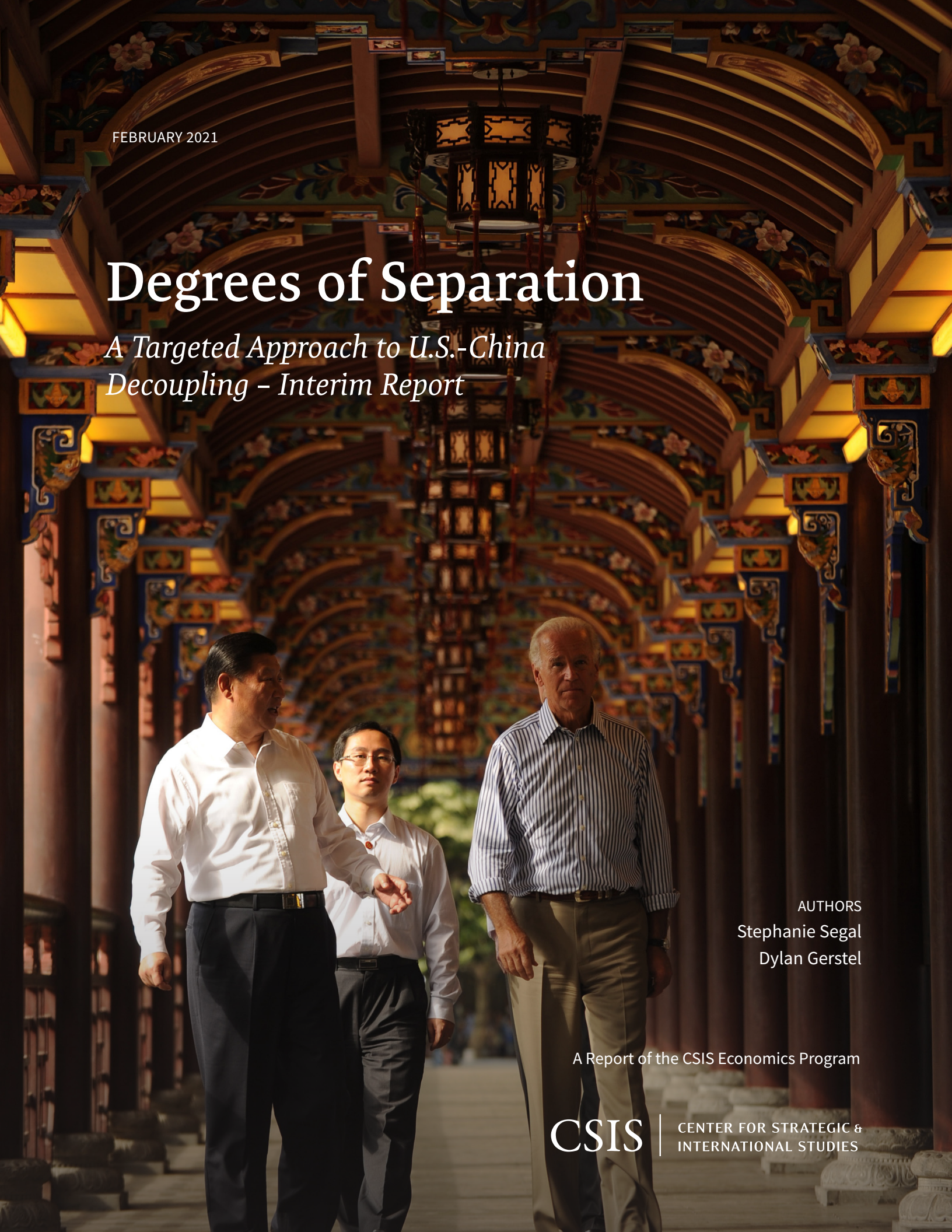

FEBRUARY 2021

Degrees of Separation

A Targeted Approach to U.S.-China Decoupling – Interim Report

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Stephanie Segal

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A Report of the CSIS Economics Program

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Executive Summary

A 2003 article by former congressman Lee Hamilton, entitled "The State of U.S.-China Relations," identifies tensions in the bilateral relationship that threaten a "troubling divergence . . . as China becomes an economic powerhouse, a military force in Asia, and a potential rival to U.S. hegemony."[1] Unfortunately, Hamilton's ability to see into the future did not prevent its realization. Today, amid a presidential transition, great power competition is the motif most often applied to the U.S.-China relationship. How to manage that competition will arguably be the most consequential item on President Biden's foreign policy agenda.

Not long ago, comprehensive decoupling of the U.S. and Chinese economies was considered a possible approach to advancing U.S. interests. But analysis of the connectedness—not only between U.S. and Chinese economies but of each economy with the rest of the world—relegated such a sweeping proposal to the back burner. This project, *Degrees of Separation*, starts from the premise that wholesale decoupling of the United States and China is neither feasible nor beneficial to advancing U.S. interests. But it also acknowledges the many areas of tension in the relationship and the failure of past bilateral engagement to adequately address these tensions, thereby requiring a different approach.

This interim report reviews the evolution of the U.S.-China relationship since President Nixon's visit to China in February 1972 and the subsequent normalization of relations starting in January 1979. It takes stock of the current bilateral economic relationship, with particular focus on trade, investment, and innovation linkages, finding the two economies more interconnected now than in the past. China's decades of rapid economic growth have increased its relative importance to the U.S. economy, while the U.S. share of Chinese exports and imports has been declining or flat. The study also looks at the ability of U.S. economic tools to achieve desired outcomes, taking into account the position of U.S. allies and partners and the private sector given their ability to influence the effectiveness of certain U.S. actions.

This background helps explain past motivations and outcomes of U.S. engagement with China in order to develop realistic objectives for the relationship. The report identifies six distinct areas that motivated U.S.-China engagement, beginning with Nixon's visit to China in 1972 through the end of the Trump administration: (1) geostrategy; (2) economics; (3) human rights and civil society; (4) global rules and norms; (5) global public goods; and (6) technology and innovation. While specific objectives in each area continue to evolve, these six areas remain relevant to guiding bilateral engagement today.

They also provide a foundation to assess whether a narrow form of decoupling—for example, one limited to a specific activity or type of activity—will advance U.S. objectives. Such a targeted approach would allow, in Hamilton's words, the multifaceted policy approach required of the multifaceted relationship with China. A subsequent report, delivered later this year, will present a framework for assessing specific economic activities as candidates for targeted decoupling, along with four case studies designed to test the framework.

Historical Motivations for U.S. Engagement with China

Area	1972–1989	1989–2001	2001–2017	2017–2020
I. Geostrategy	Counterbalance Soviet Union			
	Prevent aggression (e.g., Taiwan)	Prevent aggression (e.g., Taiwan)	Prevent aggression (e.g., Taiwan)	Prevent aggression (e.g., Taiwan)
	Support non-proliferation	Support non-proliferation	Support non-proliferation	Support non-proliferation
		Cooperate on rogue states	Cooperate on rogue states, terrorism	Cooperate on rogue states
			Enforce maritime norms	Enforce maritime norms
II. Economics		Promote market-oriented reform and integration into global economy	Promote market-oriented reform and integration into global economy	
			Promote balanced growth model	Promote balanced growth model
			Increase market access	Increase market access, reciprocity
			Maintain global economic and financial stability	
III. Human rights and civil society	Limit support for revolutionary regimes			
		Build domestic support in China for openness, human rights, and democratic choice	Build domestic support in China for openness, human rights, and democratic choice	Build domestic support in China for openness, human rights, and democratic choice
		Support civil society	Support civil society	
				Push back on human rights violations
IV. Global rules and norms		Encourage compliance with global trade rules	Encourage compliance with global trade rules	Enforce compliance with global trade rules
			Cooperate in updating global governance	
V. Global public goods			Address climate change	
			Improve global public health	
			Develop low-income countries	Develop low-income countries
VI. Technology and innovation	Encourage R&D collaboration	Encourage R&D collaboration	Encourage R&D collaboration	
		Develop market for U.S. products and integrate supply chains	Develop market for U.S. products and integrate supply chains	
		Protect intellectual property	Protect intellectual property	Protect intellectual property
			Expand rule of law and regulatory transparency	Expand rule of law and regulatory transparency

2

Introduction

The economies of the United States and China are more interconnected today than at any time in modern history. China's bilateral trade surplus with the United States remains "the largest by far" of any U.S. trading partner, while the stock of U.S. investment in China peaked in 2019.[2] Scientific collaboration as measured by co-authored publications has been on a steadily upward trajectory for decades. Yet, U.S.-China relations sharply deteriorated in 2019 and 2020 after years of steady decline. There is a conviction among public- and private-sector participants alike that decades of reform and opening up have spurred China's economic growth but failed to resolve fundamental differences on issues ranging from human rights, to the role of the state in the economy, to the future of Taiwan. Exacerbating these tensions, China has proven willing to use its economic power to advance a vision for Asia and the world that often conflicts with U.S. interests.

Citing the failure of engagement, President Trump launched a trade war with China in 2018 that quickly expanded to encompass technology, finance, and broader diplomatic ties. The tension in the economic relationship encouraged calls for the United States to "decouple"—separate, disengage, or dissociate—from China's economy. Some analysts view any activity that benefits China as counter to U.S. interests, making the case for an extreme version of decoupling. At the opposite end of the spectrum, critics of decoupling reject it as impossible given complex supply chains, the non-physical nature of services trade, and highly mobile human and financial capital. Opponents of decoupling argue that even if such impediments could be addressed, the costs to the United States of decoupling would be too high.

Such dramatically different views toward decoupling have increased uncertainty, lowered business confidence, depressed economic activity, and threatened national security. The CSIS Economics Program launched *Degrees of Separation* to establish clearer objectives for U.S. engagement with China and to assess whether disengagement from specific activities can help in meeting such objectives.

The world has changed dramatically in the months since this project began. By the end of December, there were over 80 million cases and 1.8 million deaths attributed to Covid-19 globally, and those figures continue to rise. Countless more lives and livelihoods have been disrupted. While the lasting impacts of the pandemic, including on the global economy, remain to be seen, the emergence of the disease and its spread has led to the further deterioration in U.S.-China relations and an expanded list of economic sectors viewed as critical to national security.

In addition, the election of Joe Biden as the 46th president of the United States has shifted the discourse on U.S.-China relations. Although the Trump administration advanced several policies in the lame-duck period to sever U.S.-China economic linkages, the idea of broad decoupling has fallen out of favor as the new administration has signaled a more targeted approach. However, neither the U.S. policy community nor the private sector have a consensus view on the rationale, goals, consequences, or structure of a rebalanced economic relationship with China.

These developments underscore the need to establish clearer parameters for the U.S.-China economic relationship. This report informs objectives for future engagement, based on analysis of prior engagement with China, a comprehensive measure of existing economic linkages, and a review of the efficacy of economic tools to achieve foreign policy outcomes.

The authors hope this report will add nuance to existing policy discussions and offer a guide for the new administration. A subsequent report, later this year, will present a framework for assessing specific economic activities with China along with case studies applying the framework to assess whether engagement or targeted decoupling better serves U.S. objectives.

