# American-Chinese Tensions in the Trump Era: The Pitfalls of Economic Codependency

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**21 February 1972, from left: Zhou, interpreter Nancy Tang, Mao, Nixon, and Kissinger**

**Abstract:** At a time when the possibilities of a new and more contentious U.S.-China relationship is under discussion by the Trump administration, this article cautions that economic codependency should caution against aggressive moves that could jeopardize core American economic and financial interests and increase tensions in the Pacific. In assessing the deep two-way relationship, the article notes that China as well as the United States has powerful resources to bring to bear on their relationship including curbing US exports to China and ceasing to prop up the US deficit economy through the massive purchase of US treasury bonds.

Dating back to the 1972 rapprochement between President Richard Nixon and Chairman Mao Zedong, the complexities of the US-China relationship have been in a league of their own. Brought together by their shared grand strategy of addressing the threat of the former Soviet Union, the two leaders sowed the seeds of what could well be the most important economic relationship of the 21st century.

But the trajectory of this relationship, which has hardly evolved in a straight line, is now very much in question. As a candidate for president, Donald Trump was strident in his expression of politically charged anti-China rhetoric on a wide range of issues. At the top of his list was trade – and its alleged deleterious impact on jobs, wages, and America's once preeminent manufacturing sector.

But that was just campaign rhetoric. The hope was that the most strident rhetoric would be tempered, as is normally the case in the aftermath of a tough election. Yet that has not been the case in the early days of Donald Trump's presidency. As America's 45th president now turns to governance, early indications suggest that he had done little to move away from his campaign agenda. Therein lies the risk.

The Trump Administration has left little doubt that it will be going after China. Its initial pronouncements point to a wide range of economic and political sanctions – from imposing punitive tariffs and designating China as a "currency manipulator" to denouncing Chinese territorial claims in the South China Seas to embracing Taiwan and establishing the long sacrosanct "One-China" policy as a bargaining chip.

This approach suffers from one critical strategic flaw: It is based on the mistaken belief that a newly muscular United States has all the leverage in dealing with its presumed adversary – or that any Chinese response is hardly worth considering. Nothing could be further from the truth – especially when it comes to economic and financial considerations.

## A Two-Way Relationship

Contrary to conventional wisdom, the US and Chinese economies actually are both heavily dependent on each other. Shifts in the support of either nation for the other have played an important role in shaping the growth experience of both economies over the past several decades. This two-way relationship is likely to have equally profound implications for what may now lie ahead.

Yes, the US has long been one of China's largest and most lucrative export markets – and thus a central pillar of its spectacular 35-year development trajectory. Exports went from 5% of Chinese GDP in 1979 to 36% in pre-crisis 2007 – by far the sharpest increase of any major sector in the Chinese economy over that same period. Since 2000, the United States has accounted for an average of 19% of total Chinese exports – easily the largest country-specific market for Chinese exports, albeit slightly below the multi-country pan-European share beginning in 2006. Needless to say, closing off the US market, as the Trump Administration appears to be threatening, would certainly crimp Chinese economic growth – a threat that China hardly takes lightly.

But there is another side to this coin: The US has also become heavily dependent on China, which is now America's third largest export market (behind Canada and Mexico) and its fastest growing source of foreign demand for American-made products over the past decade. Moreover, with China long the largest foreign holder of US Treasuries and other dollar-based assets – albeit slipping slightly below Japan in late 2016 – its hoard of over $1.25 trillion of Treasuries and other dollar-based assets has played a vital role in funding America's chronic budget deficits.

In other words, China has not only been providing US consumers cheap and increasingly high quality products and American exporters with an increasingly important source of foreign demand, but it has also been lending much of its surplus saving to a United States that has been woefully derelict in saving enough to support its own economy. Moreover, in America's zero interest rate environment of recent years, these loans have been the functional equivalent of Chinese donations – driven less by rate-of-return considerations and more by China's tactics of currency management aimed at keeping the renminbi (or the yuan) in relatively close alignment with the US dollar.

All in all, an interruption of Chinese capital inflows or a disruption of bilateral trade between the two nations would hardly be inconsequential for the United States. Like China in the event of a curtailment of US demand for its products, in the face of diminished Chinese support, the US economy would also be in trouble.

