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SURVIVING MARCH MADNESS

SCOTT KENNEDY

Markets are being whipsawed by the daily news and rumors surrounding U.S.-China trade tensions. The latest reports of ongoing negotiations have revived hopes for a quick resolution. But before observers pop the champagne, we should realize that a cessation of hostilities is not the goal; rather, constraining Chinese industrial policy is. There is, in fact, a danger that the trade war could end prematurely. The right outcome is more important than a fast outcome.

Lighthizer's 301 Report

Although Tweets and announcements in front of the cameras come with eye-catching rhetorical flourishes, it would be worth everyone's time to read the U.S. trade representative (USTR) report to the president with the results of its Section 301 investigation into China's misbehavior regarding intellectual property. Its 215 pages deliver a damning indictment detailing hundreds of regulations and policies that together form a comprehensive and cohesive strategy to acquire foreign technology by hook or by crook at almost any cost.

The report highlights four areas of concern. Although China has promised no less than eight times since 2010 to desist from requiring foreign companies to transfer technology in order to invest in China, this expectation is still standard practice in a wide range of industries, from cloud computing to electric vehicles. (There currently are almost 70,000 U.S. firms operating in China.) Discriminatory regulations also keep U.S. companies from being able to negotiate licensing fees for their technology at market rates. Further, Beijing has underwritten a clearly scripted plan for Chinese state-owned and private companies to scoop up U.S. tech firms to access their knowhow in semiconductors, artificial intelligence (AI), communications, chemicals, aviation, and other sectors. Finally, the report provides evidence that state-backed cyber espionage directed at U.S. companies "persists and continues to evolve" despite a September 2015 agreement between Presidents Barack Obama and Xi Jinping.

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The only missing element from the report is a precise quantification of the harm caused to U.S. commerce by each of these measures—the claim of at least \$50 billion contained in the administration’s fact sheet is not included here—but such estimates depend on a series of assumptions that are open to reasonable challenge and may be beside the point given the other evidence brought to bear.

This report is at least the third effort of the Trump administration to explicate the breadth and depth of Chinese industrial policy, the others being the Commerce Department’s fine-grained explanation from October 2017 of why the United States does not view China as a market economy and USTR’s January 2018 annual report to Congress on China’s World Trade Organization (WTO) compliance record. Together, they collectively demonstrate a pattern of behavior that places China far outside its bilateral and multilateral commitments, damaging the interests of its trading partners and global supply chains, and eroding confidence in the international system. In short, China appears to be clearly in the wrong and deserves to be punished if it doesn’t change its ways.

Sizing Up the Opponent

But a U.S. win against China is easier said than done. Just as in the annual National Collegiate Athletic Association (NCAA) college basketball tournament, even though the United States is stronger on paper—given its greater wealth, more efficient capital markets, and being a more important destination for Chinese exports than vice versa—an upset is certainly possible. It is early in the game, but the United States is already down several points and will need to rally.

Washington’s first mistake was in underestimating its Chinese opponent. The Trump administration appears to have expected China to fold very quickly and may have been surprised that China would dare fight back and risk an escalation of the conflict. But if there’s one thing veteran China watchers agree on, Xi Jinping is less risk averse than his predecessors. So, the United States should believe China when it says it isn’t looking for a fight but will defend itself if punched. In fact, it is possible China sees this

