mac and Fannie Mae) securities, corporate securities, and equities (such as stocks), China's investment in public and private U.S. securities totaled $1.54 trillion in 2017 [14]. It is the largest holder of U.S. Treasury securities. The dynamics of Chinese holdings of U.S. Treasury securities is presented in Table 2.

Foreign direct investment flows (FDI) both from China and the U.S. are both naturally smaller but also somewhat controversial in terms of measurement. The official figures that the U.S. government uses come from the Bureau of Economic Analysis (government agency).

The latest data according to the U.S. Bureau of Economic Analysis (BEA), net U.S. FDI flows to China in 2018 were $7.6 billion (down 22.9% from 2017). Net Chinese FDI flows into the United States were negative (-$754 million, compared to $25.4 billion in 2016), as outflows exceeded inflows (e.g., asset divestitures). Additionally, the stock of U.S. FDI in China was $116.5 billion while Chinese FDI in the United States was $60.2 billion. In 2018, China accounted for 1.4% of total FDI stock in the United States [6].

However, the Rhodium Group (RG), a private consulting firm, contests BEA's and Chinese official government sourced data claiming that they do not accurately reflect the values of FDI of the two countries. One of the major reasons for this is that foreign direct investment flows of U.S. and Chinese foreign investment made by companies going through third countries are not taken into account. In order to take this into account RG developed its own transaction-based dataset to track investment by U.S. and Chinese-owned firms using commercial databases and news reports. Using its tracker, it puts gross Chinese FDI flows to the United States in 2018 at $5.4 billion and gross U.S. FDI flows to China at $13.0 billion. In addition, it estimates cumulative Chinese FDI in the United States at $140.5 billion and U.S. FDI in China at $269.6 billion. In other words, RG thinks that FDI stock of both countries in each other's economy is more than twice as large as claimed by official estimates [13]. Figure 1 illustrates this well.

China is also present in the U.S. real estate market. The cumulative Chinese investment in the U.S. real estate between 2010 and end 2018 has been $181 billion [7, p. 20].

The major characteristics of the economic interaction between China and the U.S. have been a rising U.S. trade deficit with China, large U.S. investment in China and China emerging as the largest holder of U.S. government debt. This had occurred against the background of prolonged record-high Chinese GDP growth rates that have made it the second largest world economy in total nominal GDP terms, and the largest world economy in total GDP at purchasing power parity. As already noted, this has resulted in a phenomenal rise in GDP per capita in China, which

Table 2: China's Holdings of U.S. Treasury Securities: 2002-2017

Year	2002	2004	2006	2008	2010	2012	2014	2016	2017
China's holdings $billions	118	223	397	727	1,160	1,203	1,244	1,058	1,185
China's holdings as a % of total foreign holdings	9.6%	12.1%	18.9%	23.6%	26.1%	23.0%	21.7%	17.6%	18.7%

Source: [2].

Note: Annual data are year-end.

Note: Data excludes Hong Kong and Macau which are treated separately. Adding Hong Kong ($139 billion) and Macau ($1.13 billion) would bring the total up to $1,325 billion at 2017 year's end and the percentage to 21% of all foreign holdings.

despite high income inequality has created a new large middle class in China. Due to Chinese purchases of the U.S. debt, the U.S. was enabled to continue with double deficits (budget and balance of payments) by borrowing cheaply and keeping long-term interest rates low. The U.S. also experienced very low inflation due to low prices of consumer and other products imported from China.

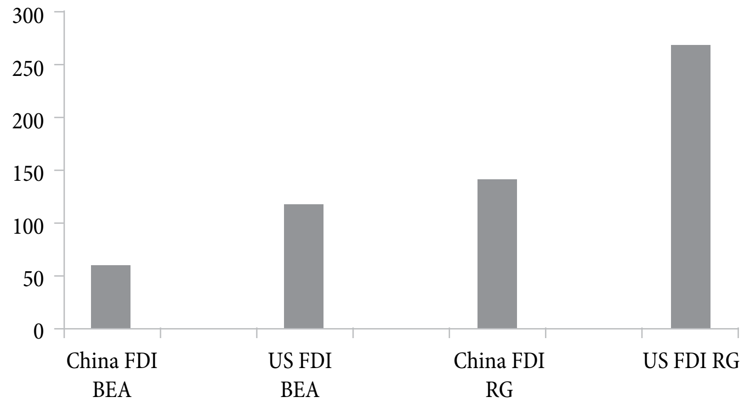
The US-based and other multinationals made large investments in China benefiting from low labor costs in the beginning as they rose in later years. They also benefited from sales in an enormous market as the standard of living was on a continuous rise in China for the last forty years. Finally, the multinationals kept their competitiveness and probably made huge profits from exporting these products to the EU and North America. It is difficult to estimate their total benefits but it should be clear that a significant percentage of exports from China can be attributed to multinational companies including those that are U.S. based. At the very basic level the return on investment (ROI) to U.S. multinationals was 12.5 % in China as opposed to 7.8% in the rest of the world in 2017. The latest reports say that due to the tensions between China and the United States, as well as other foreign competition that challenge China's position, these figures went to 11.2% and 8.9% respectfully in 2018. Nevertheless, it seems safe to conclude that investments in China over the years contributed to significantly higher profits for multinationals than in the rest of the global economy [9].