## Deep Roots

The roots of this two-way dependency – the economic equivalent of what psychologists call codependency – can be traced back to the initial engagement of Nixon and Mao. But it took challenging economic developments in both nations to create a sense of need that ultimately cemented this relationship. That need is an important part of the recent history of both nations.

Back in the early 1980s, in the wake of the Cultural Revolution, which left its economy in shambles, China was desperate for a new source of economic growth. Coming out of a destructive bout of "stagflation" of the late 1970s and early 1980s, the US also needed a new economic recipe. The hard-pressed American consumer solved both problems, by becoming a powerful source of external support for Chinese growth and by benefiting from the lower prices of products made in China.

The two countries thus entered into an awkward marriage of convenience that served each other's needs. China built an increasingly powerful export-driven economy as the Ultimate Producer while the US embraced the ethos of Ultimate Consumer.

As mirror images of each other, interactions between the two economies became increasingly comfortable and ultimately addictive – so much so that these codependent partners were keen to enable each other's economic identities. The US opened the door to China's accession to the World Trade Organization in late 2001 – a milestone in China's ascendancy as the Ultimate Producer. And China's voracious appetite for Treasuries in the early 2000s helped keep US interest rates low, sustaining the froth in asset markets that allowed the Ultimate Consumer to live well beyond its means – until, of course, the music stopped in 2008.

At the same time, the marriage of convenience has had its rough edges for both the US and China. Both economies took their stylized growth models to excess and unmistakable imbalances emerged. Fixated on production, the private consumption share of the Chinese economy started to plunge – ultimately falling to 35% of its GDP by 2010, about half that of the United States. Meanwhile, fixated on consumption, job creation in the US manufacturing sector continued its long descent – falling from a modern peak of 32% of total nonfarm employment in 1952 to just 8.5% in late 2016. Needless to say, this latter trend – traceable in large part to technological change, international specialization, and globalization – largely predates the rise of modern China; in fact, more than 80% of the decline in the manufacturing share of US employment had occurred prior to China's WTO accession in late 2001. This point seems all but lost on a Trump Administration that wants to blame America's secular decline in manufacturing jobs on the more recent rise of China.


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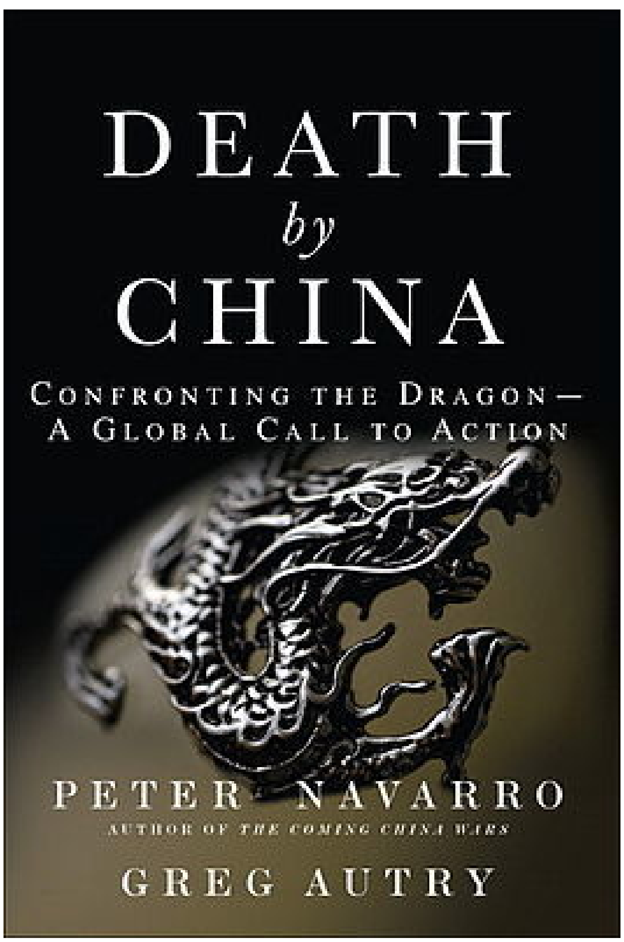
Of course, the United States and China are hardly unique in their economic codependency. Indeed, some elements of mutual reliance are evident in most of the world's major trade and economic relationships. Trade in general, and China-US trade in particular, has certainly been growing steadily over time – at least, until recently. Trade has surged as a share of world output – with exports rising from 17% of world GDP in 1986 to a record 31.5% in 2008 before flattening out in the aftermath of the financial crisis of 2008-09.