Recent Events

- **A Speech by Chen Chu, Mayor of Kaohsiung, Taiwan.** Hosted by the Freeman Chair in China Studies and China Power Project: March 20, 2018. *Mayor Chen Chu gave a speech about her involvement in the movement to fight for human rights and democracy in Taiwan and about her views on Taiwan’s future. The event also featured a conversation with CSIS’ Bonnie Glaser and a Q&A period with the audience.*
- **Consolidating Xi’s Position and China’s Direction: A Readout of China’s Annual Legislative Session.** Hosted by the Freeman Chair in China Studies: March 15, 2018. *Freeman Chair Deputy Director Scott Kennedy moderated a panel featuring Freeman Chair Christopher Johnson and Paulson Institute fellow Dinny McMahon. They discussed the major personnel, policy and constitutional changes made at this year’s annual legislative session in China and the implications for US-China relations.*
- **Discussion of Taiwan-U.S.-Japan Relations.** Hosted by the Freeman Chair in China Studies: March 12, 2018. *Freeman Chair Christopher Johnson moderated a panel featuring Senior Vice President for Asia and Japan Chair Michael J. Green, Vice Admiral Masanori Yoshida, and Michael Fonte, Director of the Taiwan Democratic Progressive Mission in the United States. The experts discussed the economic, political, and security dimensions of the trilateral relations of the U.S., Taiwan, and Japan.*
- **China Reality Check Series: Controlling Pollution in China.** Hosted by the Freeman Chair in China Studies: February 22, 2018. *Freeman Chair Deputy Director Scott Kennedy moderated a panel featuring the Wilson Center’s Jennifer L. Turner and UCLA’s Alex Wang. The experts discussed progress in reducing different kinds of pollution, China’s plan for greater progress, and the implications of China’s policy for different industries.*

SURVIVING MARCH MADNESS IN U.S.-CHINA TRADE RELATIONS *(continued)*

fight as an opportunity to remove any and all shackles from its industrial policy machine.

Courting Allies

Given that China hasn't been sufficiently intimidated to immediately raise the white flag of surrender, a trade war will come down to a contest of wills. A key potential source of U.S. strength is its allies and other economies that have also suffered at the hands of Chinese malfeasance. Take South Korea, whose firms have been harassed or denied market access in the wake of the Republic of Korea (ROK) decision to install the Terminal High Altitude Area Defense (THAAD) missile system. Or Germany, where China has invested billions of dollars to acquire advanced manufacturing capacity. Or Taiwan, which sends 40 percent of its exports to China and is petrified about the hollowing out of its economy as China moves up the value-added chain.

Instead of working diligently to court these economies to stand shoulder to shoulder against Beijing, Washington has alienated them time and again, first by withdrawing from Trans-Pacific Partnership (TPP), by putting aside the Transatlantic Trade and Investment Partnership (TTIP) negotiations, and by forcing South Korea to renegotiate its bilateral trade agreement with the United States. The final slap in the face was the tariffs on steel and aluminum resulting from the Section 232 investigation. In the last week, the United States has granted exemptions to most of its friends—though not yet Japan or Taiwan—but this only mildly heals those wounds.

The United States may believe that others might never stand firm against China because of their fears of Chinese retaliation. While it may be true that no one else is likely to enact unilateral tariffs against China, the United States would have had more luck coaxing cooperation—such as expanded export controls, more rigorous investment screening, and vigorous direct criticism of China—had it positively engaged others who suffer from China's behavior rather than using high-handed tactics. The United States has also alienated the business community from likeminded countries. As several industry leaders of a close ally told me during a recent trip to China, the cumulative effect of all of these offenses is that

Recent Events *(continued)*

- **China's Rapid Drive into New-Generation Cars: Trends, Opportunities and Risks.** Hosted by the Freeman Chair in China Studies: February 21, 2018. *Freeman Chair Deputy Director Scott Kennedy provided an overview of recent developments in Chinese policies and its new-generation cars sector. The event also featured a panel discussion moderated by Kennedy featuring Zachary Kahn of BYD Heavy Industries, Anand Shah of Albright Stonebridge Group, and Jonas Nahm of Johns Hopkins-SAIS.*
- **Media and Ideology in Xi's China.** Hosted by the Freeman Chair in China Studies: January 29, 2018. *On January 29th, the Freeman Chair hosted Georgia State University's Maria Repnikova on how the Chinese party is adapting to the media technology environment. Following her presentation, Kaiser Kuo, the host and co-founder of the Sinica Podcast, and Freeman Chair Christopher K. Johnson offered commentary.*

SURVIVING MARCH MADNESS IN U.S.-CHINA TRADE RELATIONS *(continued)*

these companies now would feel no remorse about taking the market share of their American cousins following China's inevitable retaliation against U.S. penalties rather than supporting the United States in a common cause against China's market machinations.

