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**China and the United States: Trade Conflict and Systemic Competition**

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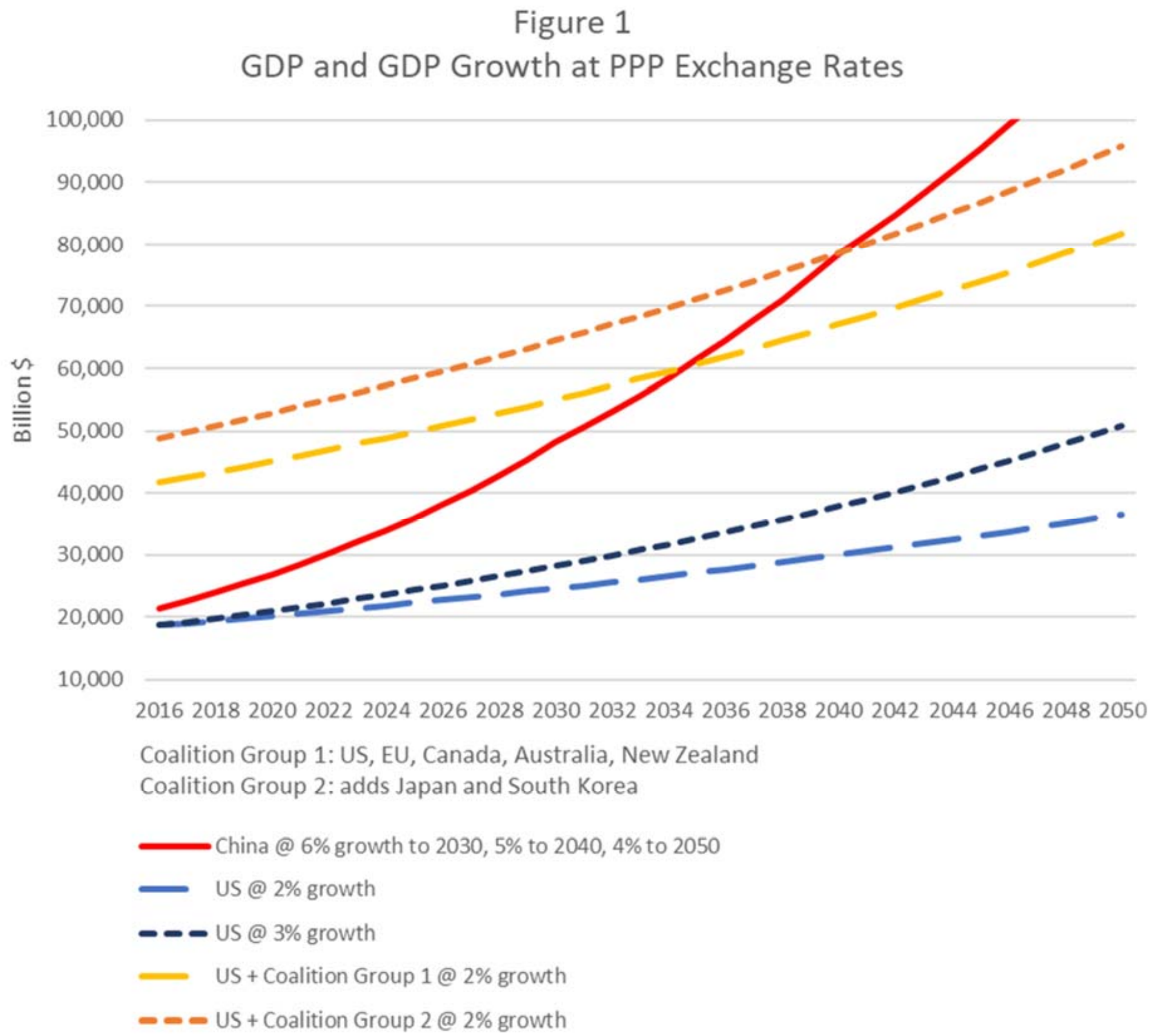
The current trade conflict between the United States and China, important as it is, obscures the more fundamental issue between the two countries: their contest for leadership of the global economic system in the 21st century. Resolution of the current confrontation will require addressing critical systemic questions, especially concerning the role of governments in economic policy, as they affect such issues as trade and investment protection, subsides, state-owned enterprises (SOEs), technology transfer, intellectual property rights (IPR), and currency manipulation. Conversely, resolution of the present problems will have an important bearing on the ultimate outcome of the systemic competition.