Moreover, codependency is not just an economic phenomenon. Cross-border trade in goods and services has also been tied to important defense and security linkages around the world. That is certainly the case with relationships that the United States has with its major allies in the Asia Pacific, especially Japan, South Korea, and Australia. In each of these instances, the balancing act between trade and geostrategic security – especially, the hosting of US military bases – is an important aspect of the glue that binds these nations together. Needless to say, mounting tensions in the South China Sea can only complicate this delicate balance.

**A Precarious Codependency**

While both the United States and China have been largely successful thus far in maintaining stability in their codependent relationship, there are no guarantees this will continue. Indeed, as in the case of humans, economic codependency has the potential to turn into a very destructive relationship. Blinded by the gratification phase of their codependency, partners can eventually lose their way – becoming so caught up in their role of serving the other that they ultimately lose sight of their economic sense of self. Therein lies the ultimate twist of codependency: one partner invariably looks inward and turns on the other, in order to recapture that missing piece of its identity. That, in fact, is now a growing risk for the United States and China.




Indeed, that is precisely where Donald Trump enters the relationship. By targeting China as the villain that purportedly prevents America from being great, the recent and prospective escalation of US-Sino tensions is worrisome, to say the least. Trump has assembled a team of like-minded senior trade advisers to plan the attack. From Peter Navarro as Director of the National Trade Council and author of the highly inflammatory book, *Death by China,* to Wilbur Ross as Commerce Secretary, Robert Lighthizer as US Trade Representative, and Rex Tillerson as Secretary of State, the new administration's anti-China credentials are without modern precedent.

Yet their battle plan overlooks a critical risk: Codependency is a highly reactive relationship. When one partner changes the terms of engagement, the other, feeling scorned, usually responds in kind. And that, in fact, is exactly what is occurring, as the early efforts of the Trump Administration risk destabilizing the US-Sino relationship.

In the aftermath of a highly provocative December 2 phone call between Donald Trump and Taiwan President Tsai Ing-wen that seemingly elevated Taiwan's status from "renegade province" to sovereign nation, stunned Chinese officials said little at first. But as Trump's China-bashing strategy started to crystalize around the advisers he appointed and the issues he raised – especially his subsequent challenge to the long sacrosanct "One-China policy" – China's official media finally warned that "big sticks" would be used in defense, if need be. A February 9 telephone exchange between Presidents Xi and Trump seems to have defused this issue for the time being, with the US President backing down from his earlier bellicose threats regarding Taiwan and the One-China framework. But volatility apparently is the norm for the new Trump Administration and there is no telling if and when there will be another twist on this key issue. At a minimum, President Trump has put Beijing on notice that nothing is off the table when it comes to dealing with China.

Team Trump has moved quickly to destabilize other aspects of the relationship, as well. In his Senate confirmation hearing, Secretary of State Rex Tillerson upped the ante on the possibility of US military action in the South China Sea. Moreover, the new president has threatened to abrogate America's carbon reduction pledges, a step that would undermine previously negotiated joint US-China commitments to climate change and ultimately threaten the global Paris Accord. And Trump's suggestions that Japan and South Korea should be responsible for their own nuclear weapons capability could have far reaching implications for China's posture in pan-Asian security matters.

All of this suggests that we now could be moving into the reactive phase of a destabilized codependency. Rhetorical tit for tat is only the start. If US threats are converted into action – or just appear to be moving in that direction – the scorned partner, China, would be quick to hit back. And if that occurs, America will then have to face the consequences of the Chinese response.

**A Risky Endgame**

Smugly confident that the US has nothing to fear when it comes to China, the Trump administration risks a major miscalculation. America could quickly feel the full wrath of Chinese economic and financial retaliation – the big sticks, in China's words. If President Trump follows through with his long telegraphed threats, expect China to reciprocate with sanctions on US companies operating there, and ultimately with tariffs on US imports – hardly trivial considerations for a growth-starved US economy.