Maintaining Domestic Unity

Another key source of stamina is domestic unity, ensuring that business and labor remain united and willing to sacrifice short-term pain for long-term gain. But the administration has done little to assuage the concerns of business and reassure them that it is acting in their best interests. Instead, the administration has intentionally kept business out of loop. There's been equally no outreach to labor unions or consumers; instead the administration has avoided any and all talk of potential costs. One consequence of limited transparency, reassurance, or consultation has been jittery financial markets unsure about what comes next. Sudden market movements could push Trump to seek a quick, though superficial deal in order to avoid the wrath of Wall Street now and voters in the November midterm elections.

The First Troubling Shots

The problems of potential international isolation and domestic internal disunity were likely exacerbated by the nature of the announced penalties and how they will be implemented. The United States said that it will place a 25 percent additional tariff on approximately \$50 billion worth of Chinese products, limit Chinese investment, and launch a WTO case challenging China's rules regarding licensing. (The United States formally requested consultations with China at the WTO the day after the initial announcement.) The administration has hinted that the list of products to be hit with tariffs will be high value-added technology goods that are related to the "Made in China 2025" industry development master plan. If so, since many of these products often exist in long supply chains and may be composed of components from foreign-invested companies in China or from other countries, the United States runs the risk of further alienating the suppliers from other countries who are predisposed to sympathizing with the U.S. complaints.

In the News

"It's not clear what the Trump Administration's bottom line is. We know what the Chinese bottom line is. They won't do anything to relent on their industrial policy system. They won't clip the wings of China Inc." *March 23, 2018*

—Scott Kennedy in Reuters, "Extent of U.S.-China trade fight depends on Trump's goals"

"You really have to be smart. The Chinese aren't just going to fold over on this. You want to teach them a lesson. But it's not as simple as going up in the playground and punching them on the nose."

March 15, 2018

—Scott Kennedy in the New York Times, "Trump Readies Sweeping Tariffs and Investment Restrictions on China"

"I think really what we have seen instead is through what I call political shock and awe, he [Xi Jinping] has so outmaneuvered these people in the system that there is really nothing they can do about it." *February 26, 2018*

—Christopher K. Johnson in PBS News Hour, "China might make Xi Jinping president for life. What does that mean for the U.S.?"

"It tells us very clearly that these days the state presidency is actually fairly important for a country that wants to exercise greater influence on the global stage." *March 7, 2018*

—Christopher K. Johnson in Financial Times, "Xi Jinping and China's 'good emperor, bad emperor' problem"

SURVIVING MARCH MADNESS IN U.S.-CHINA TRADE RELATIONS *(continued)*

Moreover, the administration has said that it will publish the proposed list in the Federal Register within 15 days and then welcome comments from industry and others for an estimated additional 30 days. The result will most assuredly be the formation of a long line of industry lobbyists outside the USTR's Winder Building, hoping to have imports they depend on removed from the list. This unseemly process cannot but generate greater domestic ill will and reduce U.S. resolve. A more effective approach would have been to quietly consult industry in advance and then issue a list that was not subject to adjustment.

By contrast, China issued a very different list of \$3 billion worth of initial products slated for higher tariffs. Although officially offered as a response to the Section 232 investigation, the announcement was certainly timed to immediately follow the United States' 301 action. But in contrast to the U.S. list, China's was composed entirely of simple commodities—various agricultural products and steel pipes—produced entirely in the United States, thereby avoiding creating collateral damage in other countries. Moreover, the products originate from a wide range of states, geographically and politically—California, Texas, Washington, Florida, Arizona, New York, and Iowa—meaning that opposition to confronting China could come from many quarters. Not surprisingly, the media has started to air stories of farmers expressing fears about lost markets. Also not surprising, no such stories have run in Chinese media. Should Trump eventually turn toward limiting student and worker visas for Chinese graduate students, he can expect university presidents, graduate program directors, and Silicon Valley to voice their displeasure as well.

Hold the Line

The missteps with other trading partners, the home front, and initial penalties could be ameliorated if the United States were to have a principled bottom line in negotiations centered around constraining Chinese industrial policy. The Trump administration, though, has never been clear about its ultimate aims. On the one hand, the 301 investigation highlights the dangers of China's statist system, but on the

Testimony

Evaluating CFIUS: Challenges Posed by a Changing Global Economy

On January 9, 2018, Deputy Director Scott Kennedy gave a testimony before House Committee on Financial Services' Subcommittee on Monetary Policy and Trade on "Evaluating CFIUS: Challenges Posed by a Changing Global Economy."

