

Beyond the Brink

Escalation and Conflict in U.S.-China Economic Relations

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SEPTEMBER 2019

THE ISSUE

As the United States and China mark their 40th anniversary of formal diplomatic relations in 2019, the world's most important bilateral relationship is increasingly defined by mistrust, competition, and uncertainty. After four decades of deepening economic integration, the talk in Washington today is about the extent to which the two economies will “decouple” over the years ahead. In a recent study, the CSIS Simon Chair drew on several different academic disciplines to model how an economic conflict between the United States and China could escalate and eventually de-escalate. Our findings suggest that economic conflict is likely to be an enduring feature of the U.S.-China relationship for many years to come. Until perceptions of relative costs in the two countries shift, Washington and Beijing seem set on a path of continued escalation, no substantial trade deal, and at least partial decoupling of their economies.

On July 6, 2018, the United States imposed tariffs of 25 percent on \$34 billion worth of Chinese imports, launching the largest trade war in recent history. A year later, more than three-quarters of the \$660 billion in two-way goods trade—an amount roughly the size of Thailand's economy—was subject to tariffs. During that time, the United States also announced export restrictions for dozens of Chinese companies and designated Beijing a currency manipulator. The potential economic costs of the conflict, and any decoupling it prompts, are enormous, not only to the United States and China but to the entire global economy. Moreover, the trade war has elevated the potential for spillovers into other aspects of the relationship and the risk of great-power conflict.

Despite these risks, the United States entered the trade war relatively unprepared for such a confrontation, with

only a vague sense as to how it could unfold. Without an appreciation of where the trade war may lead, the United States may find itself weakened in economic, diplomatic, and security terms, without achieving significant policy changes in China. Most importantly, policymakers risk miscalculating and stumbling into a new Cold War—or worse.

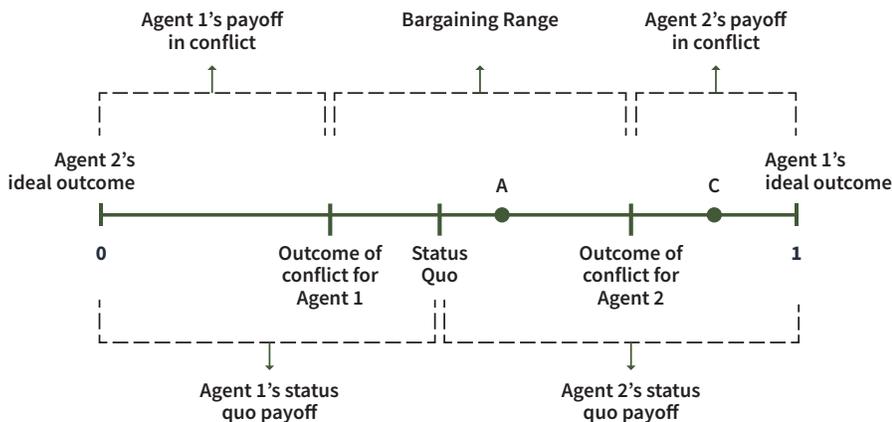
We launched this project to help U.S. policymakers navigate the complexities of a trade war with China. To do so, we developed a model for the likely dynamics of how a trade war might escalate using game theory, inventoried and analyzed the tools of economic statecraft available to each side, and tested our model through two one-day simulations with experts. Although the real U.S.-China trade war quickly escalated over the course of this 18-month project, our theory-based approach provided valuable predictive power, as well as a basis for understanding the strategic logic of the other side.

MODELING A TRADE WAR

We began by developing a model for the likely dynamics of how a trade war might escalate. We applied various game theoretical concepts to help explain decision-making processes and escalatory pathways in the U.S.-China economic conflict. We primarily relied on two interrelated theories to model escalation in a bilateral trade war: deterrence and compellence theory and bargaining theory. Each of these concepts simplifies complex, strategic interactions between two or more agents into a framework to help inform decision-making. Bargaining theory describes how parties decide to divide a set of goods between themselves, often using leverage or threats. Theories of deterrence and compellence study how agents induce opponents to refrain from or take certain actions, either by threatening force or by denying them a necessary resource. Although these concepts were created to analyze kinetic warfare, they can be applied to economic conflicts by changing some key assumptions.

