



## Perception vs. reality: understanding the US–China trade war

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ARTICLE



## Perception vs. reality: understanding the US–China trade war

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### ABSTRACT

Despite being an economic and military powerhouse, the United States (US) has started seeing itself as a victim of exploitation by other countries, particularly by China, due to its sheer size and the magnitude of its trade with the US. It was under the leadership of the US that the present international economic order was created. This article argues that this order has had pre-existing frictions, which have culminated in this trade war between the US and China. The U.S. arguments of being in a disadvantageous relationship with other countries come across as flawed and misguided when looked at in the light of current economic reality. The reasons behind the mutually harmful nature of this conflict are discussed and potential conciliatory solutions are provided.

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## Introduction

After having been in the forefront of the tariff liberalisation efforts for decades, the United States (US), under the leadership of Donald Trump, imposed tariffs specific to goods from certain countries. Import tariffs were levied on 12,007 products covering \$303 billion of the U.S.' annual imports in 2017. As a result, tariffs on imports have seen a drastic increment, from 2.6% (pre-2017 tariff imposition rate) to 17% (post-2017 tariff imposition rate). These measures are being seen as the most expansive protectionist trade policy since the 1929 Smoot–Hawley Act and the policy undertaken by the then President, Richard Nixon in 1971 (Fajgelbaum, Kennedy, & Khandelwal, 2019). U.S. trade partners have not hesitated in retaliating and as a result tariffs on U.S. exports have seen a rise from 6.6% (pre-2017 tariff imposition rate) to 23.0% (post-2017 tariff imposition rate), on 2931 exports covering \$96 billion worth of exports to China.

Drawing from the results of the work done by Fajgelbaum et al. (2019), the aggregate impact of the trade war is seen to depend on three factors, the direct impact of tariffs on prices, on price changes induced by reallocations and tariff revenue. Producer and consumer losses are estimated at \$68.8 billion (0.37% of GDP). Terms of trade gains, due to reallocation towards domestic producers (which led to higher producer prices) are estimated at \$21.0 billion (0.12% of GDP). And finally, after including tariff revenues it was found that, the trade war in the short run reduced U.S. welfare by \$78.0 billion (0.04% of GDP).

It is not as if the world trading system had been functioning smoothly before this shock; there had been in existence a series of fissures in the system (Panagariya, 2018). First, the current era, termed as the 'second wave of globalisation', has distributional conflicts at its forefront. These conflicts are both internal and external. Internal conflicts pertain to the belief that trade liberalisation has disproportionately benefitted those who are at the top of income and wealth distribution and actually harmed those who are at the bottom. External conflicts, on the other hand, deal with the idea that trade liberalisation and openness have benefitted developed countries and a few East Asian countries more than others.

Second, there has also been a proliferation of preferential trade agreements (PTAs) which is at odds with the spirit of multilateralism which hinges on the most favoured nation (MFN) principle. The third fissure is the emergence of large developing economies. Up until the Tokyo Round of the General Agreement on Tariffs and Trade (GATT), it was just the developed countries taking part in multilateral negotiations. With certain developing countries emerging, the bargaining process has become more complicated since the interest of the two parties is

often not the same. With the start of the Uruguay Round, developed countries, under the leadership of the US, started insisting that developing countries also make commitments to trade liberalisation. This made negotiations quite difficult but eventually developed countries made a strategic move, of creating the World Trade Organisation (WTO) midway through the round. Developing countries had no choice but to agree to those demands because otherwise, they would be out of the WTO which would have also made them lose their MFN status. Fourth and finally, there has been withdrawal of the US from the leadership role. The prospects of progress in the Doha round waned after the US started insisting on zero-for-zero tariffs in certain sectors and formula based tariff reduction in certain industrial sectors. On the other hand, India had demands for Special Safeguards in the agricultural sector. This resulted in the collapse of negotiations. Subsequently, in the Obama presidency, there was hardly any mention of Doha rounds. The Trade Facilitation Agreement at Bali Ministerial Conference in 2013 was the only step forward in multilateral trade negotiations. Even the large scale move towards PTAs worldwide started after the US first started signing PTAs and this was big damage to the multilateral system. From playing a leading role in the multilateral trading system, the US has moved towards becoming more a selective trade partner. Over the years these fissures have continued deepening and its cumulative effect is now being felt in the form of this trade war.