Podcasts

LISTEN Motley Fool Answers: What's the Deal With China? with Scott Kennedy (April 24, 2018)

LISTEN cogitASIA podcast: Igniting a U.S.-China Trade War with Scott Kennedy, Matthew Goodman, and William Reinsch (March 28, 2018)

LISTEN CSIS podcast: Tillerson Out and Xi's Power Grows with Christopher K. Johnson and Scott Kennedy (March 16, 2018)

LISTEN CSIS podcast: Taiwan's Cybersecurity Environment: Challenges and Opportunities with Christopher K. Johnson (January 5, 2018)

Recent Publications

"No Domestic Consensus in China on ZTE"

Maria Sinclair and Qiu Mingda, China Innovation Policy Series website, April 25, 2018

"Coordinated Chaos"

Scott Kennedy, South China Morning Post, April 18, 2018

"Finding the Right Off-Ramp from the Trade War"

Claire Reade, CSIS Commentary, March 27, 2018

"Surviving March Madness in U.S.-China Trade Relations"

Scott Kennedy, CSIS Commentary, March 27, 2018

SURVIVING MARCH MADNESS *(continued)*

other the president has continually stressed the need for China to reduce its bilateral trade surplus. The administration has confirmed that in late February it asked China for a plan to reduce the surplus by \$100 billion. Unfortunately, China can manipulate the trade balance by making a few large-ticket purchases of individual products, such as soy beans, shale gas, or Boeing aircraft, without modifying its industrial policy goals and measures one iota. This would mean big benefits for a small number of sectors but leave most of the U.S. economy, not mention our friends in other economies, permanently vulnerable to the vagaries of China, Inc.

Hence, it is vital that the United States not settle for a quick pyrrhic victory just to get a deal with flashy numbers whose true value would quickly fade. An outcome that does not involve constraining Chinese industrial policy would not be the worth the sacrifices that industry, labor, and investors may need to endure in the coming months.

A “Top 10” list of changes the United States should pursue include: (1) Require China to limit subsidies to pre-competitive research and development (R&D) and make them available to domestic and foreign firms alike; (2) Eliminate ownership caps and joint venture requirements for foreign investors; (3) Eliminate technology transfer requirements; (4) Lower tariffs on manufactured products such as automobiles and machinery; (5) Fully open up value-added services (finance, health care, education, and logistics) to private and foreign firms alike; (6) Move toward market-based standards and certification systems; (7) Better gear its cybersecurity regime to promote global commerce and protect privacy; (8) Liberalize government procurement; (9) End window guidance for bank interest rates and adopt a neutral registration system for initial public offerings; and (10) Make the national and local regulatory process more transparent. Taking these steps wouldn’t fully eliminate China’s industrial policy machine, but it would push China to have a much more market-friendly and efficient economic governance system that would benefit both itself and its trading partners.

Recent Publications *(continued)*

“Is the US Ready for a Trade War?”

Scott Kennedy, YaleGlobal Online, March 6, 2018

“Seven Chinas”

David Kelly, CSIS Report, February 5, 2018

“Onward & Upward: An Update on China & the Global Innovation Index”

Qiu Mingda and Maria Sinclair, cogitASIA Blogpost, January 30, 2018

“Meeting the China Challenge: Responding to China’s Managed Economy”

Scott Kennedy and others, CSIS Report, January 29, 2018

“The New Southbound Policy: Deepening Taiwan’s Regional Integration”

Scott Kennedy and others, CSIS Report, January 19, 2018

“Evaluating CFIUS: Challenges Posed by a Changing Global Economy”

Scott Kennedy, Government Testimony, January 9, 2018

SURVIVING MARCH MADNESS *(continued)*

A contest fought for the cause of more open, freer markets is highly risky, but it is worth engaging. It's imperative that the Trump administration orient its goals to this higher purpose in order to obtain the international and domestic support needed to achieve a meaningful victory.

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