The rise to global economic superpower status of China, with its distinct national characteristics, inherently poses a challenge to the international economic order and to its incumbent leader, the United States. History suggests the real possibility of inevitable conflict between rising and incumbent powers, the so-called Thucydides trap. Germany's challenge to Great Britain in the late 19th century was associated with the end of the first era of globalization and the descent toward the First World War. The confrontation of a rising Japan by the newly powerful United States in the 1930s contributed importantly to the onset of the Second World War.

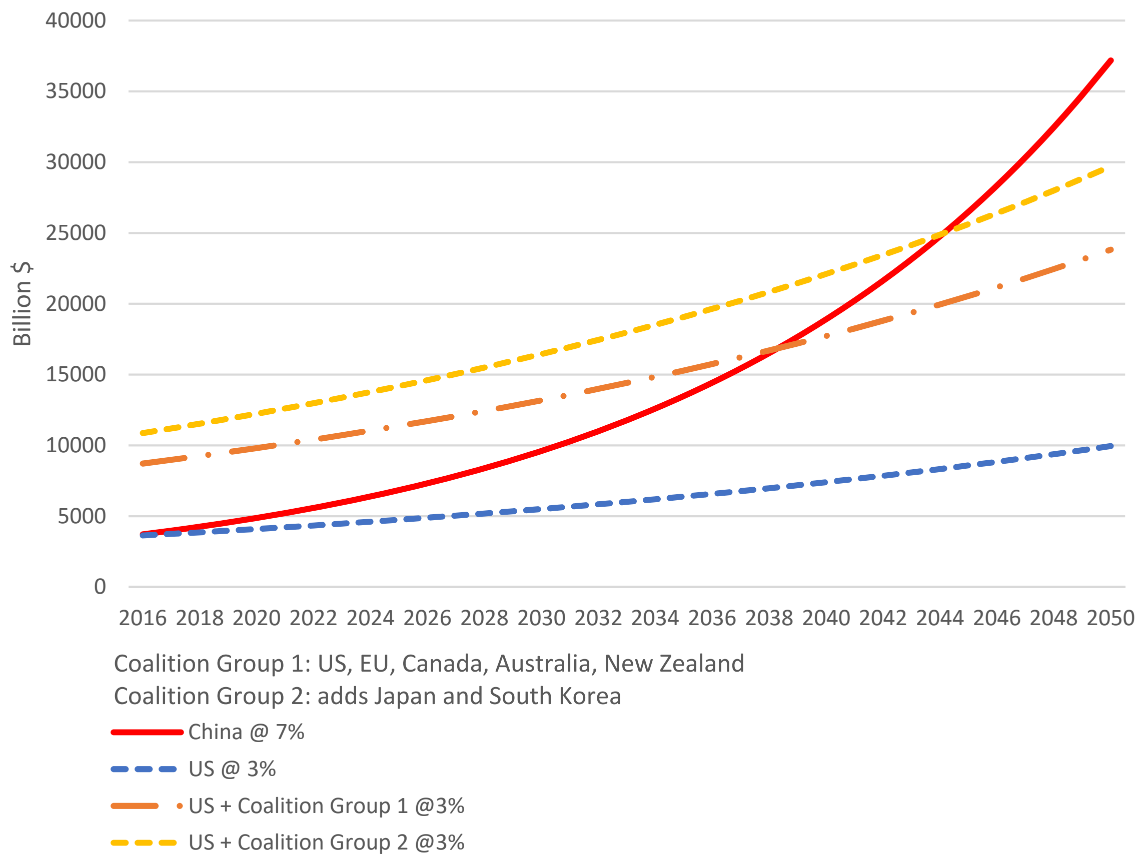
Transition periods in global leadership also lead to major economic disruption. Economic historian Charles Kindleberger blamed the Great Depression largely on the unwillingness of the newly powerful United States to replace the traditional but faltering leader, the United Kingdom, in providing global public goods that were essential to head off the spread of that calamity: open markets for trade, adequate lending to debtor countries, and provision of needed liquidity in the face of financial crises. Such a "Kindleberger trap" could occur today if the United States were no longer willing or able to exercise such leadership and if China were not yet able or willing to do so.