This self-reinforcing relationship between the U.S. and China with China as banker and the U.S. as spender has been called "Chimerica" by Niall Ferguson [8]. However, the relationship is more complex, because the Chinese motive for buying debt is to encourage consumption in the U.S. rightfully assuming that this will lead to higher Chinese exports. High export growth contributes not only to Chinese overall growth, but also gives multinational companies incentives to invest in low-wage China to spur their own growth by producing merchandise for export whether to the U.S. or the rest of the world. It is a self-reinforcing circle that not only provides growth to China but also upgrades its economy and results in high returns to multinationals. The "Chimerica" self-reinforcing circle is illustrated in Figure 2.

This type of interdependence could have been seen as too costly to jeopardize, given that benefits from the relationship for both partners are substantial. However, it was also unrealistic to assume that it could go on unmodified in the long run. The shift in this relationship was bound to come as China labor costs increased due to higher income and as its development moved Chinese industry to more sophisticated products including high-tech. These trends combined with the emergence of Chinese multinational companies on a global scale would necessarily position China as a serious competitor to the United States. What sped up the beginning of the confrontation between the U.S. and China, in my view, was the financial crisis of 2008.

It is true that even before that, the U.S. had raised several issues concerning economic relations with China. The major one was the size of the bilateral trade deficit which was perceived as a result of unfair practices (not adhering to WTO rules) and (less so in recent times) an undervalued Chinese currency. Furthermore, restrictive practices in regard to U.S. exports to China were identified. Perhaps, more importantly, the rising imports from China

Figure 1: Estimates of U.S. FDI stock in China and Chinese FDI stock in the U.S. by BEA and RG (2018 - $ billion)



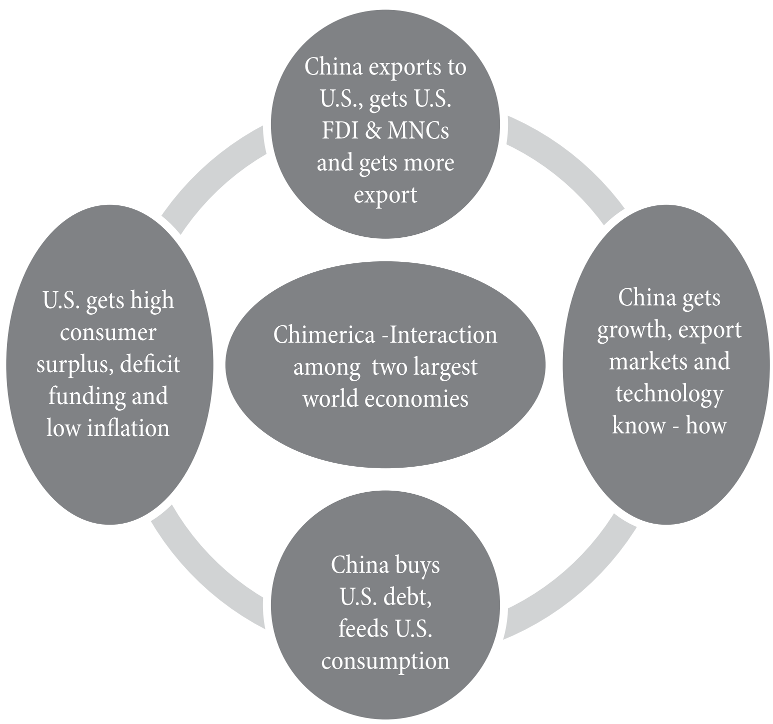
have recently begun to be seen as a cause of the loss of jobs in U.S. industry. Additionally, the U.S. had shown dissatisfaction with the Chinese barriers of entry for foreign investment in certain sectors (e.g., finance) and the inadequate protection of intellectual property rights. At this point in time, China is being accused of coercing the transfer of technology through joint ventures with U.S. companies. There are other important and less important issues, raised over the years, but they have all been put forth and listed recently in a much more vigorous (and aggressive) manner as the major explicit reasons for the tariff war that the Trump administration initiated in 2018.

The trade war between the U.S. and China

The trade war had been in the making for some time, as president Trump had come to power promising to impose tariffs on imports from China in order to reach a trade deal that would alleviate some of the problems perceived to be connected to the trade deficit. The expected outcomes were a more equal export and import balance in trade between the two countries, the preservation of industrial jobs in the U.S. and better opportunities for both U.S. exports and investment in China. All of these would hopefully contribute to a more balanced economic relationship from the point of view of the current U.S. administration.