Also expect China to be far less interested in buying Treasury debt – a potentially serious problem, given the expanded federal budget deficits that are likely under Trumponomics in light of the new administration's pledge of large tax cuts for individuals and businesses, together with massive commitments to rebuilding American infrastructure. Without Chinese demand for Treasuries, the US risks having to make concessions on the terms by which it has been able to attract foreign capital – in effect, putting upward pressure on interest rates and/ or downward pressure on the value of the US dollar, reversing the greenback's recent strengthening. And, of course, in the event of a further escalation of sanctions by the US, China could tighten the screws even further by outright sales from its massive portfolio of dollar-denominated assets.

But the greatest tragedy for the US may well be the toll all of this takes on the American consumer. "America first" – whether it comes at the expense of China or via the so-called border-tax equalization (basically taxing imports but not exports) that appears to be a central feature of proposed corporate tax reforms – will unwind many of the efficiencies of global supply chains that hold down prices of a broad range of consumer goods in the US.

In the absence of low-cost global production platforms, or in the face of tax-related dilution of their impacts, the so-called Wal-Mart value proposition will be drawn into serious question. By now, American consumers have gotten used to low-price imports. They count on them to make ends meet in an era of anemic wage and income growth. If Trump's China policy causes those prices to rise, middle-class workers, Trump's core constituency, will be the biggest losers.

**The Unraveling of America's Social Compact?**

Largely for those reasons, the pitfalls of codependency raise profound questions about America's social compact – and the role that globalization and trade play in supporting that compact. The income generating capacity of the US economy has, in fact, been under extraordinary pressure since the 1970s. Yet that hasn't stopped America from consuming beyond its means and drawing down domestic saving in order to make ends meet.

US politicians and policymakers have been put under enormous pressure to respond to those forces. And they have taken great risk in doing so by borrowing heavily from surplus savers from abroad – in effect, condoning chronic current account and multilateral trade deficits as a price for sustaining US economic growth. And that's, of course, where China fits into the story, with its outsize supply of cheap goods and surplus saving.

China, with its own set of powerful aspirations, has been more than willing to step into that role. In other words, US-China codependency is an outgrowth of the strategy America has embraced in order to finesse what otherwise might have been a far more tenuous prosperity. If the Trump Administration wants to reduce China's role in the implementation of that strategy, then the United States will have to find another partner(s) to fill the void – and in doing so probably pay a steeper price in terms of interest rates and/ or the dollar in order to attract surplus saving.

Unwittingly or not, all of this has left the US economy in a precarious state – vulnerable to sharp downdrafts in asset markets or to withdrawals of surplus saving from abroad. And this can only intensify the debate over the political economy of prosperity. Unable to deliver on the social compact of the American Dream – a progressive state of prosperity with each generation doing better than its parents – Washington needs foreign lenders such as China in order to close the gap. They have not only loaned us their surplus savings but by doing so they have helped keep interest rates low, asset markets frothy, and an asset-dependent US economy growing.

Like it or not, putting pressure on China – saving-short America's low cost provider of foreign goods and external capital – could force the United States to face one of its most formidable challenges: To the extent that China has enabled the US to avoid otherwise tough economic and financial pressures, codependency has worked to our advantage. Tearing up the rules of engagement between the two nations could well unmask the tenuous equilibrium in this grand bargain. In the end, it all boils down to the political economy of prosperity – in effect, bringing into focus the geopolitical compromises nations are willing to make in order to sustain economic prosperity.

In this vein, the search for new sources of funding could prove especially daunting for a Trump Administration that has also taken aim at Germany and Japan, the second and third largest pools of surplus saving in the world, respectively. Without a new source of external capital, the United States will then have no choice other than finally to face up to the need to boost domestic saving by cutting federal budget deficits – as noted above, not exactly a realistic assessment of the fiscal trajectory of Trumponomics. Failing to do that, US investment, the seed corn of future growth and prosperity, could then be at risk.

In the end, Sino-American codependency not only poses a formidable challenge to Trump's strategy of China bashing but it raises even deeper questions about what truly needs to be done to "Make America Great Again." In his inaugural address, Donald Trump insisted that, "Protectionism will lead to great prosperity and strength." If actions against China turn out to be the means toward this end, the pitfalls of codependency frame the ominous prospect of a rupture in the world's most important economic relationship, with potentially devastating spillovers on the rest of the world. Those same pitfalls underscore China's role in America's growth equation and pose the related tough question of how that equation gets solved without China.

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