China has been a larger economy than the United States in purchasing power parity (PPP) terms since 2010 (figure 1). Its trade is now slightly larger than that of the United States (figure 2). Its GDP at market exchange rates will exceed ours, on likely growth projections, in about a decade (figure 3). China is likely to outdistance the United States substantially on all these metrics over the coming decades.



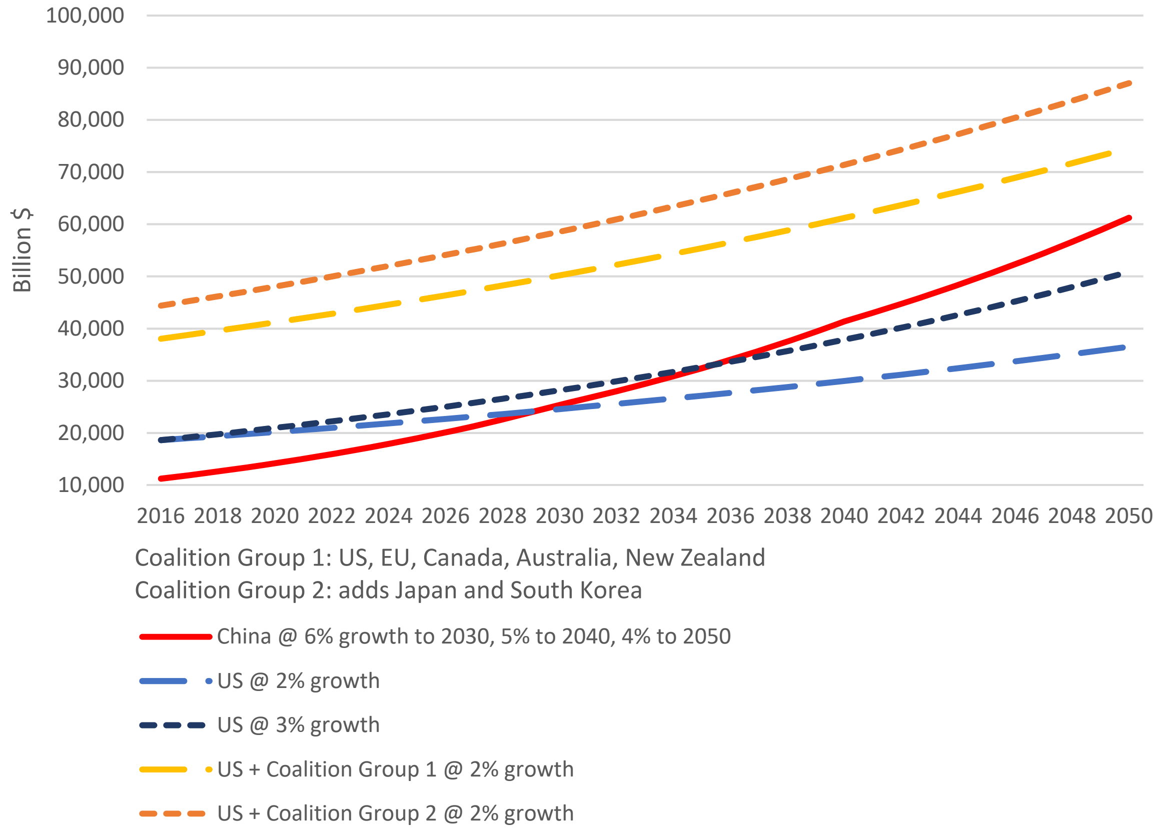

*Sources:* IMF World Economic Outlook Database, October 2017; and author's calculations.