The trade war began in February 2018 with a U.S. hike on tariffs on solar panels and washing machines, followed by a raising of tariffs on steel and aluminum. At that point, the new U.S. measures had affected around $30 billion worth of imports. China responded rather shyly by raising tariffs on imports from the U.S. on $3 billion value of goods. By October the U.S. had introduced new measures affecting $60 billion with China retaliating with a short lag by the amount of $60 billion. The tariffs were set at 25% by both countries. In October the value of goods affected by new U.S. tariff expansion rose to an extra $200 billion worth of imported goods from China with China retaliating to the extent of new tariffs on $60 billion of value of goods imported from the United States. Both countries set the tariff rates at 10%. Finally, as of May 2019, the U.S. in several hikes puts extra tariffs on the previous $200 billion of worth of goods and China retaliates with tariffs on a part of previous list of $60 billion worth of goods imported from the United States. The tariffs went up to 25 %. In September 2019, the U.S. adds tariffs of 15% on an extra $125 billion worth of imported goods from China. China retaliates with tariffs of 10% on an

Figure 2: Chimerica



extra $35 billion of worth of goods that it imports from the U.S. [4]. At this point, a trade deal to be implemented in phases was announced. The U.S. figures did not affect only China, but also India, Europe, Canada, Mexico and others so they do not exclusively deal with China. However, they were mostly aimed at China.

By the end of 2018, U.S. tariffs affected 50% of imports from China, while retaliatory tariffs affected 70% of exports from the U.S. to China. In 2018, the average tariffs on U.S. imports from China went from 3 to 12 % and the average tariffs on imports of U.S. goods to China went from 10 to over 18% [5]. These figures are averages and are just an illustration, because other antidumping and special protection measures were taken by the U.S. over the previous years. The lack of space prohibits further discussion of these topics. It got worse towards the end of 2019, with U.S. tariffs on $360 billion worth of imports from China. Finally, had the tariffs that were threatened to come into effect in December of 2019 come into effect, as well as retaliatory measures by China, almost all trade between the two countries would have been covered by new tariffs. These were suspended as negotiations on the new trade deal were coming to a close. The new trade deal did not suspend the tariffs that had been introduced leaving this to further negotiations depending on the implementation of the deal. Had these last tariffs been imposed, the only way to continue the trade war would have been to keep raising existing tariffs. The other option was to introduce quotas.

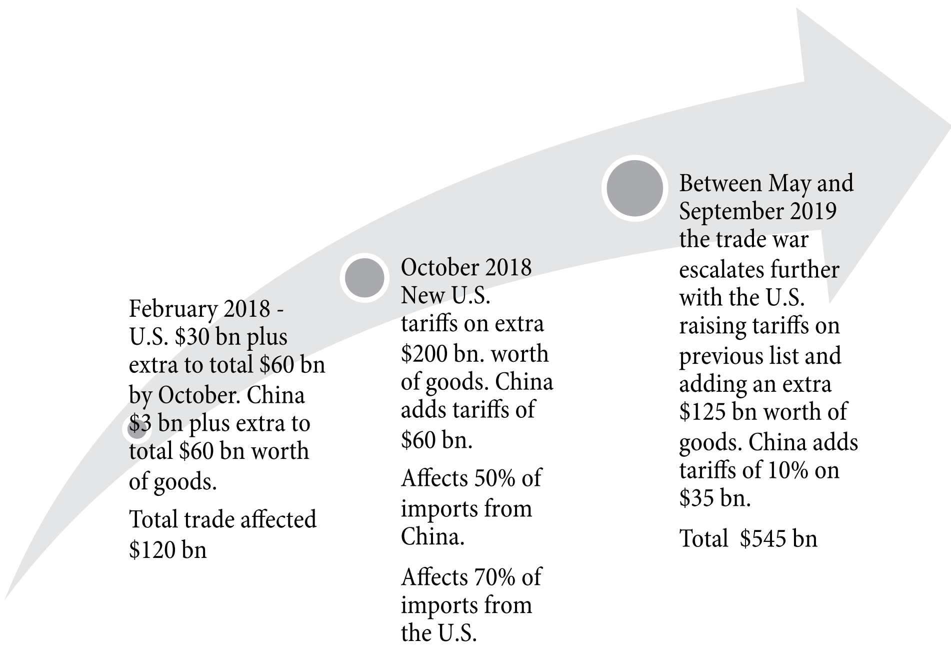
The total figures and dynamics are still staggering as presented in Figure 3.

Having presented most of the background and data, a closer look at some of the data, meaning of deficits, objectives and results of the trade war is in order.