## Historical background

As presented in Panagariya (2018), what can be termed as the 'first wave of globalisation', started in 1870 when a series of bilateral trade agreements were signed, mostly between Western European countries. Inspired by the Anglo-French Cobden-Chevalier treaty of 1860, these nations started extending MFN status to each other. Meanwhile, outside Europe, a one-way trade liberalisation in the guise of 'free trade' was being imposed by imperial powers on their colonies. Given this bilateral trade regime, between 1870 and 1914, a liberal economic order was in place and western countries witnessed rapid expansion and growth in their economies.

The First World War put a halt to this. In the atmosphere of distrust and lack of cooperation, both tariff and non-tariff barriers proliferated. The war itself also led to disruption of trade flows. During the inter-war period, colonies were able to gain some control over the formation of their trade policies and after long periods of exploitation these countries also showed preference for protectionism. Meanwhile, in the US, the Smoot-Hawley tariffs were enacted in 1929 and this added to the already large amount of protection in place. There was retaliation to the tariffs by trade partners, fuelling an even further rise in global protectionism.

In 1932, there was some reversal to this situation after the election of Franklin D. Roosevelt. The reciprocal trade agreement was signed in 1934 which authorised the Executive to have a say in U.S. participation in trade agreement. Prior to this, the U.S. Congress was solely responsible for setting up tariffs with hardly any room for negotiation. By 1939, the US had signed 20 treaties covering more than 60% of its trade. Also, U.S. tariffs had fallen below 40%, down from over 50% a few years before.

The Second World War brought this liberalisation process to a halt. However, after the war ended the US started with its efforts to restore international financial stability, start post-war reconstruction and development and on the whole, promote a liberal international order. To work towards the first two objectives, the Bretton Woods conference was held in 1945 and it culminated in the establishment of the International Monetary Fund (IMF) and the World Bank. A parallel effort to liberalise the world trading system was also underway. The United Nations Economic and Social Council had started the process of drawing up a charter for the establishment of an international organisation for this purpose, the International Trade Organisation (ITO). Fifty six countries including the US, signed a charter in Havana on 24 March 1948. The US eventually did not ratify the charter, as a result, the effort to create an international organisation failed. What did succeed was that the 23 countries which were a part of the Preparatory Committee responsible for drafting the charter, had been able to negotiate 45,000 tariff concessions worth \$10 billion, between April 1947 and October 1947. These countries signed an agreement titled the General Agreement on Trade and Tariffs (GATT), effective from 1 January 1948.

This agreement was intended as an interim measure but as the ITO could not be created, the GATT became the de-facto institution for the implementation of the tariff concessions that had been signed. It, in fact, evolved into an umbrella for any future negotiations of trade liberalisation. Over the period of the next 50 years, eight rounds of GATT were conducted. The last round, conducted in Uruguay, GATT gave way to the creation of a much more formal institution, the WTO. The creation of the WTO led to agriculture, services and intellectual