Figure 2
Trade Level and Growth




*Sources:* IMF Direction of Trade Statistics; and author's calculations.

Figure 3
GDP and GDP Growth at Market Exchange Rates

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A very different pictures emerges, however, when the economic weight of America's traditional allies is added to that of the United States itself. The "hegemonic coalition" as a whole, whether limited to the core group of Europe-Canada-Australia-New Zealand ("HC1") or also including Japan and Korea ("HC2"), more than doubles the size of the leadership alliance and prolongs its numerical superiority over China for at least two more decades (figures 1-3).

The inevitable systemic competition between the United States and China has thus been largely viewed, in both countries and around the world, as a gradual and long-term process that would play out over a period of many years and probably decades. Three shocks surrounding the current US-China conflict now threaten to sharply accelerate the timetable, however, and greatly heighten the salience of the systemic issues for the resolution of that confrontation (and vice versa).

First, President Donald Trump's abdication of America's traditional international role, and especially his threatening of the alliances that underpin America's hegemonic coalition, could create a global leadership vacuum reminiscent of the 1930s. This could tempt China to make a dash for dominance rather than biding its time per the traditional mantra of Deng Xiaoping. A systemic clash could become much more imminent.

President Trump is of course not alone in endorsing US withdrawal from global responsibility. Many Democrats take credit for pulling out of the Trans-Pacific Partnership (TPP) before he did and most of them also oppose the North American Free Trade Agreement (NAFTA). Both parties criticized globalization sharply during the 2016 campaigns. There is now substantial domestic pushback against Trump's abdication and protectionism, and a future administration from either party would probably be less extreme and much less shrill, but it is unclear whether the United States will regain the will to reassume global economic leadership at anything like the traditional level in the foreseeable future.

A dash for dominance by China is especially plausible because of the second new shock: the ambitious agenda of President Xi Jinping to realize "the China Dream" sooner rather than later (though there are some indications that the rhetoric to that end is now being dialed down). The "Made in China 2025" program explicitly endorses this goal. Xi's assumption of political power for an indefinite period gives him the capability to pursue such an effort. It reflects a widespread Chinese view that US responsibility for the global financial crisis in 2008–09 severely, perhaps fatally, discredited the American economic model and the ability of the United States to provide credible global leadership and sets it up for a frontal assault.

The third shock emphasizes the importance of the possible acceleration of the global transition timetable: the apparent reversal of China's economic policy strategy. As my colleague Nicholas Lardy lays out brilliantly in a forthcoming new book, the emphasis on marketization that drove Chinese economic policy for 30 years after the opening-up reforms of the late 1970s has given way to a new focus on state enterprises, governmental intervention, and central control—political as well as economic. This significantly affects China's foreign economic policy and carries profound implications for what increasing Chinese leadership will mean for other countries.

In this very new global environment, three systemic outcomes are possible.

The first, and perhaps most likely, is a G-0 world without any effective national leadership. The United States is arguably still able to lead but no longer willing. China may not yet be either able or willing. The result could be an unstable G-0, a replication of the

“Kindleberger trap” of the 1930s: a systemic vacuum with no provider of public goods that would prevent another, perhaps even worse, global trade and/or financial crisis.

On the other hand, a G-0 could turn out to be stable (G-0s) even without its traditional leader. The rest of the world has responded admirably to the Trump abdication so far by keeping the system intact, and indeed moving ahead, on many fronts: the Paris agreement on climate change, the TPP without the United States (TPP-11), new free trade agreements (most notably EU-Japan). The Federal Reserve, as an independent institution, can continue to support the monetary system as it did so critically during the financial crisis in 2008–09.

Will the rest of the world be able to proceed successfully without the “indispensable nation,” especially when the next crisis hits? Will the institutions that have been built up so painstakingly over the last 70 years hold? The European Union, and especially the euro area and the European Central Bank on monetary issues, will be key determinants of the outcome. So will China, if it chooses (as it has on several occasions in the past) to shore up the current system.