Firstly, if the focus is on bilateral trade between the U.S. and China, one should be aware that so far the data presented dealt with merchandise goods. It should be noted that both the U.S. and China trade with each other in services and that this trade is not small. The U.S. has a surplus with its first four trading partners in services, China being the fourth trading partner for U.S. exports and eighth trading partner in imports of services. In 2017, the U.S. had a $40 billion surplus with China in trade in services [7, p. 8]. This is also by far the largest surplus in trade in services of the U.S. than with any other trading partner. If the focus is on bilateral trade, this should be taken into account, thus making the deficit smaller.

Furthermore, unless total foreign trade is conducted between two countries, trade deficits should not be considered as being bilateral. In that special case, tariffs would cut the deficit, raise government revenue, lead to loss of consumer surplus, raise producer surplus and create

Figure 3: The escalation of tariffs on the worth of goods by the U.S. and China (2018-2019)



some deadweight loss. This is elementary economics. However, in a system in which many countries participate, the result of tariffs could lead to the substitution of imports by imports from other countries that have not had new tariffs imposed. In turn, this would probably not lower the deficit by much, if at all, and would not lead to substantial government revenue, but would most certainly result in a loss of consumer surplus. For sure, it would provoke retaliatory measures by the counterparty.

It should come as no surprise that all of this did occur. Although it can be argued that the tariffs did not have time to affect trade, at the end of 2018 the U.S. trade deficit with China actually rose to $419 billion. This can also be explained by the frontloading of imports in anticipation of the tariffs. When the tariffs began to kick in, the bilateral U.S. trade deficit with China did go down to $346 billion, a reduction of 18% compared to 2018, but only 8% down from 2017. Compared to 2017, American exports to China were down by 18 %, while imports from China were down by 11%. However, the overall U.S. trade deficit with the rest of the world was just $20 billion lower (or 2.5%) than in 2018 and $60 billion higher (7.5%) than in 2017. In a nutshell, the whole trade war practically made a minute dent in the U.S. trade deficit with the world [15]. An obvious reason could be that there was diversion of trade leading to a rise in imports from other countries not hit by the tariffs, but at higher prices.

In 2018, the effects of the tariffs were overall negative for the United States. The hike in tariff revenues did not compensate for the loss of consumer surplus due to higher prices and deadweight loss. True, the overall loss was small, but still a loss [2]. In other words, most of the price hikes were passed through to U.S. consumers. The overall drop in U.S. imports from China on goods that were hit by the tariff has recently been estimated at 25%. However, there was trade diversion benefiting mostly Taiwan, Vietnam, Mexico and the European Union [16, pp. 11-12]. Looking at retaliatory measures by China, it should be noted that they were aimed at U.S. agriculture exports that had reached $19 billion. These exports were halved, but farmers were directly compensated.

As noted at the very beginning of this paper, the trade war did not end, but a provisional agreement was reached to be implemented in phases. Currently the agreement (signed on January 16th of this year) has phase I in its title. A basic overview of the facts leads to the conclusion that this deal is quantitatively unrealistic, difficult to implement, destabilizing for the international institutions and norms of trade and potentially a source of a new escalated conflict.

According to the agreement, China has obliged itself to import $200 billion of goods and services from the United States. In the first year China has committed to buy $77 billion of certain goods and services from the U.S. and another $123 billion the following year. The sectors covered by the agreement account for $134 billion imports from the U.S. leaving $52 billion uncovered. The idea that it is possible to bring the level of $134 billion of U.S. exports to the level of $257 billion by the end of 2021 at this point seems overly ambitious and extremely difficult to attain. The extremely high growth rates of U.S. exports would be remotely possible only under the condition of record high Chinese growth rates that will almost certainly not be attained for reasons that have nothing to do with the trade war. In other words, there is a clear danger that the failure to reach these highly unrealistic levels of U.S. exports to China within a time span of only two years could result in the implosion of the agreement, the rekindling of the trade war and a higher level of economic confrontation than exists now. In other words, the signing of this unrealistic deal can only be interpreted by political motives on both sides.

The way that China may try to accomplish some of these targets can be through trade diversion. This means that it could cut back on imports of the covered products from other countries, some of which are U.S. allies, thus exposing their economies to trade shocks. This could become an issue with the WTO, given that some countries could file complaints on the grounds of discrimination. China could combine this approach with cutting back on U.S. imports in the areas not covered by the agreement (as noted $52 billion worth of goods) and diverting trade to other partners. This would hurt other American exporters. In short, the shocks of this deal if it is to be implemented, can be significant. In terms of trade diversion, the most important question is how has the trade war already affected the perception of the future of trade between the two countries? Will American farmers expand production after taking huge drop in exports to China during the trade war? Will Chinese divert to imports from other partners after suffering the uncertainty of supply and price shocks? In brief, has the trade war already created trade diversion that is difficult to overcome?