**Table 1.** US–China trade disputes (2002–2018) at the DSB.

Case status	Complainant	
	United States	China
Total number of disputes at the WTO level	<b>DS309</b> -VAT on Integrated Circuits <b>DS340</b> -Automobiles; Subsidies and Countervailing Measures <b>DS358</b> -Subsidies and Countervailing Measures, TRIMs <b>DS362</b> -TRIPs <b>DS363</b> - Services; Trading rights and distribution <b>DS373</b> - Services; Financial Information <b>DS387</b> -GrSants, Loans and Other Incentives; Agriculture, Subsidies and Countervailing Measures <b>DS394</b> -Measures Related to the Exportation of Various Raw Materials <b>DS413</b> -Services; Electronic Payment Services <b>DS414</b> -Anti-Dumping, Subsidies and Countervailing Measures <b>DS419</b> -Subsidies and Countervailing Measures <b>DS427</b> -Anti-Dumping and Countervailing Duty Measures <b>DS431</b> -Measures Related to the Exportation of Rare Earths <b>DS440</b> -Anti-Dumping and Countervailing Duties; Automobiles <b>DS450</b> -Subsidies and Countervailing Measures; Automobile and Automobile-Parts Industries <b>DS489</b> -Subsidies and Countervailing Measures <b>DS501</b> -Tax Measures, Aircraft <b>DS508</b> -Export Duties on Certain Raw Materials <b>DS511</b> -Domestic Support for Agricultural Producers <b>DS517</b> -Tariff Rate Quotas for Certain Agricultural Products <b>DS519</b> -Subsidies and Countervailing; Primary Aluminium <b>DS542</b> -TRIPs <b>DS558</b> -Additional Duties on Certain Products from the United States	<b>DS252</b> -Steel Safeguards <b>DS368</b> -Anti-Dumping and Countervailing Duty <b>DS379</b> -Anti-Dumping and Countervailing Duty <b>DS392</b> -Poultry, SPS <b>DS399</b> -Measures Affecting Imports of Certain Passenger Vehicle and Light Truck Tyres from China <b>DS422</b> -Shrimps; Anti-Dumping <b>DS437</b> -Subsidies and Countervailing Measures <b>DS449</b> -Countervailing and Anti-Dumping <b>DS471</b> -Anti-Dumping Methodologies <b>DS515</b> -Anti-Dumping <b>DS543</b> -Tariff Measures <b>DS544</b> -Measures on Steel and Aluminium Products <b>DS562</b> -Safeguards <b>DS563</b> -TRIMs, Subsidies and Countervailing Measures <b>DS565</b> -Tariff Measures
Settled <i>via</i> /during consultation	9	1
Ruling favouring complainant	10	4
Ruling favouring respondent	0	1
Split decision	0	3
Pending	4	6
Total	23	15

Source: Author's compilation based on WTO (2019) data.

property rights being brought into the ambit of the multilateral trading system. A dispute settlement body with binding judgments came into force and developing nations became far more active participants than they had been before. From liberalising merchandise trade, the U.S. leadership, supported by other developed countries, also started focussing on and linking up other areas such as intellectual property, investment, services, etc.

### The liberal international order and U.S. hegemony

As pointed out by Kim (2019), the US after the Second World War had unparalleled resources, be it in terms of manufacturing capabilities, food supply, stock of capital or military power. The foreign policy elites tapped into this situation and created a global economic order based on interdependence under the leadership of the US. At the time, the primary end was to contain Soviet power expansion and in addition to also put a check on other countries that could potentially be competitors for the US, but it did not have an iron hold over the system and countries were allowed to flourish. Over time competitors like Germany and Japan emerged. The logic behind why the US chose to be part of a system where there are challengers finds its basis in international relations theory. One explanation, albeit an unrealistic one, is that the US is acting as a benevolent hegemon which means that it is not looking out for its own interest but rather the collective interest of the global economy. This (if at

all) can be applied only to the US, quarter of a century after the Second World War when it was not using its power to overtly force open markets of other countries.

Stokes (2018) presented the history of growing U.S. hegemony by pointing out that the US was in fact looking out for its own interest even when it was committed to principles of multilateralism. The promotion of free trade was as a matter of fact the promotion of free trade, *so that it benefits U.S. business interests* since they were expanding rapidly at that time. The second explanation follows from this, that at the time there was a certain confidence in the competitiveness and predominance of the American industry and as this confidence started facing challenges, the American commitment to the liberal order also waned. Nowhere was this clearer than when the US abandoned the gold-standard monetary regime in 1972 clearly signalling that it does not want to be held accountable or constrained and that it intends to put its own national interest first. With such developments, the US started transitioning into a different kind of a hegemon. The coercive hegemon or the 'structurally advanced hegemon' acts solely for its self-interest and is willing to follow the route of coercion to make other countries follow economic policies that will benefit it. In fact, the latter has more often than not been the case when US turned to this nature of hegemony, and this can be evidenced by how so many countries underwent crippling economic crises after liberalising and opening up their economies under American pressure.