We created an original model that synthesizes these theories to explain the core decision-making logic of economic conflict, discussed in part two of this chapter. The predictions of our model depend primarily on each country's appetite for risk and perceived knowledge about their adversary's resolve to endure pain. *If both countries have a high appetite for risk or underestimate their counterpart's ability to withstand economic pain, our model predicts escalation.* If both countries have a low appetite for risk or have a clearer sense of their opponent's resolve, our model predicts agents would be more likely to avoid escalation and seek agreements early on.

An Example of The Classic Bargaining Theory of Conflict



Note: The placement of the status quo, probable outcome, and costs of conflict are not set in stone and should be adjusted depending on the context to which this model is applied. This figure is an amalgamation of figures from Fearon, "Rationalist Explanations for War," p. 387 and Powell, "Bargaining Theory and International Conflict," p.8.

These theories can help determine the dynamics of strategic interactions in the U.S.-China trade war, but they have their limits. No model can perfectly reflect or account for the complexity of the real world, and any predictive model will have its caveats. Still, these methods offer a valuable theoretical basis for analyzing complex topics and understanding how conflict develops.

Dimensions of Escalation in Economic Conflict

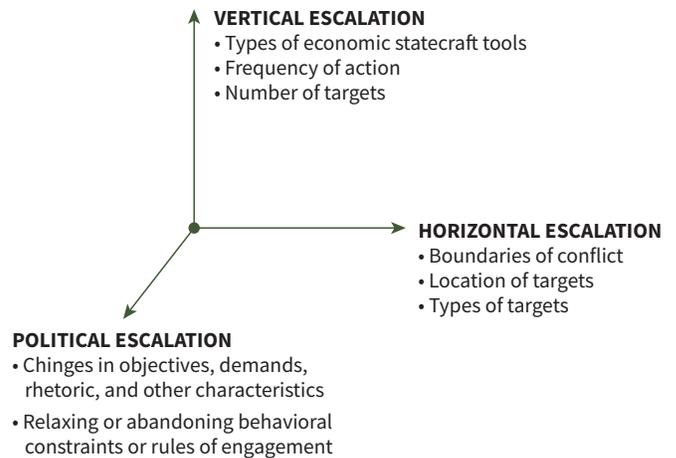


Figure based on Morgan et al., *Dangerous Thresholds*, p. 20. and has been modified to apply to economic conflict.

TOOLS OF A TRADE WAR

Game theory is helpful to understand the broad strategic logic and escalation dynamics of economic conflict, but it cannot explain the use of specific actions at the tactical level. While our model can predict escalation or de-escalation, it does not anticipate which tools of economic statecraft each side will deploy. A more complete understanding of these tools, including associated costs and use cases, will help U.S. policymakers better apply strategic pressure and understand Chinese responses.

We group tools of economic statecraft into three broad categories: (1) **outbound economic actions**; (2) **multilateral coalition building**; and (3) **domestic interventions**.¹ These categories each have different associated impacts and use cases, which are outlined in this chapter. Although it is impossible to rank tools *ex ante* in terms of impact—for example, a tariff could be applied to \$1 billion of goods or \$100 billion—each category of tools has distinct economic costs. Countries may simultaneously deploy tools from different categories, which may or may not be part of a coordinated strategy of escalation or de-escalation.

OUTBOUND ECONOMIC ACTIONS

Outbound economic actions are those that directly influence bilateral current and capital account balances (i.e., trade and investment flows). We break down outbound economic actions into three subcategories based on the degree of perceived legitimacy of their use in economic conflicts.

- **Internationally Compliant Outbound Economic Actions:** Examples include WTO complaints and WTO-sanctioned trade remedies.
- **Nationally Compliant Outbound Economic Actions:** Examples include non-WTO-sanctioned tariffs, import quotas, investment restrictions, and delisting foreign companies on domestic stock exchanges.
- **Extralegal Outbound Economic Actions:** Examples include currency manipulation, regulatory process abuse, commercial espionage, and intimidating foreign entities.