3

Evolution of U.S. Economic Engagement with China

U.S. policy toward China in recent years is nearly unrecognizable from the approach taken just a few years ago. U.S. strategy has shifted from the longstanding doctrine of measured engagement toward a paradigm of competition and even direct confrontation. The Obama administration's 2015 *National Security Strategy* (NSS) reasserted that Washington "welcomes the rise of a stable, peaceful, and prosperous China" despite growing signs of friction. It underscored that "the scope of our cooperation with China is unprecedented" while also recognizing the need to "manage competition from a position of strength while insisting that China uphold international rules and norms."[3] In stark contrast, the Trump administration's 2017 NSS explicitly labels China a revisionist power intent on "challenging American power, influence, and interests, attempting to erode American security and prosperity."[4] The diagnosis, if not the tactics, mostly received bipartisan support, and the foreign policy community similarly shifted into a mindset of managing great power competition.

The rapid change in U.S. views is based, in part, on the narrative that the previous strategy of engagement assisted China's rise but failed to strengthen U.S. leadership and prosperity or spur further liberalization in China. The 2017 NSS argues, "for decades, U.S. policy was rooted in the belief that support for China's rise and for its integration into the post-war international order would liberalize China. Contrary to our hopes, China expanded its power at the expense of the sovereignty of others."[5] Michael Pillsbury, who advised the Trump administration, alleges that China is intent on "a new global hierarchy in which China is alone at the top" and that past U.S. policy of engagement has fueled this rise.[6] Even the architects of U.S. engagement with China have acknowledged Beijing's backsliding on commitments to market reforms.[7]

It is clear that Beijing has not liberalized politically and that China's rise has disrupted the global order. International rules have not sufficiently tamed Chinese discriminatory treatment of foreign

firms, opaque industrial subsidies, and import surges that distort global trade. Ongoing human rights violations in Xinjiang, Tibet, and Hong Kong and Beijing's construction of an Orwellian surveillance state underscore the deep, fundamental differences between China and advanced democracies.

Yet the narrative that engagement was a total failure risks misreading the motivations for U.S. engagement with China and obscuring notable successes. A new U.S. approach toward China is clearly necessary, but a selective view of history risks overcorrection. Sober analysis of the four decades of normalized relations can help determine which elements of engagement should be preserved and where a rebalanced strategy is required.

This section of the report offers a brief overview of U.S.-China relations since President Nixon's groundbreaking visit to Beijing, Hangzhou, and Shanghai in 1972. While a comprehensive account of that history is far beyond the scope of this report, it provides a baseline appraisal of U.S. motivations for engagement and the degree to which they were achieved.

Several themes emerge, notably that U.S. motivations have generally been balanced across a wide range of objectives, with a desire to enlist Chinese support for global governance and global public goods emerging in the last 20 years. As for the Chinese Communist Party (CCP), the primary goal throughout the period of normalized relations has been to maintain power. As China has developed, the CCP's strategy and tactics have evolved—often determined by the relative influence of reformers and conservatives and the state of national development—but its objectives have not. Until the Trump administration, U.S. policy toward China balanced engagement and hedging as Washington recognized Beijing's potential both as a partner and a rival and sought to empower reformers in Zhongnanhai. However, China's rapid growth and increasingly assertive international behavior, combined with a belated recognition in the United States of the dislocations associated with China's rise and incorporation into the global economy, have disrupted the prior equilibrium and forced U.S. policymakers to reckon with the fundamental question of whether and how two large, interdependent, and politically incompatible powers can coexist.

1972–1989: Early Engagement and Normalization

The normalization of the U.S.-China relationship in the 1970s was driven by the strategic imperatives of the Cold War and the threat of the Soviet Union.[8] After decades of estrangement, U.S. and Chinese statesmen embarked on a gradual process of deepening bilateral relations to balance the Soviet threat, beginning with the Shanghai Communiqué in 1972 and culminating in the normalization of relations with the Joint Communiqué on the Establishment of Diplomatic Relations, which came into effect January 1, 1979.[9]

Concurrently, U.S. policymakers sought to tame Beijing's disruptive and anti-capitalist behavior. China represented a fifth of the world's population and possessed a nuclear arsenal yet was not formally recognized or represented at most international bodies. Beijing often acted as a rogue regime, skirmishing with many of its neighbors and funding revolutionary movements abroad.[10] Cross-strait relations threatened regional stability, and the United States was desperate to avoid armed conflict over Taiwan. Normalization helped achieve these objectives, although the United States maintained military sales to Taiwan despite formally recognizing the People's Republic of China.

Alongside rapprochement with the United States, Beijing under Deng Xiaoping supported an ambitious program of domestic market-oriented economic reforms. The horrors of the Great Leap Forward

and the Cultural Revolution had decimated the Chinese economy and left hundreds of millions in extreme poverty. China's gross domestic product (GDP) per capita in 1978 was $156, roughly a third of aggregate levels in sub-Saharan Africa.[11] Desperate to revitalize the country, Deng announced a policy of reform and opening at the Third Plenary Session of the 11th Central Committee of the CCP in 1978. Under the new policy, Beijing allowed experimentation with market mechanisms at the local and provincial levels, typified by Special Economic Zones, and began to gradually open up to foreign investment. Success was self-reinforcing, and centrally-encouraged competition between cities and provinces fueled rapid growth. Deng's reforms worked. By the time the Berlin Wall fell in 1989, China's GDP per capita had doubled in just a decade.[12]

During the early reform period, Chinese policymakers took a pragmatic approach, learning from and selectively adopting elements of other models. Western economists eagerly offered advice, and many believed not only that China was a strategic partner in the Cold War but that its economy could one day follow free-market principles.[13] But rather than adopt foreign advice wholesale, Beijing took a hybrid approach to reform, introducing markets first to agriculture and then to other sectors while retaining a dominant role for the party-state.[14] Four months after the 1978 Third Plenum, Deng outlined the Four Basic Principles in thought and politics that continue to be part of the CCP's ideological foundation today. They dictate that China must uphold the socialist path, dictatorship of the proletariat, leadership of the CCP, and Marxism-Leninism and Mao Zedong Thought.[15] The subsequent "Four Modernizations," which build on the Four Basic Principles, and the sixth Five-Year Plan (1981–1985) underlined the role of the state and boundaries to economic liberalization.

Throughout the reform period, Beijing supported reform not for its own sake but as a means to grow the economy and, by extension, bolster CCP legitimacy and enhance national power. Despite the departure from Mao's more radical ideas, the CCP held fast to the Maoist concept of "self-reliance," although the application of the concept shifted from relative autarky under Mao to reform and opening up as a means to ensure independence.[16]

While economic considerations were not a central motivation for early U.S. engagement with China, normalization of relations created a climate conducive to future economic integration. The U.S.-China Business Council formed the year after Nixon's trip to advocate for closer commercial relations as U.S. businesses began to invest in China.[17] Shortly after normalization in 1979, the United States reduced tariffs on Chinese imports by granting China most-favored-nation (MFN) status, although this was subject to annual review. Reflecting on the changes in 1982, the Congressional Joint Economic Committee concluded that "recent economic and political trends in China have been very favorable to the United States" and urged that U.S. policies "ought to be designed to foster China's efforts to achieve balanced economic development and to strengthen, not jeopardize, our relations."[18]

Washington largely achieved its objectives of early engagement with China, although the degree of causality is debatable. Normalization with China put pressure on the Soviet Union, which collapsed just short of two decades after Nixon's trip. Beijing no longer preaches international revolution or funds armed insurgents, instead donating significant amounts to UN agencies and peacekeeping missions. Taiwan remains highly sensitive, but the United States and China have avoided armed conflict thus far. Economic motivations were secondary for the United States, but progress in the 1970s and 1980s laid the groundwork for China's integration into the global trading system and reflected significant reform, albeit not accompanied by political liberalization.

1989–2001: From Tiananmen to the WTO

Events in 1989 had the potential to disrupt the growing engagement between China and the United States. The fall of the Berlin Wall lessened the need for strategic balancing, and the Tiananmen Square crackdown, which resulted in the deaths of hundreds if not thousands of protestors, underscored the CCP's authoritarian grip despite economic reforms. While the collapse of the Soviet Union and resulting U.S. unipolarity hardened defense postures in Beijing and Washington, economic rationale emerged as a dominant force bringing the countries closer. Even in the aftermath of Tiananmen, President George H.W. Bush refrained from terminating China's MFN status to preserve constructive engagement and avoid isolating reformers in Beijing.[19]

For some Western policymakers, the end of U.S.-China strategic alignment after the Cold War was replaced by a new hope: that China's economic liberalization would be followed by political liberalization.[20] The continuation of market reforms under Jiang Zemin, who took over as general secretary of the CCP after Tiananmen, demonstrated a continued commitment to opening the Chinese economy to trade and investment. Meanwhile, the collapse of communism in Eastern Europe suggested an inevitable path toward democratization. Despite recurring tensions in the bilateral relationship in the 1990s, the Clinton administration advocated for China's greater participation in the global economy, culminating in Chinese membership in the World Trade Organization (WTO) in 2001.

The prospect of China joining the WTO sparked heated debate and would not have been possible without buy-in from Washington. U.S. domestic support for China's accession was bipartisan but not monolithic. Liberals and conservatives alike expressed concern over China's human rights record and the potential negative impacts on manufacturing jobs in the United States and U.S.-Taiwan relations. Supporters of China's WTO membership argued that U.S. economic interests, particularly in agriculture, would incur significant opportunity costs without the agreement and that economic linkages with China would bring about further liberalization. In a widely cited March 2000 speech, President Clinton called supporting China's accession to the WTO "the most significant opportunity that we have had to create positive change in China since the 1970s" and warned that a vote against granting China Permanent Normal Trade Relations (PNTR)—a necessary step in order to apply the terms of China's WTO agreement in the United States (and likely vice-versa)—would "cost America jobs."[21]

Despite the lofty public rhetoric, the Clinton administration likely had more realistic goals for engagement with Beijing than democratization. Observers suggest that U.S. officials may have used the hope of political liberalization to help sell PNTR at home despite harboring doubts of its likelihood.[22] Neil Thomas, a China watcher at the Macro Polo think tank, analyzed major speeches and policy documents from the 1990s to depict a pragmatic Washington seeking to solve common challenges and manage security risks.[23] Clinton's first major China speech in 1997 outlines a "pragmatic policy of engagement, of expanding our areas of cooperation with China while confronting our differences openly and respectfully."[24] In another speech on China in 1999, delivered on the eve of Chinese premier Zhu Rongji's official visit to Washington, Clinton asserted that China will be "less likely to succeed if its political system does not gain the legitimacy that comes from democratic choice," but that "we don't assume for a moment that this kind of (people-to-people) engagement alone can give rise to political reform in China."[25]

Clinton's 2000 NSS echoed his speeches and offered more measured goals for engagement with China. The document states, "our policy toward China is both principled and pragmatic, expanding our areas

of cooperation while dealing forthrightly with our differences."[26] It identifies several areas of focus, including regional security, non-proliferation, and expanding market access, while highlighting the economic benefits of China's integration into the global trading system. The document establishes democratization as a pillar of U.S. foreign policy in general but does not mention specific political liberalization in China.