The agreement itself did not reduce all of the imposed tariffs. It reduced the $125 billion tariffs imposed by the U.S. in September 2019 by half to 7.5%. The agreement did not reduce the previous tariffs, leaving this issue for the next phase of negotiations. As mentioned, new tariffs that were planned to cover an additional $160 billion of worth of imports from China were suspended indefinitely as were the last Chinese retaliatory tariffs on U.S. automobiles (25%).

The U.S. also got a promise of the opening up of Chinese financial markets to American credit card companies and banks as well as approval of biotechnology products. In respect to financial markets, considering that European banks have already been let into China in 2018, this does not consist of a real gain, as this option already existed. Given the individual digital payment systems that are more present in China than in other places, it is difficult to see a significant space being conquered by American credit card companies in the near future.

Further improvements have been left for the next phases of negotiation depending on implementation. The trouble is that the dispute settlement mechanisms have not been delegated to a third party like in most agreements of this nature. This means that as disputes arise they will be delegated to the upper echelons of bureaucracy, which could bring back punitive tariffs at will at any time. Reiterating what has been said about highly unrealistic goals to be achieved, the probability of breakdowns of dispute resolution is high. In spite of the agreement and its substance, this in itself raises the level of uncertainty. This is not conducive to long-term trade arrangements.

The other aspects of the deal consist of intellectual property rights protection and forced technology transfer. The agreement would supposedly end the pressuring foreign companies to transfer technology to Chinese companies as a condition for obtaining market access. China has also agreed to combat patent theft and counterfeit products. Other administrative ways of obtaining technology from U.S. companies was also dealt with and highlighted in the agreement. How possible breaches in this area will be dealt with remains to be seen. However, there seems to be a fundamental misunderstanding in regard to technology transfer. Joint ventures throughout the world have been seen as a method of technology transfer that would lead to development. Why should China be different?

Back to the future: Perceptions and realities

From the U.S. point of view what makes China different is the Chinese economic system itself. The system of "state capitalism" as practiced in China gives state-owned enterprises a privileged position both in obtaining finance through the state-owned banking sector as well as government subsidies. This gives the state sector a permanently privileged position in regards to their competitors and foreign companies. In short, it makes them more competitive on the world market. State-backed competitiveness boosts exports and, accompanied by currency exchange rate manipulation, gives rise to enormous trade surpluses. Summing up, China is winning in economic growth and trade expansion through unfair practices. Along the way, it uses all kinds of dishonest methods to prevent competition (administrative and trade barriers) and to obtain advanced technology. All of this is done under the auspices of a totalitarian state seeking to rise to superpower status in order to dominate the world. Needless to say that this is the opposite of the approach of previous U.S. administrations whose policy was based on the assumption that as China grew and got more integrated into the world economy, it would involve into a stakeholder and responsible actor in the international system.

If this perception of China is accurate, as the U.S. administration seems to believe, then confrontation, decoupling and a new version of the containment doctrine are in order to meet the challenge of a rising China. The success of this type of policy would depend on many factors with foremost among them being the possibility of its success as judged from the perspective of empirical evidence that would make it implementable, and secondly, but not less important, the costs that the U.S. would have to bear in pursuing it. Finally, and perhaps most importantly, there should be full awareness of the global context in which this policy is to be enacted.

The policy should slow down Chinese economic and other expansion with the desired outcome of fundamentally changing the current Chinese political and economic system. The end result would be a China that would play by Western style market economy rules. The described policy has not been formulated in this fashion by the current U.S. administration, but given some of the statements, the views of some of the top officials and the actions undertaken so far, it is fair to say that taken to its logical final conclusion, it seems a valid description of an implicit view and the accompanying policy of the U.S. administration. The fact that this policy is pursued with inconsistencies, contradictions and somewhat incoherently makes no fundamental difference.

Obviously, there are close analogies with the containment policy applied to the Soviet Union during the Cold War. The collapse of communism in Europe and the break-up of the USSR were the hoped for, but unpredicted result. In the Regan years, this policy was combined with extra pressure by rising military spending, threatening the pursuit of military technology that would put the USSR in an inferior position ("star wars") and an initially bellicose attitude ("evil empire"). It should be noted that in terms of internal politics, the boost in military spending was accompanied by tax cuts which (although tempered later in the Regan years by raising taxes) led to an almost doubling of public debt. The other analogy to the Reagan era is the effort at negotiating exchange rates hikes of five states (with the Japanese and German currencies taking the largest burden) in order to boost U.S. exports. This was the essence of the "Plaza Accords". Also, in order to protect the U.S. car industry, voluntary quotas on imports of Japanese cars were negotiated [1].