### American dissatisfaction

U.S. dissatisfaction with the present global trading system can be seen as a result of certain asymmetries in the trading system. First, the external account imbalance between US and China is significant. Second, as *2017 Report to the Congress on China's WTO Compliance* (United States Trade Representative, 2018) states that despite efforts, nothing more than 'incremental market access improvements or the repeal or modification of problematic Chinese measures that should never have been issued in the first place' has been achieved. Third, there is also the concern that China has been using illegal and unfair ways to acquire American technology at discounted rates. Fourth, the US has contended that the WTO has failed to protect its interests and also not allowed the US to protect its own interests. The latter has been in relation to outcomes of dispute settlements in the WTO involving the US. The US had initially retaliated by not allowing the appointment of appellate body judges, thus making the appellate body non-functional (Table 1).

As far as the second point is concerned, technology transfer has been a condition for foreign companies to obtain market access in China for a long time. In Bransletter (2018), it has been discussed how this has been a sensitive issue for the US for a long time, which is why it is surprising that only now it has made an effort to tackle this problem. This change in U.S. policy could have been because of China is now growing demand for truly 'frontier technology' and not the kind of technology that the US and other developed countries have discarded and moved forward from, and hence would not have had too much issues sharing with China. Also, the emergence of China as more of a strategic competitor than a strategic partner has indicated that it should not be treated like any other developing country. The problem of 'forced technology transfer', however, does exist and it does violate China's WTO commitments related to intellectual property rights and also adversely affects China's own long-run ability to contribute to the advancement of the global technological frontier. However, the policy response by the US is counterproductive as it would undermine the support to the US by multinational corporations and its allies. This trade war would only add to uncertainty in the global trading system which is not good for business or trade relations.

With respect to the fourth point, the reality is contrary to what the US has claimed. Data reveal that the Dispute Settlement Body has ruled in favour of China only one-third of the time. At the WTO, it is evident from the above table that the US has confronted Chinese practices 23 times with a win-loss record of 19–0. From the table, it is clear that, close to 40% of the time, U.S. complaints against China were resolved after mere consultations and there was no drawn-out process of settlement by a dispute settlement panel. This highlights that the U.S. contention the WTO is opposed to its interests is erroneous.

The reason behind US currently seeing itself as the victim, is the result of three flawed assumptions as elucidated in Norrlof (2018). First, *that international cooperation is a public good and the largest state bears disproportionate costs*. This in reality does not add up because the public good analogy is not quite appropriate as few international issues can be seen as non-rival and non-excludable. Second, *that there is a fundamental trade-off between U.S. military and economic capabilities*, when in fact it is this security dominance that support American commercial and monetary dominance. The nature of American power is multidimensional and significant