Similarly, two spring 2000 congressional testimonies from U.S. Trade Representative (USTR) Charlene Barshefsky focused on the possibility of promoting China's domestic economic reforms and integrating China into the global economy, rather than political liberalization.[27] This emphasis aligned with the interests of large foreign companies, led by U.S. corporations, who viewed China both as a platform to produce exports and a massive, untapped market. Barshefsky argued that WTO accession, in addition to supporting U.S. prosperity, had "potential beyond economics and trade: as a means to advance the rule of law in China, and a precedent for willingness to accept international standards of behavior in other fields."[28] She noted that "a number of leading Chinese and Hong Kong advocates of democracy thus endorse WTO membership not only for its economic value, but as a foundation for broader future reforms" but was careful to differentiate those views from the administration's. Barshefsky and other senior Clinton administration officials sought to empower reformers in Beijing but were more circumspect about the prospects of political liberalization.

U.S. Trade Representative Charlene Barshefsky (L) exchanges signed bilateral agreements on China's accession to the World Trade Organization with Chinese minister of foreign trade and economic cooperation Shi Guangsheng (R) 15 November 1999 in Beijing.

STEPHEN SHAVER/AFP via Getty Images

After 15 years of negotiations, China joined the WTO on December 11, 2001. As a condition of membership, Beijing agreed to domestic reforms that would further liberalize the economy, including the reduction of tariff and non-tariff barriers, the transparent notification of subsidies, and market-based governance of state-owned enterprises (SOEs).[29] Expert congressional testimony at the time described China's WTO accession agreement as "sweeping," emphasizing market access commitments that were "much more far-reaching than those that governed the accession of countries only a decade ago" and protocol commitments that "substantially exceeded those made by any other member of the WTO."[30]

On the eve of WTO accession, China had already been rapidly integrating into the global economy. Net inflows of foreign direct investment (FDI) accelerated after 1991, reaching 3.5 percent of GDP in 2001 after peaking at 6.2 percent in 1993.[31] Export growth followed increased investment. China's total trade (exports plus imports) grew from 25 percent of GDP in 1989 to 38.5 percent in 2001 and peaked at 64 percent of GDP in 2006, thanks in large part to the stability provided by WTO membership.[32]

For Chinese reformers, WTO accession was an opportunity to achieve long-sought economic reforms, especially of SOEs. The Tiananmen Square protests had sparked a conservative backlash in China amid fears that economic reforms would lead to political change, as in the Soviet Union. In response, Deng, no longer officially in power, embarked on his famous Southern Tour to underscore the need for economic reform and ensure further policy experimentation and opening up. Deng's successor Jiang Zemin carried the mantle of economic reform and embarked on massive privatization of SOEs. From 1995 to 2003, the number of SOEs in China declined from roughly 118,000 to about 34,000, while SOE employment fell by 44 million people.[33]

Yet, as with earlier reforms, the CCP conditioned economic changes on undisputed central authority. Deng's Southern Tour, which signaled a restart of economic reform and opening, came after he authorized the Tiananmen Square crackdown, underlining that political change was non-negotiable and distinct from economic liberalization. Jiang further developed the concept of self-reliance by connecting it with indigenous innovation, declaring in a 1995 speech that "only by mastering core technologies and having our own intellectual property will we be able to securely grasp the destiny of the motherland."[34] Beijing undertook massive SOE reform on the condition that it would be "grasping the large, letting go of the small," or retaining control of core industries.[35] While some U.S. policymakers interpreted SOE reforms as moving away from state planning, Beijing was instead corporatizing and strengthening strategic state assets.

Amid the excitement surrounding China's WTO accession, the defense communities in both capitals drew different lessons from the 1990s. After the fall of the Soviet Union, the United States reduced military forces from all foreign theaters except for Asia. The Pentagon's 1995 *Security Strategy for the East-Asia Pacific Region* resolved to maintain 100,000 troops in the region "for the foreseeable future" and flagged China's military modernization while resolving to support Beijing's "constructive integration into the international community."[36] The 1995–1996 Taiwan Strait Crisis and the accidental U.S. bombing of the Chinese embassy in Belgrade in 1998, as well as the U.S. affirmation that the disputed Senkaku Islands fell under the U.S.-Japan defense treaty, hardened attitudes in Beijing that the United States would inevitably seek to contain China in the region.[37]

The George H.W. Bush and Clinton administrations achieved many of their immediate goals of engagement with Beijing, although, as with the earlier period, the results largely reflected Chinese priorities for domestic reform. Beijing continued its rise as a regional power, increasingly

participating in international institutions and non-proliferation dialogues and refraining from extraterritorial use of force. Both sides successfully deescalated security issues after brief periods of elevated tensions. Through WTO accession talks, Washington helped reformers in Beijing lock in long-sought adjustments that challenged vested interests. By the end of the 1990s, there was a sense in Washington that U.S. policymakers could work with Beijing and, through further economic integration, encourage deeper reforms.[38]

2001–2017: China Inc. Becomes China Shock

China's WTO accession accelerated its integration into the global economy. Between 2000 and 2017, China's share of global goods trade increased from 1.9 percent to 11.4 percent, and by 2013, China had become the largest goods-trading nation.[39] Over this period, China also grew to become a major source of and destination for FDI. In 2000, China was the 7th-largest destination and 30th-largest source of FDI flows; in 2017, it was the second-largest destination and third-largest source.[40]

Concurrently, China became a vital market for many Western companies and investors. As discussed in the following section, several large U.S. technology companies rely on the Chinese market not only for essential production but also for significant portions of their global revenue. Alongside reforms to its economic system, China deepened its financial markets, often working closely with U.S. experts. By 2016, just over 25 years after the Shanghai and Shenzhen stock markets were officially launched in 1990, mainland China boasted the second-largest equity market, and in 2019 China became the second-largest bond market by securities outstanding.[41]

However, developments in the two decades since China's accession to the WTO in 2001 fell short of expectations in other respects. Under the conservative administration of Hu Jintao, Beijing began backsliding on economic liberalization and enhancing central control. Although Beijing had repealed, revised, or enacted over a thousand laws to bring its system in line with WTO requirements, a 2006 USTR report concluded, "China's record in implementing WTO commitments is decidedly mixed."[42] Progress in removing tariffs and formal trade barriers was offset by persistent intellectual property violations and discriminatory treatment of foreign companies. The report noted, "over the past 12 months we have seen an upsurge in industrial planning measures as tools of economic development by central government authorities." Part of such measures included the National Medium- and Long-Term Program for Science and Technology Development (2006—2020), under which Beijing set targets for indigenous innovation and planned state support in strategic sectors.[43] The five-year deadline for Beijing to implement most of its WTO accession commitments passed with many left unmet.

The effects of the Global Financial Crisis (GFC), with its origins in the U.S. housing market, further strengthened the position of conservatives in Beijing wary of market-determined outcomes and U.S. advice. The trend away from liberalization intensified under Xi Jinping, dashing early hopes for reform following the 2013 Third Plenum. Since Xi took office as general secretary of the CCP in late 2012, the state has played an increasing role in economic decisionmaking and resource allocation at the expense of market-driven actors.[44] Under Xi, SOE reform focused on further consolidating state behemoths. In 2017, 48 Chinese SOEs made the Global Fortune 500 list of largest companies, up from 6 in 2003.[45] Beijing allowed private companies, notably in technology and other innovative sectors, to grow but subjected them to increasing scrutiny from CCP committees embedded within the organizational structure.[46]

While backsliding on economic reforms, Beijing strengthened state control and CCP primacy and began projecting its economic strength abroad. Fearful of a potential color revolution and internal turmoil, especially in Xinjiang, Beijing purged notable dissidents and established a brutal "re-education" campaign targeting Uighur Muslims.[47] Under Xi, Beijing has increasingly projected its growing economic power, including through the ambitious Belt and Road Initiative and repeated use of coercive tools to discipline trading partners acting against China's interests.[48]

Meanwhile, the promised economic benefits to the United States of greater integration with China were uneven. Corporations and high-skilled workers, many in service sectors, benefitted from increasing access to a market of over a billion consumers and a low-wage Chinese workforce, but blue-collar U.S. workers disproportionately suffered the downsides. Landmark research by economists Daron Acemoglu, David Autor, David Dorn, Gordon Hanson, and Brendan Price estimated "job losses from rising Chinese import competition over 1999-2011 in the range of 2.0-2.4 million," with declines concentrated in manufacturing.[49] Regions of the United States most affected by the "China Shock" suffered declines in employment and wages and tended to remove moderate, pro-trade politicians from office.[50] Acute impacts politically overshadowed the gains in export-facing sectors and the broad, dispersed benefits of lower prices to consumers. While economists, including Autor, recognize the positive net effect on U.S. GDP of Chinese WTO accession, public views of China turned negative in 2012 and have further declined since.[51]

Though the size of China's economy alone meant its entry to the WTO would have a significant global impact, policy responses in Washington failed to mitigate the disruption and fairly distribute the benefits. The administration of President George W. Bush neglected to fully use special safeguards built into China's accession agreement to prevent import surges.[52] Beijing's interventions in the foreign exchange market between 2003 and 2008 to depress the value of the renminbi relative to the U.S. dollar gave Chinese exports a competitive advantage and went unpunished.[53] Trade Adjustment Assistance failed to adequately compensate those in the United States hurt by trade.

In September 2006, President Bush and President Hu created a Strategic Economic Dialogue (SED) to provide an overarching framework for bilateral economic discussions "at the highest official levels." The fact sheet announcing the SED's creation reflected bilateral economic tensions and explicitly recognized interdependence, highlighting the SED's "essential goal" of ensuring that the benefits of growing economic ties with China "are fairly shared by citizens of both countries" and emphasizing opportunities for the United States and China to act as "responsible stakeholders in the international economic system."[54] The massive economic imbalances, which in part motivated the SED's creation, were ultimately addressed by the GFC, as collapsing demand in the United States forced a rapid external adjustment. But the SED also fostered close policy cooperation during the GFC, including a strong economic stimulus from China credited with supporting the global recovery.

Shortly after President Obama came into office, the United States and China expanded the SED under a Strategic and Economic Dialogue (S&ED). In contrast to the SED, which was led by the treasury secretary on the U.S. side, the S&ED included separate "strategic" and "economic" tracks, led on the U.S. side by the secretary of state and the secretary of the treasury, respectively. More than a decade of SED and S&ED bilateral meetings yielded incremental gains on issues ranging from exchange rate flexibility, to economic rebalancing, to data transparency, but did not produce sufficient progress on the main structural issues that continued to distort the relationship.

While the Bush and Obama administrations recognized negative spillovers from certain Chinese policies, they were reluctant to take aggressive action in response.[55] U.S. policymakers believed that dialogue would yield better results than punitive trade remedies, which could isolate reformers in China and lead to retaliation from Beijing to the detriment of U.S. companies. Litigation at the WTO to authorize tariffs could take years, and there was a high bar for proving injury from specific Chinese actions. Finally, the 9/11 terrorist attacks on the United States, the GFC, and the desire for Chinese cooperation on issues such as climate led U.S. officials to prioritize areas of common interest, including countering the financing of terrorism and global financial stability, rather than adopt a more aggressive stance on trade that might jeopardize cooperation.