President Trump seems to be finding his inspiration in the policies of the Regan years. Leaving aside tax cuts, budget deficits and growing public debt, he has openly tried (and succeeded?) to pressure the Federal Reserve to keep a loose monetary policy. Most probably the fear is that a tighter monetary policy and the resulting higher interest rates would lead to an appreciation of the U.S. dollar, making American exports less competitive. This would directly lead to higher U.S. trade deficits which the U.S. administration considers to be a major problem of the American economy. Threats during the negotiation process (just as in Regan's treatment of Japan) are considered a legitimate way to achieve more favorable trade agreements and bilateral trade deals. These are seen as an appropriate instrument to limit and lower trade deficits. In the view of the U.S. administration, the briefly discussed new trade deal with China should achieve this goal at least in part.

One must keep in mind that aside of the fact that Trump sees the U.S. trade relationship with China as dysfunctional, he also sees other existing trade agreements (NAFTA now USMCA, trade with the EU, etc.) as detrimental to the U.S. economy. The loss of manufacturing jobs is seen as proof of the inferior position of the U.S. within the framework of these agreements. It should come as no surprise that he has chosen those economists that share this view as advisors. According to his chief economic advisor on this issue Peter Navarro, trade pacts and unfair trade practices (especially since China's entry into WTO in 2001) have been the main causes of the slowdown of the U.S. economy since the beginning of the 2000's. The job loss in manufacturing can almost entirely be attributed to this [11].

Changing perceptions is extremely difficult, time-consuming and needs an intellectual openness that allows for the possibilities for correction. The latter is absolutely lacking in the current U.S. administration. This is not the first time that the U.S. has exhibited a level of apprehension close to paranoia, when perceptions led it to believe that its position was being seriously threatened. Recount the McCarthy "red scare", the shock of Sputnik, the conscious overestimation of Soviet military might and the fear of a rising Japanese industrial and technological supremacy. Finally, there was the fear of China under Mao who had nuclear weapons and was proclaiming world revolution while imposing self-isolation on the largest population in the world. It took the U.S. a long time indeed, from the ridiculous question of "who lost China?" in the early 1950s, to reestablish diplomatic relations under the leadership of Nixon and Kissinger in the early 1970s. The goal was both to integrate China and at the same time deter it from pursuing goals that could be seen as contrary to fundamental U.S. interests.

China today is a much different country in spite of retaining some of the worst traits of the communist regime. It has transitioned to a market economy highly dependent on the world market, almost eradicated poverty, has opened up to foreign direct investment and has generally been a force that has bolstered the international order. It has committed to taking action on climate change for both international and domestic reasons. In other words, it is a country that is much more a part of the international order than ever in its history. Paradoxically, it was Xi Jinping proclaiming China's commitment to free trade and multilateralism at a time when the U.S. administration was taking actions that were seriously undermining both.

In spite of phenomenal economic expansion and development, China is still significantly behind the West in the general standard of living, hard and soft power and diplomatic clout. However, in all of these areas, China continues to advance in a systematic fashion. Finally, it should not be forgotten that China has not been involved in any military conflicts since the war with Vietnam in 1979. In other words, it has not really shown bellicose intensions over the last forty years. In short, the China we are dealing with today has a much higher stake in the international order (to a large extent created by the U.S. since WWII) than the China of the "the great leap forward", "cultural revolution" and exporter of worldwide communist revolution. It seems that the grim view of a totalitarian aggressive China is more than somewhat exaggerated.

As opposed to perceptions, judging economic arguments is somewhat easier. This is especially true when analogies are being drawn with the Regan era. In other words, the world was much less globalized in the 1980s. The Cold War was still a stark reality and China had only begun its reforms. More importantly, although trade was expanding, the WTO had not been formed and foreign direct investment was mostly among the developed Western nations. Multinational corporations did not have complex supply chains and IT technology were still far into the future. The world is intertwined to a much greater extent at the present moment and this leads to difficulties of measurement concerning some of the indicators that are at the center of the dispute. Finally, Regan was a believer in free trade and the reason he aimed for voluntary quotas was to avoid the introduction of tariffs through legislation which was what the U.S. Congress was pushing him to do.

Next, a hard sober look at the facts is in order to assess the scale of the perceived problem. As already mentioned, the U.S. surplus in the trade of services with China should be subtracted from the trade deficit in merchandise goods in order to come to a lower and more realistic number. These types of calculations are also valid when looking at U.S. trade deficits with other countries. In highlighting the trade deficit with China, the fact that the U.S. had a trade deficit with over one hundred countries is not mentioned at all. Similarly, the U.S. has surpluses in the trade of services not only with China, but also with other major players, including the EU as a whole.