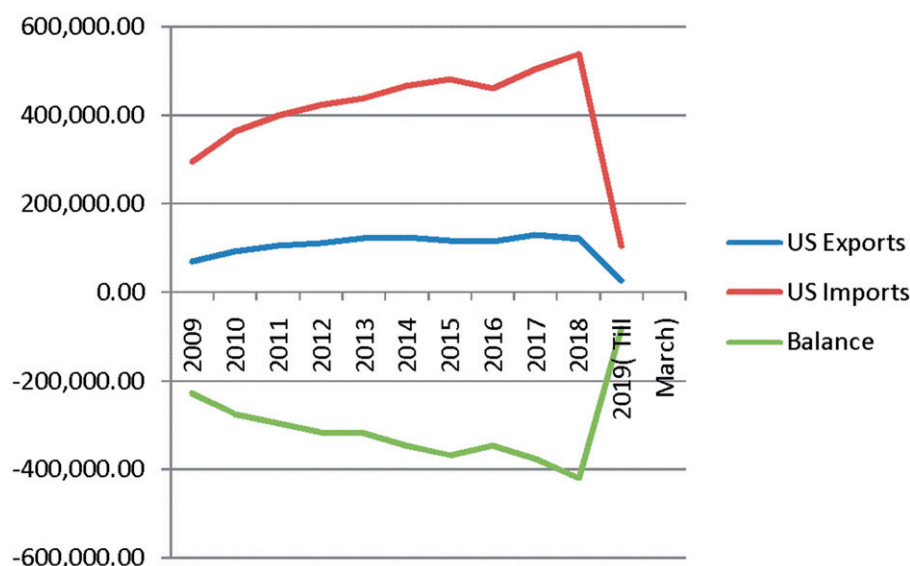


Figure 1. Trade in goods between U.S. and China (all figures are in millions US dollars)

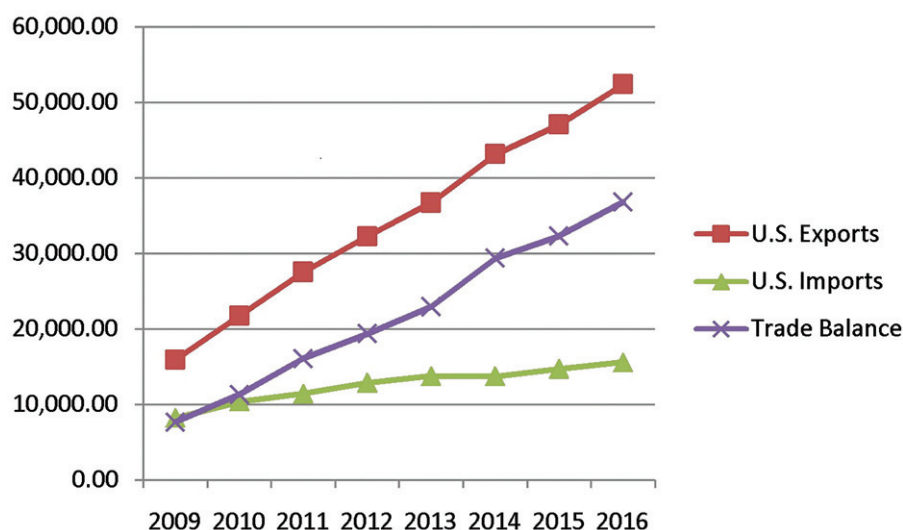


Figure 2. Trade in services between U.S and China (all figures are in millions U.S dollars)

synergies exist between these dimensions. Third, *there is a trade-off between America's domestic and international engagements, and that resources spent on the latter could easily have been diverted to welfare-enhancing goals domestically.* This highly understates the benefits that are accruing to the US because of this system (also referred to in the literature as the 'Liberal International Order') in the form of the leverage that it has over regimes that it helps underwrite and also the fact that the world order remains centred around the US (Figure 1).

An additional point that needs to be considered is US does have a surplus in services trade, with China. Although this surplus is nowhere near as large as the size of goods trade deficit, it seems to be on a stable growth trajectory as seen in Figure 2.

As China's exports started expanding rapidly in the 1990s, U.S. trade deficit with China started increasing. This was extremely apparent in the manufacturing sector and has led to a shrinking manufacturing sector within the US. As of now among its trading partners, the US has the largest goods trade deficit with China at \$419 billion in 2018 in goods trade. This is the highest the deficit has been since the financial crisis. This shows the ineffectiveness and failure of the protectionist trade policy that had been put in place in 2017. In economic theory, trade deficit per se is not considered a sign of weakness of an economy. And in any case, the tax cuts by the Trump administration would have been capable of raising domestic spending on imports. The strengthening of the



**Table 2.** US–China Trade in Goods: 2009–2018 (all figures are in US millions \$).

Year	US exports	US imports	Balance
2009	69,496.70	296,373.90	–226,877.20
2010	91,911.10	364,952.60	–273,041.60
2011	104,121.50	399,371.20	–295,249.70
2012	110,516.60	425,619.10	–315,102.50
2013	121,746.20	440,430.00	–318,683.80
2014	123,657.20	468,474.90	–344,817.70
2015	115,873.40	483,201.70	–367,328.30
2016	115,545.50	462,542.00	–346,996.50
2017	129,893.60	505,470.00	–375,576.40
2018	120,341.40	539,503.40	–419,162.00
2019 (Till March)	25,994.40	105,973.90	–79,979.50

Source: United States Census Bureau (2019).