Overall, the record of U.S. engagement with China during this period is mixed. In economic terms, Beijing lowered trade barriers, gradually built a stronger intellectual property rights regime, and eventually abandoned aggressive currency depreciation.[56] China's overall current account deficit decreased from 10 percent of GDP in 2007 to 0.2 percent in 2018 but its trade surplus with the United States has remained persistently high. Chinese companies continue to receive massive state support and benefit from discriminatory treatment of their foreign peers.[57] Despite a 2015 agreement between Xi and President Obama, China still engages in commercial espionage and cybertheft.[58] In 2018, USTR determined that elements of China's "technology transfer regime . . . are unreasonable or discriminatory and burden or restrict U.S. commerce." While China successfully integrated into the global economy, Beijing also doubled down on industrial policies to promote national champions, especially in key emerging technology sectors, thereby distorting global markets.

The geostrategic picture is similarly mixed. Beijing has actively participated in global talks on climate change and recently pledged to reach net-zero carbon emissions by 2060.[59] Under the Obama administration, Beijing cooperated on nuclear non-proliferation and reluctantly endorsed UN sanctions on Iran and North Korea.[60] Yet China steadily pressed its territorial claims in the South China Sea through island-building, in violation of international law and despite committing to the opposite. Finally, the strengthening of civil society which had been fostered through much of the 1990s and 2000s has gone in reverse under President Xi. And while political liberalization may have always been more of a hope than a formal U.S. objective, it clearly has not materialized.

2017–2020: Trade War and Decoupling

Throughout the 2010s, pressure mounted on U.S. officials to address Chinese practices that impeded foreign access to its domestic market and advantaged Chinese companies in markets overseas. Many observers argued that China's protracted negotiating tactics and growing technological prowess, based at least in part on the theft of foreign intellectual property, called for a new approach to Beijing. The election of Donald Trump as the 45th president of the United States cemented views of great power competition within the White House, but the specific objectives of U.S. engagement with China were not well defined.

On the economic front, the clearest articulation—apart from President Trump's focus on China's chronic bilateral trade surpluses with the United States—came in a March 2018 report from USTR, titled *China's Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation*.[61] The report identified "Chinese acts, policies or practices that are unreasonable or discriminatory and that burden or restrict U.S. commerce" and served as the basis for imposing tariffs

U.S. president Donald Trump signs trade sanctions against China on March 22, 2018, in the Diplomatic Reception Room of the White House in Washington, D.C., on March 22, 2018.

MANDEL NGAN/AFP via Getty Images

on Chinese imports to the United States.[62] By 2020, the United States maintained an average tariff rate on Chinese goods of 19.3 percent, six times higher than ex ante levels, and China had a 20.3 percent average rate on U.S. goods, an increase of 14 percentage points since January 2018.[63] After nearly two years of negotiations, a ceasefire agreement went into effect in January 2020 with a "Phase One" trade deal consisting of Chinese commitments for $200 billion in U.S. goods purchases, financial sector opening, and intellectual property protections.[64] However, the deal did not address more sensitive structural issues, such as Chinese industrial policy and subsidies. China's bilateral goods trade surplus with the United States did decline from $375 billion in 2017 (1.9 percent of U.S. GDP) to $345 billion in 2019 (1.6 percent of U.S. GDP) and declined further in 2020.[65] At the same time, the overall U.S. trade deficit widened to record levels in 2020, suggesting the trade war merely diverted Chinese imports to other U.S. trading partners.[66]

Notwithstanding the trade war ceasefire, the Trump administration escalated confrontation with Beijing on various fronts. Operating under a "whole-of-government" approach to strategic competition with China, the Trump administration reported 210 actions in 2020 alone.[67] Among other policies, Washington has strengthened controls on the transfer of emerging technologies, expanded broad trade restrictions to include several Chinese companies, and limited visa access for certain Chinese nationals. In particular, Washington aggressively restricted commercial activity with Chinese telecommunications giant Huawei, including by implementing extraterritorial controls on semiconductors and semiconductor equipment to the company.[68] Other actions are pending, including the delisting of Chinese companies currently trading on U.S. exchanges and barring U.S. investors from transacting in any securities determined to be affiliated

with a "Communist Chinese military company." Thus far, Beijing has responded in-kind to U.S. tariff, visa, and diplomatic actions, and a new Chinese Export Control Law restricting the export of sensitive materials and technologies came into effect in late 2020, reportedly in response to U.S. actions.[69]

As the range of targeted economic activities expanded, the conversation in Washington shifted from reaching a short-term deal on trade to whether and how to restructure the bilateral relationship and disentangle U.S. and Chinese economic interests, especially in critical technology sectors. The notion of broader "decoupling" started to gain traction in fall 2018, with observations that the United States was heading toward a "Cold War" with China.[70] During the 2020 U.S. presidential campaign, Trump publicly mused about decoupling as a means to "end our reliance on China."[71] While President Biden's team has dismissed a broad divorce with China, the new administration is likely to pursue some degree of economic disengagement and continue certain Trump administration policies.[72]

For Beijing, the harsh rhetoric toward China, backed by actual policies to restrict economic engagement, confirmed the imperatives of indigenous innovation and central control. In an April 2020 speech, Xi outlined a "dual circulation" strategy which aims to balance domestic economic resilience and technology self-sufficiency with global integration, emphasizing the former.[73] Beijing has reaffirmed the centrality of the state in the economy in other high-profile moves, including official intervention to delay Ant Financial's initial public offering over founder Jack Ma's criticism of Chinese regulators and reported refusal to share consumer credit data.[74]

It is too early to assess the full impact of the Trump administration's hardline approach to China. The U.S. goods trade deficit with China—President Trump's primary barometer for success—narrowed in 2019, and data through November show the bilateral deficit has narrowed further in 2020, due to a rebound in U.S. exports to China and a drop in imports from China. The majority of imports, however, have been diverted to other foreign suppliers such that the overall U.S. goods trade deficit is on pace to widen in 2020. The Business Roundtable, a group of leading U.S. firms, is pushing for reductions in tariffs, and U.S. semiconductor companies are lobbying against many of the export controls implemented under the Trump administration.[75] U.S. companies continue to look for opportunities in China, and a 2019 American Chamber of Commerce in Shanghai survey found that 83 percent of U.S. companies in China are not considering relocating manufacturing plants.[76] Still, the Trump administration may have succeeded in its main objective—reorienting China policy around a paradigm of great power competition—and forcing a reconsideration of the costs and benefits of economic integration.

U.S. Allies' Engagement with China

While tempting to think of the U.S.-China relationship in a vacuum, the actions of allies and partners matter greatly to the effectiveness of U.S. and Chinese actions. U.S. allies have their own motivations for engagement with China, although they have often aligned with U.S. priorities. After the Sino-Soviet split, many U.S. allies abandoned the strict Korean War-era embargo on China. Australia and Canada exported grain to Maoist China, and Japan and Western Europe supplied industrial products, such as chemical fertilizer.[77] France and Canada formally recognized China in 1964 and 1970, respectively, but other U.S. allies continued to recognize Taiwan until Nixon's surprise announcement that he would visit China.[78] The resulting "Nixon shock" led to a wave of normalization of relations with Beijing and convinced U.S. allies to develop more independent policies toward China.[79]

Japanese political scientist Ryosei Kokubun notes that, "postwar relations [between Japan and China] have consistently preceded U.S.-China relations."[80] Tokyo normalized relations with Beijing in 1972, more than six years before Washington, and was an early proponent of China's economic modernization. Deng visited Japan in 1978 to sign a Treaty of Peace and Friendship, and in 1979, Tokyo provided $200 million through concessional lending to finance infrastructure projects in China.[81] Through 2018, China was the largest recipient of Japanese official development assistance, having received approximately $33 billion in total loan and grant aid.[82] Bilateral investment and trade flourished. At the end of 2018, China was Japan's largest goods trading partner and the fourth-largest destination for Japanese FDI, with $124 billion in total FDI stock.[83]

Despite strong economic ties, diplomatic setbacks have been a recurrent feature of the Japan-China relationship since normalization. Flareups over wartime and territorial claims have soured public opinion on both sides but have not derailed economic integration. Tokyo has largely stayed out of the U.S.-China trade war, and prior to Covid-19, few Japanese firms planned to shift production out of China.[84] The Regional Comprehensive Economic Partnership (RCEP), a regional trade agreement signed in November 2020 that includes China and Japan but not the United States, promises to further knit the two economies together.

At the same time, Tokyo has hedged against China's rise. In 2016, then-Prime Minister Shinzo Abe articulated a vision for a "Free and Open Indo-Pacific," which the Trump administration later adopted as a regional strategy based on "free, fair and reciprocal trade, open investment environments, good governance, and freedom of the seas."[85] Japan was also one of the first countries to ban Huawei from its 5G telecommunications network. And like the United States and other U.S. allies, Tokyo strengthened its foreign investment screening regime and guidelines on foreign research collaboration to limit the transfer of sensitive technologies to China. Tokyo also recently added an economic division to its National Security Secretariat to reflect the increased focus on economic issues as critical to national security.[86]

Until recently, China was a comparatively lower political priority for European countries managing regional integration and Russia's post-Soviet transition. The European Community, the precursor to the European Union, established official relations with Beijing in 1975, followed by a series of trade and investment agreements. Bilateral economic ties flourished after WTO accession, and in 2020 China became the European Union's largest external goods trading partner, surpassing the United States. China's share of total EU external goods trade tripled between 2000 and 2018, from 5 percent to 15 percent, and multinational European companies, especially automakers, rely on the Chinese market to drive revenue.[87] Bilateral FDI has also accelerated in the past decade, with EU investment stock in China more than doubling between 2008 and 2017 and Chinese investment in Europe surging nearly tenfold over the same period.[88] China is the second-largest foreign destination for European corporate research and development (R&D) funding, although there is a large gap behind the United States.[89]

China's economic emergence has forced European countries to wrestle with their approach to bilateral relations. In 2016, the European Commission outlined a new EU strategy on China, recognizing "an increased role for China in the international system" while committing to constructively manage differences on the principle of reciprocity.[90] Yet that proved inadequate to address growing concern in Brussels with China as an economic partner, and in 2019, the European Commission released a strategic outlook on China which simultaneously refers to China as a partner, an economic competitor, and a systemic rival promoting alternative models of governance.[91] An EU-wide framework for screening foreign

investment became fully operational in October 2020, and many EU member states have tightened foreign investment screening regimes to address security risks. While the EU aims to coordinate 5G deployment across member states, operational decisions are left to the member states and some EU members have banned Huawei from their national telecommunications networks. Yet Brussels recently agreed in principle to a Comprehensive Agreement on Investment (CAI) with China and seeks Beijing's cooperation in reducing global carbon emissions, a lodestar for EU economic policy. Similar to the U.S.-China Phase One trade deal, the CAI would further open Chinese markets to European companies, limit forced technology transfer, and increase transparency of Beijing's subsidies, although it still requires approval from the European Parliament, which remains skeptical over non-enforceable provisions committing China to fair labor standards.[92]

Generally, U.S. allies and partners have bristled at the notion of picking sides between Washington and Beijing. China is the largest export market for scores of countries, including key U.S. allies such as Japan, South Korea, and Australia. Few countries view China through an absolutist lens, and many countries worry that confrontation will jeopardize global public goods and imperil climate goals in particular. Nonetheless, U.S. allies are increasingly aware of security and economic challenges posed by Beijing and are struggling to calibrate policy accordingly.