Furthermore, due to complex supply chains, the very meaning of international trade statistics has come into question. A significant number of parts that make up a product have their origins in countries other than the final exporter. The OECD has started to make efforts to measure domestic value added in exports of countries in order to provide figures that would reflect net domestic exports in value terms. In 2016, the OECD data shows that U.S. exports had more than 90% of domestic content, while China was at 80% [12]. This means that 20% of the value of Chinese exports consists of imported components. In certain sectors like electronics which are one of the major exports from China to the United States, slightly more than 1/3 in value comes from imported components. In fact, over a longer period as China opened up to the world, multinational corporations have shifted the assembly of a large number of products to China.

Among these are a large number of U.S.-based multinationals that export these products all around the world including obviously, the United States. Last year's return on investment (ROI) of 11.2% for U.S. firms in China declined by 1.3 percentage points from 12.5% in 2017. Meantime, the average global ROI for U.S. companies increased by 1.1 percentage points to 8.9%, suggesting that China may be facing rising competition for foreign investment from others. Still the figures themselves prove the point that U.S. foreign investment in China gets a higher rate of return by 20% over the return that they get in other foreign direct investments globally [9].

These and other multinationals are to suffer the direct cost of tariffs, the indirect costs of falling demand in China itself and the cost as reflected in the fall of their share prices due to the trade war. Perhaps most importantly, as multinational supply chains come under pressure from tariffs, their competitiveness will erode. A potential longer-term loss in competitiveness will negatively affect employment in the U.S. as well. Nevertheless, in spite of proclamations from the White House that multinationals are leaving in droves, foreign direct investment goes unabated. The reason is that the expectations for profit are still high and that moving operations would incur high costs.

The arguments concerning trade and administrative barriers, technology theft and job losses should be briefly addressed. Firstly, according to a recent comparative study the higher income countries have increased the use of non-tariff barriers to trade in recent years. Incidentally, the U.S. is the one that has by far used them the most with India and Russia following and China taking the fourth place [15, p. 37]. Secondly, when it comes to "forced" sharing technology by multinationals by using access to the Chinese market as an instrument of blackmail, this charge seems to be rather dubious, as are some of the studies done with the purpose of reinforcing this argument. Suffice it to say, that keeping in mind that joint ventures were designed to bring about some transfer of technology and know-how, it is difficult to believe that multinational corporations cannot protect their most important business and technology assets. This is not to deny the abuse of intellectual property rights, by making counterfeit products and other means. Neither is it to deny that there is industrial espionage that has been used at least since the industrial revolution by all those committed to catching up in the most advanced technology. However, serious skepticism is in order concerning the term "forced" with the accent on coercion when it comes to multinational corporations.

The issue of job losses to China deserves a little more attention. The potential displacement effects in terms of employment due to international trade have been known to economists for quite some time. It was largely treated as a minor and short-term problem. Until recently most of the trade and FDI was among the developed countries so that cheap labor could not be the prime mover in determining either. The assumption was that the market would create new jobs in sunrise industries for displaced workers. With the spread of globalization and advanced information, multinationals and emerging markets gained an opportunity to improve competitiveness by employing cheap labor through outsourcing. Certainly some jobs were displaced from the developed countries with high wages. Manufacturing took the heaviest blow with former industrial cities closing factories and becoming the rust belt. With low labor mobility, inadequate safety nets and retraining programs, labor became the major loser in globalization. The failure of the elites to confront these processes in a serious way led to resentment which in turn bred populist movements bitterly opposed to the international economic order.

Having said this, the question is what is the scale of the loss in employment in the U.S. and how are we to measure it? The problem of measurement is not an easy one because of the secular trend of diminishing employment in manufacturing. This decline in the last forty years has reduced employment in manufacturing from a level of 30% to a little above 10% in the developed world. Manufacturing at this point contributes around 20% to GDP in the US and around 25% to GDP in the EU. These figures are obviously higher in the less developed countries. The trick is to separate the long-term decline in manufacturing employment from the effects of job loss due to competition from imports of manufactured goods from China. Although some deny that there were serious effects, other research has come up with figures in the range of a 2 - 2.4 million jobs lost due to imports from China in the 1995-2011 period [1]. This would be around 30% of all manufacturing jobs lost since the decline began forty years ago. However, in order to put this in perspective, during the Clinton administration 28.6 million jobs were created and the number of employed in the U.S. is around

150 million [3]. In conclusion, a large number of jobs were created (maybe not all well-paying ones), but it was the loss in manufacturing jobs that became most visible and therefore a matter of controversy. The point here is that the overall effect on employment is much smaller than what one would expect given the political attention that it got. The new trade deal with China will not bring manufacturing jobs back, but might preserve some if it is implemented. As already mentioned, the chances for that are very slim due to unrealistic goals.

The paradoxical results of the confrontation

The fundamental question of what all this will come to does not have a simple answer, because the ramifications are many and some of them much broader than on the trade deficit alone.