**Table 3.** US–China trade in services: 2009–2016 (all figures are in US millions \$).

Year	US exports	US imports	Balance
2009	15,969.00	8263.00	7706.00
2010	21,796.00	10,417.00	11,379.00
2011	27,581.00	11,460.00	16,121.00
2012	32,299.00	12,899.00	19,400.00
2013	36,741.00	13,776.00	22,965.00
2014	43,159.00	13,752.00	29,407.00
2015	47,081.00	14,736.00	32,345.00
2016	52,427.00	15,620.00	36,807.00

Source: United States Statistic Division: UN Comtrade (2019).

dollar also contributed towards making consumption cheaper for American consumers and producers. As a result, this singular focus on trade deficit without taking into context the above factors is misleading. Also, services are usually ignored in this discussion and it can be seen from Table 2, U.S. services exports to China are growing far more than imports of services from China by the US, so albeit smaller than goods deficit, the services surplus needs consideration. As explained in Nye (2019), militarily and economically, the US remains far ahead of any country in the world. It is noteworthy that the current political dispensation has not disengaged from the world militarily because military activities and hostilities in fact seen a rise under the Trump presidency. In the economic sphere, the evidence presented by the ‘declinists’ is that the fall in America’s post-war share in global GDP, when in fact this fall has actually been a result of U.S. efforts in the area of post-war reconstruction and assistance efforts through the Marshall Plan<sup>1</sup> Also, it has maintained a consistent 25% share in world GDP and it has had continued preponderance in global FDI, not to mention the financial hegemony enjoyed by it. Even during the financial crisis of 2008, US did not see an outflow of capital, rather there was an even greater *inflow* of capital, making the US even more powerful in the economic sphere (Table 3).

From the above discussion, it is apparent that the US is far from being the victim that the Trump administration is making it out to be. According to Felbemayr and Braml (2018), ‘misconceptions about the economy, willingness to blame foreigners and scandalously high levels of inequality’ have an important role to play in the legitimacy acquired by this trade war in the US despite the reality being more complicated than is apparent.

## The way ahead

It is because of the multilateral trading system that such a large number of countries now participate in world trade. But it also needs to be acknowledged that this system has not adequately kept up with the current geopolitical reality. As Narlikar (2005) argued the ‘rules of the game’, designed in the 1980s have not succeeded in keeping up with a rapidly changing world economy in which there is increasing interdependence between countries, particularly true in case of US and China Under the above circumstances it can be said the US sees its position as a world hegemon, rather diminished. But it needs to come to the realisation soon that arm-twisting developing countries is no longer as easy as it was for instance in the times of GATT, when decisions were made during the ‘Green room meetings’ which could be attended on an invitation-only basis. Needless to say, this excluded the developing countries (with the exception of Brazil and India, which were original members of GATT and were regular green room invitees).

As China opened up its economy, American consumers could access cheap Chinese goods. U.S. firms incorporated China into their supply chains, enjoying the low cost of labour. These firms as discussed in Egan (2019) also

gained a presence in the Chinese domestic market, which is now the largest in the world. This export focussed development created a large number of Chinese jobs and the U.S. investment also allowed Chinese firms to gain technological expertise. China's middle class is booming which is also a critical market for U.S. corporations. And America on the other hand is a huge market for cheap Chinese goods. The world's two largest economies are also each other's biggest trading partners. In 2018, China and the US have exchanged \$700 billion in goods. With \$1.1 trillion of Treasuries, China is America's largest foreign creditor as well.