If a G-0 proves to be unstable, and the United States remains in withdrawal mode from the world and attack mode on its erstwhile allies, and especially if China decides to make a dash for dominance rather than support the current regime, a G-1 led by China is a plausible alternative. The rest of the world might welcome, and even seek, such a result to fill the void. China’s domestic politics would presumably support, and even exult in, such a dash.

An international economic order with Chinese characteristics could differ significantly from its predecessors (led by the United Kingdom and then the United States). There would be less emphasis on the market and more scope for governmental intervention, especially on international transactions (managed trade) but also in domestic policies. There would be less rule of law and institutionalized dispute settlement in favor of voluntary arrangements and negotiated resolutions, preferring the United Nations institutions to those of Bretton Woods. There would be less democracy and more centralized authority.

All this would presumably evolve over time, as modifications to the existing order, rather than emerge full-blown through a “new Bretton Woods” agreement. It would clearly be uncomfortable for the United States and most other members of the hegemonic coalition, although, as otherwise opposites Tom Friedman and George Will have both noted recently, Trump has moved considerably in China’s direction on such issues and attitudes as trade protection, absolute sovereignty, the rule or non-rule of law, disregard for truth, and sycophancy.

This prospect vividly illustrates the linkage to the current US-China disputes. Those disputes center on some of these very issues: the apparent inability of the current international rules and enforcement mechanisms to prevent objectionable Chinese practices (intellectual property theft, forced technology transfer) but also objectional US practices (abuse of “national security” protection, blockage of dispute settlement system), differences over the role of the state (e.g., regarding state-owned enterprises and support for national champions), international governance and decision-making procedures (e.g, regarding China’s demand to be accorded “market economy status” in the World Trade Organization [WTO]). Different outcomes to the current debates will push the system in different directions, and different systemic reforms would lead to different resolutions of such issues in the future.

The third systemic option is thus the most desirable: a G-2 in which the United States and China, under the looming threat of trade wars and major economic and political disruption, work together to resolve their current conflicts and begin to address the systemic structural issues to head off either a Thucydides or a Kindleberger trap. Such a strategy would provide essential leadership within the existing institutions, both formal (WTO, International Monetary Fund

[IMF]) and informal (G-20, the Asia-Pacific Economic Cooperation [APEC] forum), to carry out their mandates to achieve and maintain prosperity and stability.

An action agenda, in addition to resolving some of the immediate issues, could have three major components:

1. China to join the new US-EU initiative to reform the WTO, to write new global rules (perhaps including subsidies, IPR, SOEs, investment, technology transfer, and maybe cybersecurity) in a plurilateral and thus less politically charged context.
2. China to indicate interest in joining the new Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), presumably inducing the United States to rejoin so both could then use the negotiation to reduce barriers and write new regional rules in some of these issue areas.
3. Major reform of the IMF, as already scheduled for the next two years, to provide it with adequate financial resources and modify its governance to better reflect the evolving balance of international economic powers.

Channeling the current confrontation partly in the direction of such multilateral rule-making negotiations, based on prior agreements between, and steered by, the United States and China themselves, would represent by far the most constructive path toward its resolution. A bolder variant, in part to achieve earlier deliverables, would be for the United States and China to work out their own differences first, though a new bilateral arrangement or even a free trade agreement, and then transmit their agreements into the broader regional and global contexts. Whatever the chosen strategy, the goal would be to link the immediate conflicts and long-term systemic considerations.

The United States disrupted the global economic order once before in the postwar period with the "Nixon shocks" of floating the dollar and imposing an across-the-board import surcharge in 1971. The immediate result was several years of financial instability, trade uncertainty, and high diplomatic tension. But the system held. Moreover, the long-term results were highly constructive: Most of the world moved to floating from fixed exchange rates, and the Tokyo Round reduced trade barriers substantially and agreed to major improvements in the General Agreement on Tariffs and Trade (GATT) (subsidies code, government procurement agreement, etc.). A similar outcome can be achieved on this occasion, but only if the rest of the world keeps the regime afloat during a G-0 period of US abdication, and the United States and China themselves resolve their current confrontation and agree to convert it into a cooperative effort to build a modified system that is sustainable for the longer run.