Concerning the trade deficit itself, it can be concluded with a high level of certainty that the overall U.S. trade deficit will not be eliminated. This is because a trade deficit by definition is equal to the difference between saving and investment. In other words, the trade deficit is the result of low savings in the U.S. economy. The bilateral trade deficit with China may be lowered through the new trade deal, but will not change the fundamentals of the causes of the trade deficit. In fact, the tax cuts in the U.S. under the Trump administration increase spending, some of which is reflected in higher imports which add to the trade deficit. In other words, the U.S. administration fiscal policy is in direct contradiction to the goal of reducing the trade deficit.

The more important consequence is that through the trade war (as well as imposing or threatening to impose tariffs on imports from other countries), the U.S. has become a threat to the current international order of which international trade rules are a huge part in the era of globalization. Specifically, the actions taken by the U.S. have undermined the World Trade Organization (WTO) whose very survival as a major international body within which trade disputes are settled is jeopardized. Not only has it been sidetracked in the current trade disputes initiated by the United States, but its fundamental bodies have been undermined by the U.S. for a prolonged period of time by the U.S. refusal to agree to appoint judges at the appellate body of the WTO. This has been done in spite of the appeal of the overwhelming majority of member states in the WTO to the U.S. to enable the continued functioning of this body to resolve trade disputes. The paradox lies in the fact that the WTO was established with the U.S. leading in its creation in 1994. It was portrayed as a vehicle that would promote international trade and enhance the results of the General Agreement of Trade and Tariffs (GATT) that preceded it. In fact, the U.S. had brought the highest number of cases before the WTO. The current U.S. administration is undercutting an institution that previous U.S. administrations have seen as one of the most important pillars of international trade and globalization. This in itself makes the U.S. a factor of instability in the eyes of the majority of WTO members.

When it comes to trade issues with China, the opportunity of having leverage over trade was foregone after the current U.S. administration decided to abandon the Trans Pacific Partnership (TPP), a regional trading agreement which would have included 12 countries (excluding China and India) with a 40% share of world GDP and around the same percentage of world trade. The TPP dealt with all kinds of (behind-the-border) trade issues that concerned the United States (health, security labor standards, etc.). China's membership in the TPP would depend on its meeting the adopted standards and could have been used as leverage to straighten out disagreements on other issues between the U.S. and China. The previous U.S. administration had seen the TPP as one of the major pillars of its "pivot to Asia" policy.

The remaining 11 nations have ratified the TPP. They have left out around 20 provisions that the U.S. had insisted on and have renamed it as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). They have begun to ease tariffs among each other and this will soon hurt some U.S. exports as tariffs on them will not be reduced. Japan has also signed a free trade agreement with the EU that will eliminate almost all tariffs in trade including agriculture after a phase out period. This will certainly expose U.S. exporters as tariffs will remain on U.S. agricultural products to Japan. These exports will also be facing competition from other countries members of the CPTPP. The announced U.S.-Japan trade deal can probably only salvage the Japanese market for U.S. exporters, but Japan will not be able to offer any terms that are better than the ones given to the other CPTPP members. In short, the scrapping of the TPP and the events that followed have put U.S. exporters at a disadvantage. Abandoning the TPP was the last thing that the U.S. should have done if putting pressure on China to adapt to certain standards that the U.S. deemed important was the goal.

The new the trade deal with China has transformed the U.S. approach to international trade in a fundamental way with serious consequences for all countries. In a nutshell, the U.S. has moved from the concept of free trade to the concept of "state-managed trade" with specific areas of trade defined in value. Trade arrangements of this nature, as already noted, will divert established trade with China from other countries. This might inspire other countries to make their own trade agreements with China. To prevent such an outcome, the U.S. has conditioned those potential talks on giving the U.S. advance notice and full information on such talks. Thus, the U.S. is not only promoting an inefficient way of trade, it is also portraying itself as the hegemon with no regard for the interests of others.

Finally, and paradoxically above all, the new trade deal engages with China in ways that are in direct contradiction to the main proclaimed larger goals of which trade policy was to be a part. If making the U.S. less reliant on trade with China was the goal, than the new trade deal actually will achieve the opposite through state-managed trade. In other words, obliging China to import $200 billion of U.S. goods creates a new institutional interdependence. The complaint that China's system of "state capitalism" breeds unfair practices in international trade is rendered meaningless, if the U.S. obliges the Chinese state to enforce a deal in which the state guarantees the outcome of the new trade deal. The new trade deal actually strengthens and legitimizes the same "state capitalism" that the U.S. supposedly perceived as a problem in the international economy. Furthermore, through managed trade, the U.S. has at least in an important area of the world economy introduced a "state capitalist approach."

The famous "long telegram" written by George Kennan, the father of containment policy, that was to be applied to the Soviet Union ends (the last sentence) as follows: "After all, the greatest danger that can befall us in coping with this problem of Soviet communism is that we shall allow ourselves to become like those with whom we are coping". [10].

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