Considering the trade partnership between US and China and to avoid the side effects of trade war (in an inter dependent world), a policy dialogue to establish a new roadmap for the more fair functioning of the WTO is needed. Hoekman (2018) has indicated the direction such a roadmap could take. First, that to deal with this current conflict between US and China, controlling the tit-for-tat expansion in use of tariffs, is essential because the disputes will only spiral out of control in this way. Second, for the long term, resolving the impasse on the functioning of the WTO dispute settlement mechanism is necessary. There have been more than 15 years of discussion in the WTO reviewing the dispute settlement system. These have not produced results because consensus is required to make changes. WTO members seem to lack the will to get involved in an open discussion about the performance of this system and agreeing that changes might bring about improvements.

Progress will require China to comply with its WTO commitments and to make certain reforms touching on areas of state control over the economy. Additionally, new trade rules are needed to address China's economic practices not covered by its WTO commitments, including in areas such as state-owned enterprises (SOEs), certain subsidies, and technology transfer.

On the other hand, progress would also require the US to refrain from its unilateral use of tariffs, which have undermined the WTO. Instead, a better strategy would be for the US to expand its use of trade remedy measures like, antidumping and countervailing duties that are consistent with the objectives of the WTO so that it does not end up isolating itself in the world economy.

## Conclusion

The trade war as of now shows no sign of abating and it appears that it might only get worse in the future. The US might have enjoyed some short-term benefits from this situation but its trading partners who have been on the receiving end of the tariffs have retaliated. China has shown a conciliatory posture as well but has also made it clear that it will not back down. This retaliation has cut down on the benefits the US might have enjoyed.

The US and China are big economies with a combined world GDP of \$40 trillion or 45% of the world GDP, IMF (2019). They need to consider the sheer size of their economy and the effect that it can have on the world economy. The world need to focus on future growth and it is increasingly looking difficult in the face of the two major world economies indulging in a seemingly accelerating trade dispute. As discussed before, fissures in the international economic system were already present and this dispute can be seen as a culmination of the said fissures. The basic negotiation, transparency and dispute settlement functions of the WTO are contested, undermining its ability to fulfil its designated job. This is reflected in the failure of WTO members in concluding the first round of multilateral trade negotiations launched under WTO auspices in 2001, the Doha Development Agenda. This calls for a much overdue reforms in the WTO.

As all WTO members have a stake in sustaining the rules-based multilateral trading system.

Despite an increasing reliance on bilateral trade deals, large developed economic powers, including the US, need a functioning multilateral trade regime because many of their concerns regarding foreign trade practices cannot be addressed effectively on a bilateral basis. The large scale tariff reductions that happened under the auspices of GATT and the WTO have been possible to a certain degree because of its multilateral nature. And it cannot be denied that this has benefitted these large developed countries as discussed in Narlikar (2005). With these advantages, certain restrictions do come i.e. as developing countries have become more powerful in the WTO as compared to what they were in the times of GATT, developed countries cannot indulge in rampant abuse of power. So despite being a system originally founded by most developed countries, under the leadership of the US, it has not failed to act as a mechanism to regulate developed countries too. Since rules are codified and there are penalties for breaking them, it is not as easy to renege on them for them. It has also helped developing countries for their own coalitions and thereby improving their bargaining power.



Last but not least; the problem also has a domestic dimension. It is the very disparities that are created by economic globalisation, domestically in the US, that have created support for this trade war. But as the discussion on American dissatisfaction with the international economy shows, this support is based on certain erroneous assumptions. This begs the question – does the present American government actually want to help ordinary working class Americans or is this actually just a way to reinforce American hegemony that the current political dispensation feels is eroding? In fact, economic history shows that the poor suffer most from trade wars so clearly this effort is misguided at best and actively harmful at worst.

## Note

1. Rehabilitation programme sponsored by the U.S. for 17 war-ravaged countries of Europe. From 1945 through 1947, these nations received nearly \$13 billion in aid from the US.

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