4

Taking Stock of the Bilateral Economic Relationship

While economic considerations did not drive normalization of U.S.-China relations, they have come to represent an increasingly important aspect of U.S.-China engagement, serving both as a motivator and tool. This section evaluates the evolution of the economic relationship, focusing on trade, investment, and innovation linkages.[93]

In 1980, a year after the Joint Communiqué on the Establishment of Diplomatic Relations was signed, the United States was the world's largest economy, accounting for just over a quarter of global economic output. China accounted for less than 3 percent of global output, even in terms of purchasing power parity (PPP).[94] In the four decades since normalization, China has become a vastly more open and wealthier country, with a middle class numbering in the hundreds of millions and second only to the United States in the number of billionaires among its residents. In 2019, the United States still represented roughly one-quarter (24.4 percent) of global economic output, but China's contribution has increased to 16.3 percent in U.S. dollar terms and 17.3 percent as measured in purchasing power.[95] In per capita PPP terms, U.S. GDP was nearly four times that of China in 2019—$65,297 versus $16,830—highlighting the growth potential of the Chinese market.[96] These data are important in terms of understanding the attractiveness of the Chinese market for private-sector actors motivated by profit and investment returns.[97] They are also important in terms of assessing how third countries will engage with both the United States and China.

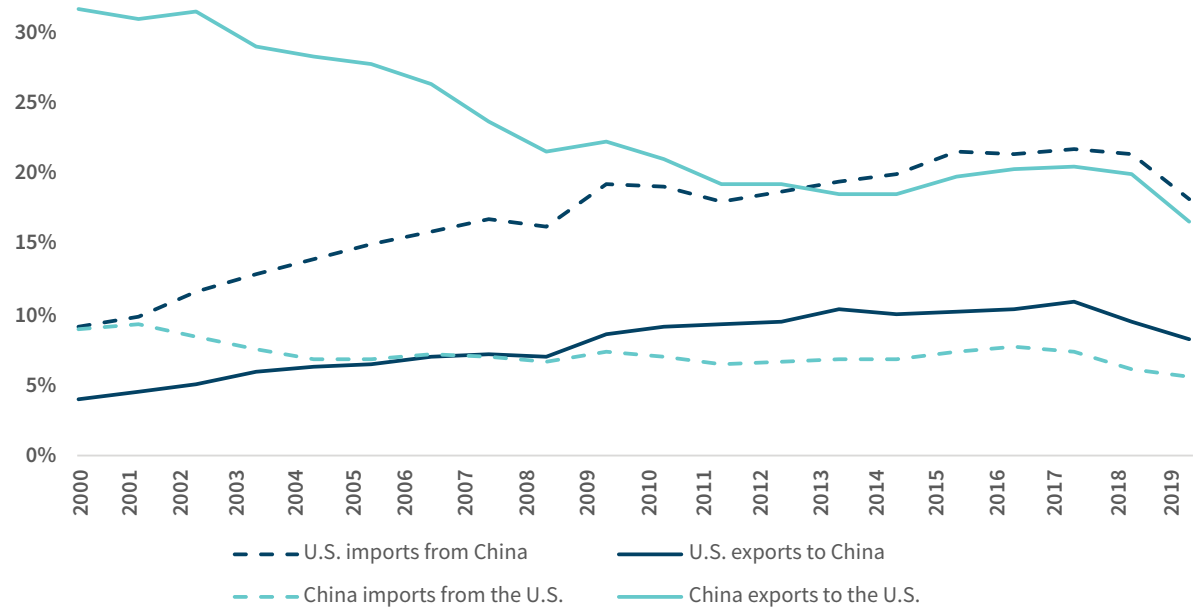
Decades of economic opening and increasing wealth have made China a more important economic partner for the United States and the rest of the world. At the same time, China appears to be diversifying its trade and investment linkages away from the United States while maintaining a high degree of interdependence in the area of innovation. As Richard McGregor, a senior fellow at Australia's Lowy Institute, observes, "China is not decoupling so much as it is de-Americanizing."[98]

Other studies identify a similar trend, exemplified by the emerging trade blocs in East Asia and the declining U.S. share of China's overall goods trade.[99]

Trade

Trade linkages between the United States and China have continued to grow, with the value of goods trade between the two countries increasing in all but 3 of the last 25 years.[100] However, while China's importance as a trading partner to the United States has increased in the two decades since China joined the WTO, the relative importance of the United States as a trading partner to China has been declining or flat. For example, China's share of total U.S. goods imports grew from 9.8 percent in 2001 to a peak of 21.7 percent in 2017 before declining to 18.1 percent in 2019, but the U.S. share of China's goods exports fell from 30.8 percent in 2001 to 16.6 percent in 2019. Similarly, the U.S. share of China's total goods imports declined following China's accession to the WTO, falling from 9.3 percent in 2001 to 5.6 percent in 2019 and averaging just 7 percent over the past decade. Conversely, China's share of total U.S. goods exports grew from 4.6 percent in 2001 to 8.3 percent in 2019 and peaked at 10.9 percent in 2017.

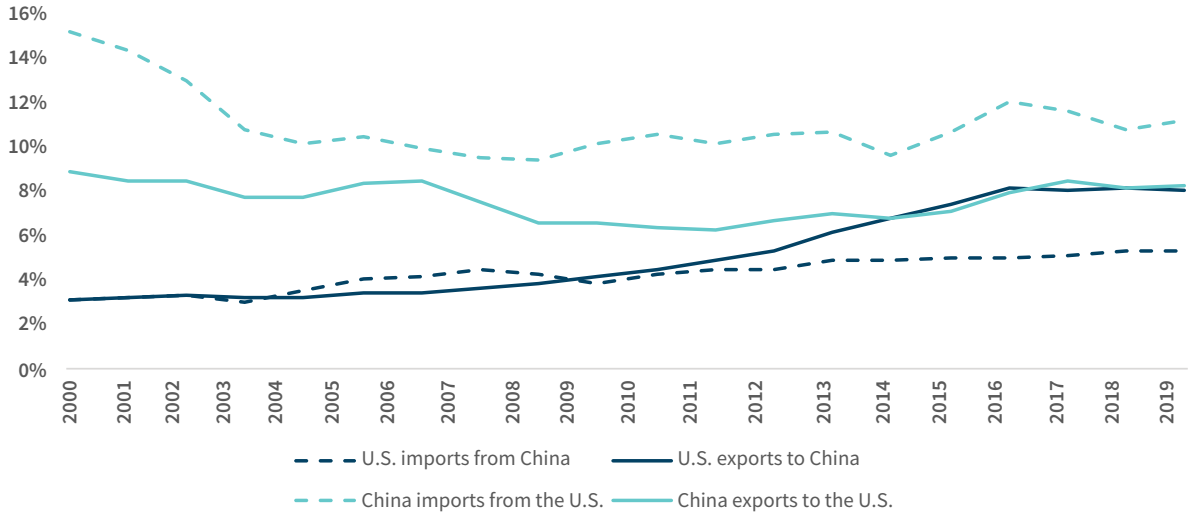
Figure 1: Goods Trade as Percent of Total



Source: U.S. Census Bureau, China State Administration of Foreign Exchange, and Hong Kong Census and Statistics Department, retrieved via Bloomberg. China data aggregate mainland China and Hong Kong.

Trade in services tell a similar if slightly less dramatic story. As with goods trade, China has grown steadily in importance as a market for U.S. services exports, increasing from 3.3 percent of all U.S. service exports in 2001 to 8.1 percent in 2019. While the rate of growth has been less dramatic, the United States also imports more from China as a percent of total U.S. services imports, from 3.3 percent in 2001 to 5.4 percent in 2019. Similar to trade in goods, the U.S. role in Chinese services trade has been declining even as China has become a more important services trading partner for the United States. Imports of U.S. services accounted for 14.3 percent of total Chinese services imports in 2001 versus 11.2 percent in 2019, and Chinese services exports to the United States decreased slightly from 8.5 percent of total Chinese services exports in 2001 to 8.2 percent in 2019.

Figure 2: Services Trade as Percent of Total



Source: U.S. Bureau of Economic Analysis and China State Administration of Foreign Exchange, retrieved via Bloomberg. U.S. imports and exports aggregate mainland China and Hong Kong data; China imports and exports only reflect mainland data.

These results are not surprising in light of China's rapid economic growth. That growth, historically driven by exports, has also made China an increasingly important destination for global imports. While the United States is still China's most important individual trading partner, other countries have become relatively more important, both as markets for Chinese exports and suppliers of imports to China. In addition, the fact that Chinese imports have been so consistent as a share of total U.S. imports over the past 20 years points to structural aspects of the economic relationship (e.g., prior investments in China by U.S. multinationals) that have led to the relative stability of the United States as a market for many Chinese goods.

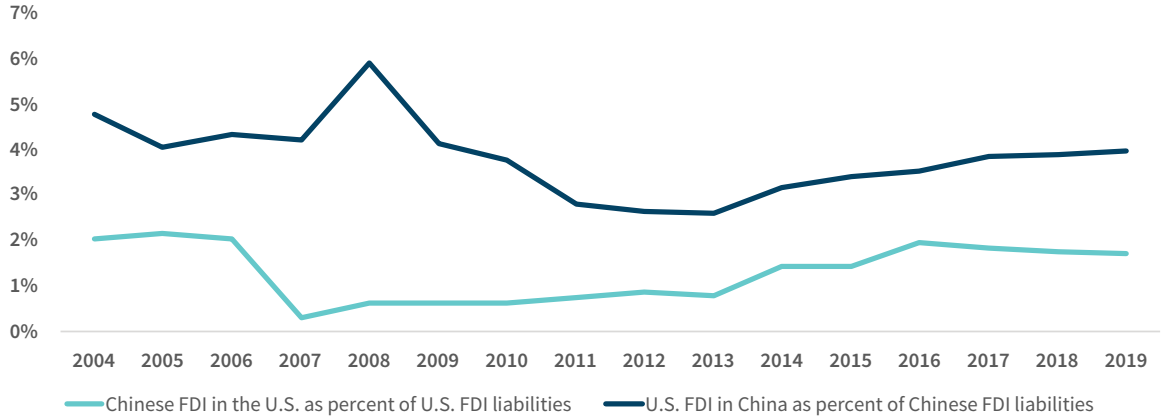
Investment

Investment flows can be categorized into FDI, which statistically requires a minimum 10 percent ownership stake and generally entails some transfer of control, and portfolio flows, which include the purchase and sale of equity and debt securities such as shares and bonds in publicly traded companies. The Chinese economy, as with most economies, has historically been more open to trade than capital flows. FDI in China was minimal until the 1990s, and portfolio investment started at scale only in the 2000s.[101]

According to Bureau of Economic Analysis (BEA) data, U.S. FDI stock in China and Hong Kong reached $198 billion in 2019, up from $6.4 billion in 1990 and $45 billion in 2001. U.S. FDI assets in mainland China alone reached $116 billion by 2019, having surpassed investment in Hong Kong in 2008. Although official data often mask the "ultimate beneficial owner" of FDI due to third-country pass-throughs or underreporting, private data show a similar trend.[102]

U.S. investment in China as a share of total U.S. FDI assets more than doubled between 1990 and 2001, growing from 1.5 to 3.1 percent and has remained stable at just over 3 percent of total U.S. FDI assets through 2019. While U.S. direct investment in China has generally kept pace with U.S. direct investment globally, China has somewhat diversified its sources of FDI, and today U.S. investors represent a smaller share of China's total FDI liabilities. BEA data show that U.S. FDI represented 4.8 percent of China's FDI liabilities in 2004 versus 4.0 percent in 2019.