COALITION BUILDING

Coalition-building tools leverage economic partnerships to pressure or incentivize a target to change their behavior. These actions are inherently multilateral and rely on the decisions of third-party countries. Examples include bilateral or plurilateral economic agreements and coordination with other countries to use outbound economic tools.

DOMESTIC INTERVENTIONS

Building domestic strength requires a different kind of tool that involves domestic policy and development. These actions are prompted by economic conflict and they help the user position itself to be in a stronger position to either compete or negotiate with an adversary. Examples include fiscal support for sectors disrupted by economic conflict and government initiatives to reduce reliance on the adversary's economy.

The tools used in economic conflict impact the nature of escalation and the degree of economic damage. Outbound economic actions have the highest likelihood of retaliation and the greatest potential to cause economic harm but can quickly apply pressure. Coalition building and domestic intervention tools have much lower costs and risks of contagion but take longer to deploy. A successful strategy will balance the use of tools from each category to minimize collateral damage while maintaining pressure.

SIMULATING A TRADE WAR

Having designed our model and inventoried the tools of economic statecraft, we used simulations to test our model and study which tools would be used in an escalating trade conflict. We ran two separate one-day simulations in the spring of 2019 involving different groups of American experts on the U.S.-China relationship and trade policy. The simulations helped us understand how Washington and Beijing approach economic conflict, which tools had the most strategic value, and possible escalatory pathways of a prolonged trade war.

The bottom-line result of both simulations was that the U.S. and Chinese negotiating teams failed to reach an agreement. In the first, China threatened to walk out of final negotiations after a complete breakdown in trust. In the second, the two sides reached a limited consensus on some issues but could not agree on specific policy decisions. In each case, the United States acted as the aggressor, steadily escalating pressure on China to make concessions. The Chinese side adopted a defensive posture, trying to support domestic growth and development while reducing reliance on the U.S. economy.

On the following two pages, we outline the escalatory and de-escalatory actions the United States and China teams took during our simulations, as well as actions inserted by a “control team.” The full report provides a review of the simulation design and scenarios, the structure of gameplay, and limitations to this approach.

1. Tools of economic statecraft do not include military force or actions that leverage military capability. Although security considerations impact economic statecraft, this nexus was outside the scope of this study.

SIMULATION 1

Held on March 5, 2019



SIMULATION 2

Held on May 6, 2019



FINDINGS

Despite the challenges inherent in modelling economic conflict, our model was validated to a surprising extent by both our simulations and real-world developments. The project produced several findings that were both unexpected and relevant to policy:

- **Game theory is useful to model the dynamics of escalation in U.S.-China economic conflict.** Generally, our simulations confirmed our model's central causal mechanism: an agent that has a high appetite for risk and underestimates its counterpart's willingness to endure pain will launch an escalatory spiral. This helps explain the current impasse in the trade war. Beijing believes the costs of fundamentally reforming their economy as part of a deal are greater than the costs of the current conflict. Washington is determined to continue the conflict because it believes the costs are higher for China.
- **A successful U.S. negotiating strategy must establish “dual credibility” about resolve and willingness to compromise.** Our model and simulations found that an optimal U.S. strategy of pressure toward China credibly demonstrates both resolve and willingness to compromise. Washington must continually persuade Beijing that the United States is willing to absorb enormous costs for longer than China and that the United States would accept a compromise agreement that both addresses its own major concerns and yields benefits for China.
- **China has an impulse to reach out and seek partners and is sensitive to multilateral pressure.** In both of our simulations, China displayed an impulse to reach out and seek allies. Beijing's tendency to use significant resources to attract partners—successful or not—suggests U.S. efforts to work with allies to isolate China have value. Beijing places a high priority on outreach, but Washington has a natural competitive advantage thanks to its network of alliances. By eschewing multilateralism and threatening tariffs against traditional allies, the United States is denying itself a stronger hand in negotiations with China.
- **Economic statecraft—if well-targeted—can pressure China to make meaningful concessions.** In our simulations, the China team felt most threatened when the United States banned exports to critical Chinese technology companies. Comparatively, they felt less pain from broad-based tariffs. As a result of this pressure, the China team in our simulations was willing to make concessions on what they perceived as non-core issues, including intellectual property protection and goods purchases. Applying our model, to reach a deal on fundamental structural issues, the United States will have to apply massive pressure to make the costs of conflict unbearable to China, which may be impossible without multilateral support.
- **China prefers to use informal tools of economic statecraft.** In our simulations, China often did not implement equivalent countervailing measures but used “qualitative” tools to retaliate to U.S. actions. These were not used at random but targeted politically salient interests. Use of informal tools allows China to pressure the United States while simultaneously passing laws that notionally liberalize its economy to attract other foreign investors. Still, this “silent” trade retaliation by Beijing is prone to miscalculation.
- **Economic conflict generates pressure for a larger government role in the economy.** Wide-ranging economic conflict pressures governments to more actively intervene in the domestic economy. For one thing, they may seek to prevent certain companies from trading with an adversary. They will face pressure to compensate interest groups harmed by escalation to maintain domestic support for continuing the conflict. And they will face broader incentives to stimulate growth to offset the pain of escalation, since neither side will want the other to perceive it as weak or damaged as a result of escalatory actions.
- **Selective decoupling is an inevitable consequence of economic escalation once a threshold is crossed.** This is arguably the most significant finding of our project. We found that escalation dynamics will push two countries apart once a certain threshold is crossed even if neither side had an initial goal of decoupling. Aggressive use of escalatory tactics erodes mutual trust, limiting the credibility that either side will negotiate in good faith or keep their promises. This is exacerbated when a country crosses certain “red lines” or if there are broader strategic concerns. Even if a deal is reached, memory of the conflict will influence public- and private-sector decisions.

All of this suggests that economic conflict is likely to be an enduring feature of the U.S.-China relationship for many years to come. Until perceptions of relative costs in the two countries shift, Washington and Beijing seem set on a path of continued escalation, no substantial trade deal, and at least partial decoupling of their economies.

RECOMMENDATIONS

Reflecting on the findings of our project in light of the real-world U.S.-China trade war, we derive a few recommendations for U.S. policymakers seeking to engage in successful economic bargaining with China:

- 1. Establish “dual credibility.”** Whether it wants to win narrow economic concessions or more fundamentally change Chinese policies, Washington must persuade Beijing that it is willing to both: (a) impose and maintain penalties—and bear the associated costs; and (b) follow through on its own commitments if a mutually beneficial deal is reached.
- 2. Set clear goals and assess the cost and benefits of achieving them.** The first step in successful bargaining, with China or any other country, is to set clear objectives and ensure that everyone on the U.S. negotiating team understands them. Once the negotiating objectives have been set, it is critical to have an accurate assessment of the costs and benefits of achieving them, including the impacts of using different tools and tactics. This should begin with the collection, analysis, and distribution of data on the benefits and costs of U.S.-China commerce, in absolute terms and relative to other policy challenges.
- 3. Enhance decision-making processes.** An administration wishing to strengthen its bargaining position with China should work to maximize procedural strengths, including institutional experience and stakeholder input, and remedy challenges of coordination and regulatory-capture risks. Potential solutions include establishing a “China policy czar” in the White House charged by the president with developing and implementing strategy and ensuring coordination across the U.S. government. More transparent and standardized consultations with industry and consumer groups would also be valuable.
- 4. Build multilateral coalitions.** No strategy toward China can succeed without extensive coordination with U.S. allies and partners. With the spread of China’s economic relationships around the world, access to the U.S. market alone no longer provides

the kind of bargaining leverage for Washington that it once did. However, mobilizing the U.S. network of allies and partners can play on Beijing’s fear of isolation. As a first step, the Trump administration should deepen its trilateral work with the European Union and Japan.

- 5. Invest in economic strength at home.** Beyond short-term interventions to improve the U.S. tactical position or offset costs to domestic stakeholders, the United States can and should strengthen its bargaining position vis-à-vis China by investing in the domestic underpinnings of its long-term economic competitiveness. This means upgrading the country’s physical infrastructure, preparing the American workforce with the skills and resilience needed in the twenty-first century economy, and investing more in research and development. ■

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This brief is made possible by the generous support of the Smith Richardson Foundation and Alcoa Foundation.

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