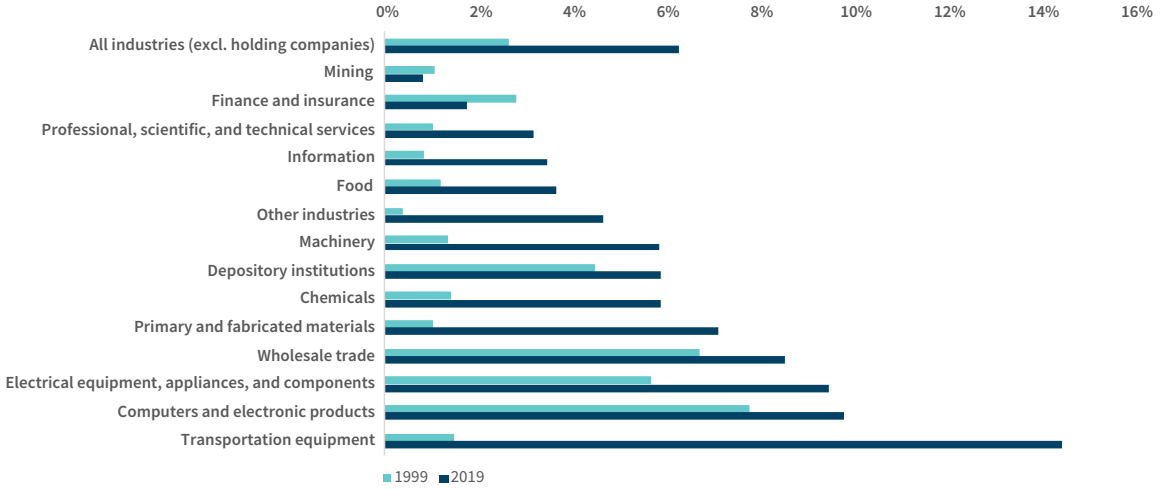
Figure 3: FDI Stock as Percent of Total



Source: U.S. Bureau of Economic Analysis and China State Administration of Foreign Exchange, retrieved via Bloomberg. U.S. FDI figures include only investment in mainland China; Chinese FDI in the United States includes both mainland and Hong Kong investors.

According to BEA data, nearly all U.S. industry categories increased investment in China between 1999 and 2019, led by the technology sector. Direct investment in China accounted for 9.8 percent of the computer and electronic product industry's total overseas investment in 2019, up from 7.8 percent in 1999. Similarly, Rhodium Group data show that U.S. information and communications technology (ICT) companies made the greatest total investment in China from 1990 through 2019 among U.S. industries, led by Intel, Motorola, Microsoft, Seagate, and Qualcomm.[103]

Figure 4: U.S. Investment in China as Percent of Total U.S. Foreign Investment



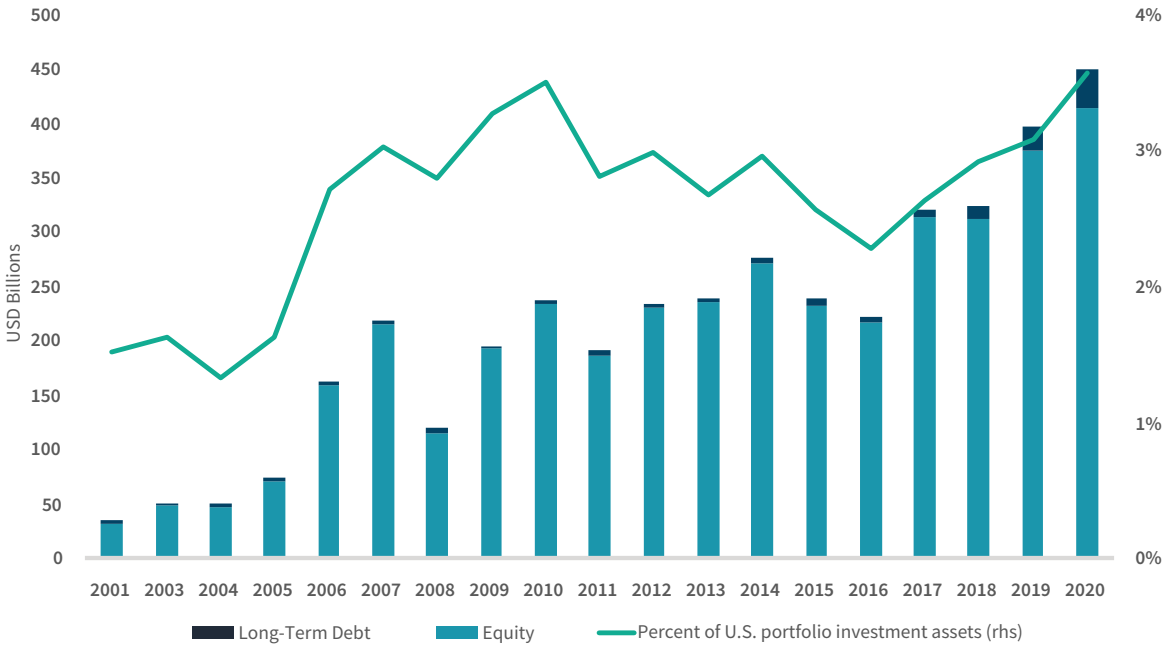
Source: "Balance of Payments and Direct Investment Position Data," U.S. Bureau of Economic Analysis, https://www.bea.gov/international/di1usdbal. Data include investment in mainland China and Hong Kong.

Chinese direct investment in the United States is a relatively new phenomenon. Through the mid-2000s, mainland Chinese direct investment in the United States was negligible, amounting to less than half a percent of total U.S. FDI liabilities. Chinese direct investment began in the United States at scale in the last decade, and by 2019, China and Hong Kong had FDI assets in the United States totaling $76.6 billion—1.7 percent of total U.S. FDI liabilities based on ultimate beneficial ownership. (Private data show larger aggregate levels of bilateral investment but a similar trend as official sources.)

By comparison, Japan, the largest foreign investor in the United States, had $645 billion invested through 2019, accounting for 14.5 percent of total U.S. FDI liabilities.[104] According to the Rhodium Group, real estate and hospitality sectors attracted the most Chinese investment, followed by ICT and transportation. Chinese inbound FDI flows peaked in 2016, and a combination of factors, including Chinese controls on outbound investment and stricter U.S. review of inbound investment from China, led to a sharp decline in Chinese direct investment in all but a handful of non-sensitive sectors.[105]

Regarding portfolio investment, U.S. investors have been increasing their exposure to China while Chinese investors are reducing their relative holdings of U.S. portfolio assets. According to U.S. Treasury data, U.S. investors held $449 billion in Chinese and Hong Kong securities as of August 2020, accounting for 3.6 percent of total U.S. foreign portfolio assets. Ninety-two percent of holdings were in equity securities, with the balance in Chinese and Hong Kong debt securities. U.S. investors' exposure to Chinese securities has increased in nominal terms and as a percent of U.S. portfolio assets every year since 2016, despite growing tensions and the U.S.-China trade war. Among the factors driving this trend are ongoing market opening in China, moves by global index providers to increase China weights, and the yield differential between Chinese and advanced economy government bonds.[106] The combination of easing restrictions on foreign investment in Chinese markets and the rapid growth of the Chinese economy means that global investors will be looking for opportunities to increase their holdings of Chinese securities absent prohibitive regulation or legislation.

Figure 5: U.S. Holdings of Chinese Securities

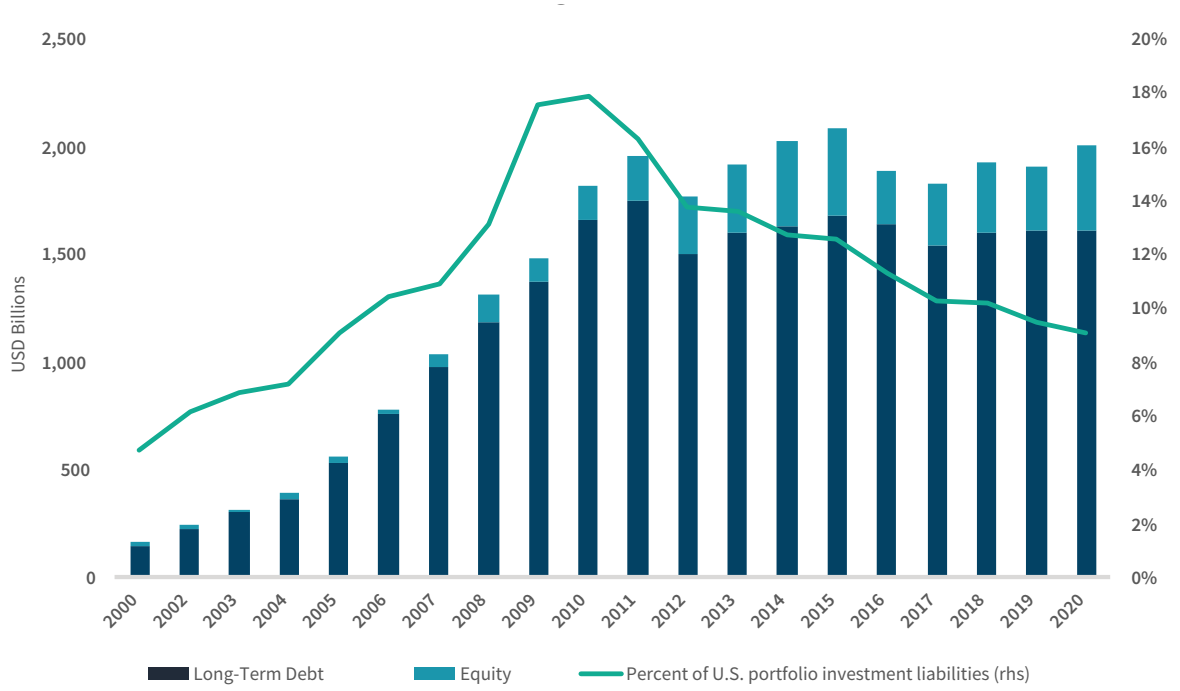


Source: "U.S. Residents' Portfolio Holdings of Foreign Securities (U.S. claims)," Treasury International Capital System, U.S. Department of the Treasury, https://www.treasury.gov/resource-center/data-chart-center/tic/Pages/fpis.aspx. Data aggregate mainland China and Hong Kong. 2020 data from August.

In contrast, official data show that Chinese and Hong Kong investors have reduced their relative holdings of U.S. assets over the last decade. As of August 2020, Chinese and Hong Kong holdings of

U.S. securities totaled $2.0 trillion, compared with $1.9 trillion in 2010, representing a sharp decline from 18 to 9 percent of U.S. portfolio liabilities. The fall is due entirely to a decline in Chinese and Hong Kong holdings of long-term U.S. debt, especially U.S. Treasury bonds, partially offset by increased holdings of U.S. equities. However, as noted previously, the ultimate owner of securities is often obscured by the use of third-country pass-throughs.

Figure 6: Chinese Holdings of U.S. Securities



Source: "U.S. Residents' Portfolio Holdings of Foreign Securities (U.S. claims)," Treasury International Capital System, U.S. Department of the Treasury, https://www.treasury.gov/resource-center/data-chart-center/tic/Pages/fpis.aspx. Data aggregate mainland China and Hong Kong. 2020 data from August.

In addition to FDI and portfolio investment, venture capital—early-stage investment in nascent, often technology-related companies—has grown over the past two decades. Beijing established its first state-backed venture funds in the 1980s, but venture capital in China only began to gain traction in the early 2000s.[107] Since then, U.S. funds have been active investors in Chinese technology start-ups, including those focused on artificial intelligence and data analytics.[108] According to the Rhodium Group, U.S. venture investment in China totaled $5.1 billion in 2019, down from a record $19.4 billion in 2018 but up from $65 million in 2000 and on par with levels from 2014 to 2016.[109] Overall, Rhodium estimates that U.S. funds have contributed 16 percent of the roughly $300 billion raised by all Chinese start-ups from 2000 through the first half of 2019.[110]

Until 2010, Chinese venture capital investment in the United States was almost nonexistent. According to the Rhodium Group, China's annual venture investment in the United States grew from a negligible amount in 2000 to $162 million in 2010 and $2.5 billion in 2019, peaking at $4.5 billion in 2018.[111] Rhodium estimates that Chinese funding represents about 2 percent of the $1 trillion raised by U.S. start-ups between 2000 and July 2019.[112] By industry, Chinese venture funding has primarily targeted health and pharmaceutical, financial services, and ICT companies.[113] In recent years,

venture capital investment from China has been more resilient than FDI, and reporting indicates that Chinese state-backed funds continue to invest in U.S. technology companies notwithstanding closer regulatory scrutiny.[114]

The deteriorating U.S.-China relationship and stricter regulatory environment in the United States and China have discouraged bilateral venture flows, which peaked in 2018. Reforms to the Committee on Foreign Investment in the United States (CFIUS) in 2018 established greater scrutiny of foreign investment in critical technology companies, including certain non-passive investments that involve board seats or access to sensitive, non-public information. New regulatory burdens and mandatory filings, as well as geopolitical uncertainty, have further complicated Chinese venture investment in the United States. For its part, Beijing's financial de-risking campaign has reduced the availability of new capital for Chinese venture funds, especially smaller firms.[115]

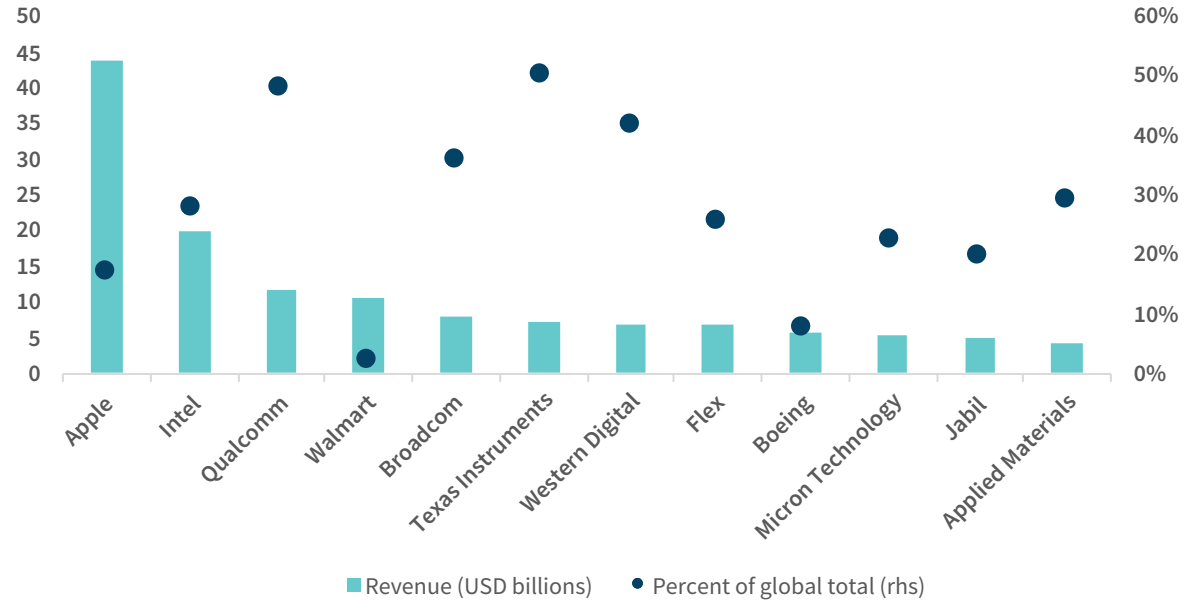
U.S. Corporate Activity in China

Since Deng's market opening measures, large multinational corporations have moved some operations to China, both to produce for export and to serve the domestic Chinese market. Beijing often compelled foreign firms to begin affiliate operations in China by using restrictions that require localized production.[116] WTO accession and the stabilization of economic relations through PNTR accelerated U.S. corporate activity in China as firms raced to take advantage of China's lower cost of production and the large and growing domestic market. Comparable data for Chinese companies in the United States is limited and also reflects Chinese firms' more modest presence in the U.S. market.

According to a 2020 U.S.-China Economic and Security Review Commission report, U.S. multinational foreign affiliate assets in China increased more than 15-fold from $29 billion in 2000 to $447 billion in 2017, and sales followed a similar growth pattern.[117] China has become a hub of technology production, and the U.S.-China Commission study noted that in 2017 China accounted for nearly a third of U.S. corporate global capital expenditure on semiconductor manufacturing assets. China was also the fourth-largest destination for U.S. corporate overseas R&D expenditures, jumping from tenth in 2000.

Technology companies, especially semiconductor firms, rely on the Chinese market for large segments of global revenue. According to data obtained via Bloomberg, 10 of the 12 U.S. public corporations with the highest 2019 revenues from mainland China and Hong Kong are technology companies, and seven are semiconductor companies. In 2019, U.S. semiconductor giants Qualcomm and Texas Instruments relied on China and Hong Kong for about half of their global revenue (48 percent and 50 percent, respectively). Other chipmakers have outsized exposure to China, such as Broadcom (36 percent of 2019 revenue from China and Hong Kong), Applied Materials (29 percent), and Micron Technology (22 percent).

Figure 7: Select U.S. Companies, Revenue from China in 2019



Source: Corporate SEC filings, retrieved via Bloomberg. Data aggregate mainland China and Hong Kong.

Innovation and People-to-People Exchanges

President Nixon's trip to China concluded with the Shanghai Communiqué, which laid the groundwork for people-to-people exchanges as "desirable to broaden the understanding between the two peoples."[118] The U.S.-China Science and Technology Cooperation Agreement was signed later that decade, forming the basis for bilateral research collaboration.[119] Unlike trade and investment linkages, which show China's declining reliance on the United States, innovation linkages as exemplified by people-to-people exchanges suggest a deepening of bilateral exchange. China remains the largest country of origin for foreign U.S. PhD recipients of science, technology, engineering, and mathematics (STEM) degrees—more than 6,000 in 2018—and the

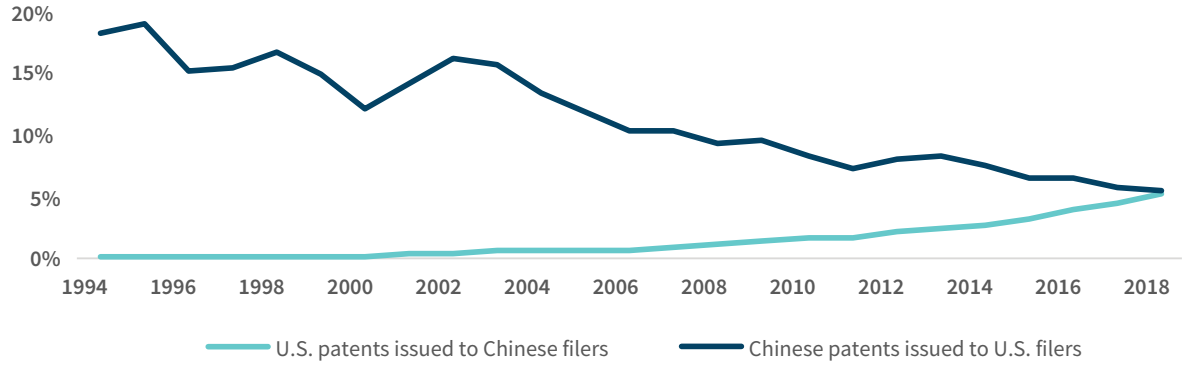
Chinese vice-premier Deng Xiaoping (L) shown in a photo dated 31 January 1979 applauding with U.S. president Jimmy Carter after signing three agreements.

ARNOLD SACHS/AFP via Getty Images

share of foreign-born recipients from China has continued to grow, reaching 35 percent in 2018. These academic linkages have fostered bilateral scientific exchange; in 2018, a quarter of U.S. internationally co-authored science and engineering publications had a Chinese citizen co-author, the highest share of any individual country and nearly double the share of the United Kingdom, the second-highest collaborator country.[120] Nearly 44 percent of China's 2018 international publications had a U.S. co-author, the highest share of U.S. co-authorship of any country.

Similarly, U.S. and Chinese companies and individuals are filing more patents in each other's jurisdictions. According to the World Intellectual Property Organization, Beijing issued nearly 23,000 patents to U.S. filers in 2018, up tenfold from 2001. However, the number of Chinese patents granted to U.S. filers as a share of the total for foreign filers decreased from 18 percent in 1994 to 5 percent in 2018 as China has diversified its innovation partners. In the other direction, Chinese filers represent a larger share of U.S. foreign patent recipients. The U.S. patent office granted over 14,000 patents to Chinese and Hong Kong filers in 2018 (4.9 percent of patents awarded to foreign filers), compared with 195 in 2001 (0.1 percent).

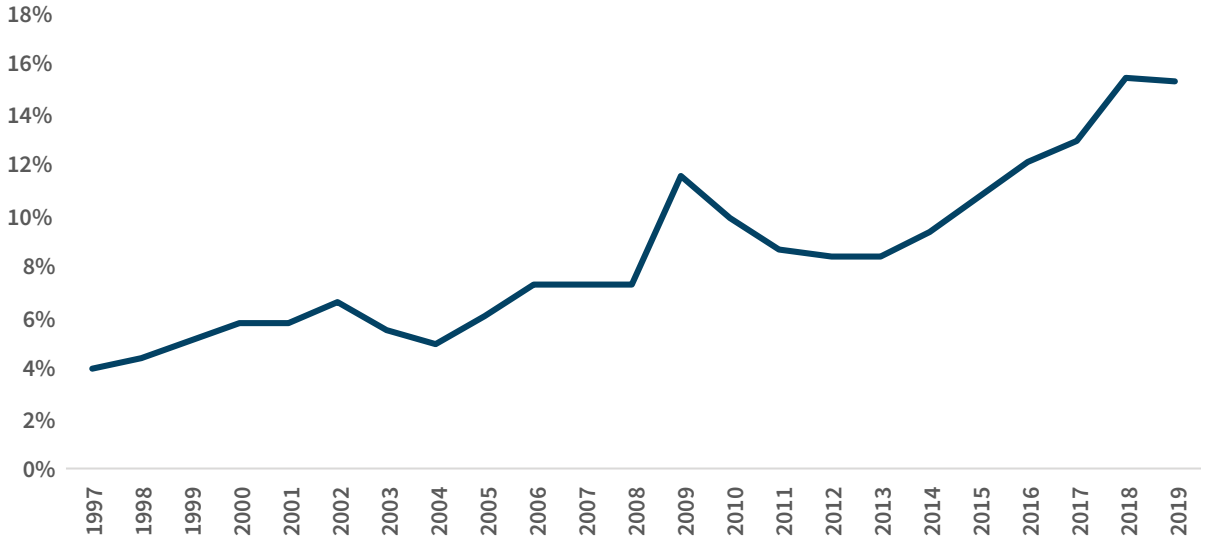
Figure 8: Patents as Percent of Total Foreign Patents Issued



Source: "IP Statistics Data Center – Total Patent Grants by Filing Office and Applicant's Origin," World International Property Organization, https://www3.wipo.int/ipstats/index.htm?tab=patent. U.S. patent issuance data aggregate mainland Chinese and Hong Kong filers.

Chinese citizens also account for an outsized share of the U.S. highly skilled workforce. Of the 188,123 H-1B visas issued in 2019, over 28,483, or 15 percent, went to Chinese nationals.[121] The Macro Polo think tank's Global AI Talent Tracker estimates that 27 percent of "top-tier" artificial intelligence (AI) researchers working in the United States received their undergraduate degree in China, while more than half of the top-tier AI researchers who received their undergraduate degree in China work in the United States, compared to only 34 percent that remain in China.[122]

Figure 9: H-1B Visas Issued to Chinese Citizens as Percent of Total



Source: "Nonimmigrant Visa Issuances by Visa Class and by Nationality," U.S. Department of State, https://travel.state.gov/content/travel/en/legal/visa-law0/visa-statistics/nonimmigrant-visa-statistics.html. Data aggregate mainland Chinese and Hong Kong Citizens.

Proponents of research-related people-to-people exchanges focus less on the benefits highlighted in the Shanghai Communique and more pragmatically on the fact that Chinese talent coming to the United States to study or work contributes to U.S. innovation capacity. According to this view, discouraging or prohibiting Chinese talent from studying and working in the United States will accrue to another country's benefit, quite likely China. Skeptics of people-to-people exchanges and bilateral research collaboration, on the other hand, note the potential for such exchanges to be abused to covertly provide sensitive information and research findings to China. They point to high profile examples of Chinese researchers lying about sources of funding and hiding ties to the Chinese military. U.S. law enforcement has described Chinese researchers in U.S. labs and universities as possible "non-traditional collectors," and a June 2018 White House report documented strategies used by China to target "intellectual property and technologies . . . to capture the emerging high-technology industries that will drive future economic growth."[123]

5

Assessing the Effectiveness of Economic Tools

Developing U.S. objectives for economic engagement with China requires a realistic understanding of the effectiveness of various tools to achieve intended outcomes. Ambitious goals that do not reflect the capacity of policy instruments to deliver are destined to come up short; modest objectives risk forfeiting more desirable outcomes. Further, given the complexities of the global economy, a deeper appreciation for the role of multilateral cooperation and private sector actors will help U.S. policymakers refine the deployment of policy tools.

There is a broad arsenal of tools available to policymakers seeking to rebalance economic relationships, achieve foreign policy objectives, or protect national security. As global economic interdependence has deepened and the cost of kinetic military action has increased, countries have increasingly relied on economic tools to avoid military conflict.

This section briefly reviews literature on economic statecraft, or the use of economic instruments to achieve specific goals. The record of the effectiveness of such tools is mixed and complicated by confounding variables. As with other policy tools, they are generally more effective when implemented alongside allies and with the cooperation of the private sector.

Sanctions are one of the most studied and debated economic policy instruments. In *Economic Sanctions Reconsidered*, Gary Clyde Hufbauer, Jeffrey J. Schott, Kimberly Ann Elliott, and Barbara Oegg study 174 case studies of sanctions and conclude, "sanctions often do not succeed in changing the behavior of foreign countries."[124] They offer several reasons for this failure—sanctions may be inadequate to reach lofty goals, unify the target country against the sanctions instigator, or alienate allies and business interests. Daniel Drezner builds on their work, finding that *threatening* sanctions is often more effective than *imposing* them.[125] Countries unwilling to bear the costs of sanctions will

acquiesce before action is taken, and "the bulk of successful coercion episodes therefore ends with sanctions threatened but not imposed."

Observers caution that the overuse of unilateral sanctions could erode their future effectiveness. The dollar's dominance as a global reserve currency enables extraterritorial unilateral sanctions. Abuse of that privilege, however, could drive economic activity away from the dollar, blunting the efficacy of future sanctions. In a 2019 speech, former U.S. treasury secretary Jacob J. Lew warned that "a U.S. push to reemphasize unilateral action is strengthening our strategic competitors and driving a search for ways to do business outside of the dollar and U.S. supply chains."[126] Lew outlined four conditions for the effective use of sanctions: a clear goal, broad international support, reliable expectation of relief under behavioral change, and rigorous execution.

Economic tools such as sanctions or tariffs may be less effective when imposed between two major economies. Through their case studies, Hufbauer et al. show sanctions imposed on the Soviet Union were rarely effective. Writing on the Trump administration's use of economic statecraft, Drezner states, "as a general rule, great powers do not acquiesce to economic pressure from other great powers, for fear that this precedent would undercut their bargaining position in future conflicts."[127] As evidence, after a year and a half of applying painful tariffs, the Trump administration signed a deal with China remarkably similar to the one on offer before the trade war began. Still, given the lack of case studies, it is difficult to extrapolate based on a few episodes that may reflect idiosyncratic factors, not a broad trend.

Export controls are another tool of economic statecraft often used to protect technology with potential military applications from adversaries. The origins of the various multilateral export control regimes can be traced back to the Coordinating Committee for Multilateral Export Controls (COCOM), which was organized by the United States and other Western countries after World War II to limit technology transfers to the Soviet Union. A 1971 U.S. Office of Technology Assessment study on COCOM described lists of technologies and products that would be embargoed, controlled, or monitored, including traditional military items and dual-use, high-tech items.[128] While COCOM was relatively broad in its controls, it had no power of enforcement. Nonetheless, the report concluded that COCOM "remains a viable, albeit imperfect, organization despite its informal nature, the lack of sanctions or adequate policing mechanisms, and the equivocal attitude of several of its members towards the continuation of present levels of export control."[129] After the fall of the Soviet Union, COCOM was reconstituted as the Wassenaar Arrangement and expanded to include Russia.

Like other tools, the scope of export controls can vary based on the objective. Tor Egil Førland argues that COCOM was a form of peacetime economic warfare that aimed to weaken the Soviet Union's economy.[130] He makes the case that COCOM should not be viewed as an economic sanction because it was not intended to coerce the Soviet Union into changing its conduct and not implemented as a rebuke to any specific misstep by the Kremlin. Førland observes that COCOM failed to implement a complete embargo because Western European countries were unwilling to sever trade relations with Eastern Europe, which sets a relevant precedent for attempts at U.S.-China decoupling.

As with sanctions, the abuse of unilateral export controls can have unintended negative consequences. A March 2020 Boston Consulting Group and Semiconductor Industry Association study estimated that Beijing's industrial strategy to support domestic champions could reduce U.S. chip companies' global market share by 2 to 5 percentage points.[131] However, the report warned that partial *unilateral*

restrictions on sales to Chinese customers could cost U.S. companies 8 percentage points of global market share as Beijing turned to other suppliers. The report suggests that a targeted, multilateral approach, taking in consultation with industry, would more effectively contain national security risks while maintaining U.S. leadership.

U.S. government reviews of previous unilateral export controls have reached conflicting conclusions about their effectiveness. A 2007 Department of Defense study found no compelling evidence that differential application of U.S. export controls accounted for the loss of U.S. market share in industries subject to control. Instead, the study attributed declining U.S. competitiveness to rising foreign competency and natural cyclicality.[132] On the other hand, a 2014 Department of Commerce review on the domestic space industry reported that unilateral export controls harmed U.S. competitiveness as foreign companies "designed-out" U.S. firms subject to regulation.[133]

Tools of economic statecraft extend well beyond sanctions, tariffs, and export controls. The United States and others have a long tradition of using trade policy to promote or discourage economic exchange in furtherance of foreign policy goals. Foreign investment screening mechanisms have also emerged as tools available to policymakers to influence capital linkages. And human capital exchanges—encouraged or deterred by visa and research policies—can also be seen as tools of economic statecraft.

Political scientists broadly argue that the success of economic statecraft—both coercion and inducements—depends less on the direct economic impact and more on whether that impact translates into domestic political pressure. Jean-Marc Blanchard and Norrin Ripsman argue that such political costs are a consequence of a regime's autonomy, capacity, and legitimacy, or, in other words, state capacity.[134] Stronger governments can afford to resist calls for policy change or seize opportunities presented by foreign inducements. Similarly, Audrye Wong argues that the effective use of inducements depends on the public accountability of a targeted country.[135] Wong examines Chinese economic statecraft over the past decade, observing that official development aid helped secure favorable outcomes in low-accountability Cambodia but failed in the Philippines and Malaysia, which had relatively higher levels of government transparency. Wong concludes that effective economic inducements are tailored to reflect unique domestic political environments.

In sum, the success of economic statecraft depends on the circumstances of each specific application. Generally, effective tools are those calibrated to leverage a target's domestic political environment and are taken with allied support and private sector input. Used judiciously, economic instruments have the potential to rebalance the relationship with China while minimizing harm to U.S. competitiveness.

6

Next Steps

Since the collapse of the Soviet Union, U.S.-China economic ties served as ballast in a relationship otherwise marked by opposing political and security interests. However, China's failure to liberalize to the extent envisioned by some Western policymakers, the economic dislocations that followed its entry into the WTO and continue today as a result of China's state-driven economic model, the emerging great power and technology competition, and continued human rights violations demand a new strategy toward China.

Faced with fundamental differences that still characterize the U.S. and Chinese systems, U.S. policymakers must manage that competition in a manner consistent with advancing U.S. interests, cognizant of the need to work with allies and partners. China's size, centrality, and global connectedness mean that wholesale decoupling is neither feasible nor advantageous to the United States. Nonetheless, limits on certain activities are warranted and require an approach to U.S.-China engagement that can assess specific economic activities against overall U.S. objectives.

In the next stage of the project, we will develop specific objectives in each of the six areas that have guided U.S. policy toward China since normalization: (1) geostrategy; (2) economics; (3) human rights and civil society; (4) global rules and norms; (5) global public goods; and (6) technology and innovation. These objectives will provide the foundation for a framework to assess specific economic activities and whether targeted disengagement is the most effective means to achieve U.S. objectives. The study team plans to test and refine the framework using case studies and will publish findings in the fall.

7

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