

Discussion Paper Series

**RIEB**

Kobe University

DP2019-10

**Through Trade Wars, East Asians  
Finally Learning to Cooperate with  
Each Other?\***

Laixun ZHAO

April 5, 2019

\* The Discussion Papers are a series of research papers in their draft form, circulated to encourage discussion and comment. Citation and use of such a paper should take account of its provisional character. In some cases, a written consent of the author may be required.



Research Institute for Economics and Business Administration

**Kobe University**

2-1 Rokkodai, Nada, Kobe 657-8501 JAPAN

# Through Trade Wars, East Asians Finally Learning to Cooperate with Each Other?

By  
Laixun Zhao  
Research Institute for Economics & Business Administration  
Kobe University  
zhao@rieb.kobe-u.ac.jp

**Abstract:** In this paper, I examine the Sino-U.S. trade disputes from less-talked about angles: institutional differences, SOEs, hukou control and contemporary Chinese history. Based on these, I provide suggestions for future cooperation and improvement.

Keywords: China, US, Trade Disputes, Institutions, East-Asian Cooperation

## 1. Introduction

Excuse me for not being modest. Hopefully, my location in a 3<sup>rd</sup> country gives me a standpoint to be a somewhat independent and impartial observer of the issues concerning the ongoing Sino-U.S. trade disputes. On the other hand, it is exactly the fact that I am originally Chinese and studied in the U.S. for many years, which gives me enough passion to care about the disputes and write on them.

Recently I had the opportunity to see the movie “The Martian.” I was in awe throughout the movie, staring at the group of younglings taking off for Mars, getting lost, stranded, and eventually rescued, and along their way, exploring Mars and literally creating life there. I wonder what a Martian might think when looking down at the disputes, conflicts or even wars on earth, from outer space. Wouldn't the Martian think that humans are silly?

I am certainly referring to the recent trade disputes between China and the U.S., which have been going on since early 2018. The disputes have wreaked havoc in the

global economy, simply because they are the biggest countries in terms of gross domestic product (GDP) and that their economies are tightly intertwined through trade and investment. Both countries, as well as the European Union, have made separate proposals to reform rules and regulations for the World Trade Organization (WTO). The trade disputes have now evolved into frictions and conflicts in areas of intellectual property rights protection, market access, industrial policy, future economic growth, national security and even ideological confrontation in terms of socialism vs. freedom. As such, the initial shocks may turn into chronic disputes and conflicts, lasting for decades to come.

Some say that the disputes are inevitable, while others even alarm that they may escalate to wars. These opinions stem from two reasons. One is the huge differences in institutions and systems between the two countries: while the U.S. runs on a democratic, federal government based on elections, China applies “socialism with Chinese characteristics”, which is called “State capitalism” by many in the West. The other is the so-called “Thucydides trap,” coined by political scientist Allison Graham (2015, 2017), which says that a rising power will cause fear in the ruling power which may even escalate into war, a thought originally due to the ancient Greek historian Thucydides. Subsequently, the ruling power, intending to keep its ruling position, will always look for the No. 2 power and attempt to weaken it. Added to these two reasons are perhaps some coincidences such as the personal characteristics of the leaders, especially the fact that those in command in China are from the Red Guard generation, who were raised and educated to fight in Mao’s class struggles.

Since the day when I heard of Thucydides trap, I have been asking myself, why are Americans afraid of China? Is it for military reasons, or culture and ideology, or technology, or economic reasons? Military-wise, the U.S. absolutely dominates the world,

with an actual military spending of \$890 billion in 2018, more than the total of the next 5 nations combined, and has military bases and stations (big or small) in more than 130 countries, with 24 aircraft carriers in service in a world total of 45, and the most advanced stealth fighters F-22 and F-35. Culturally and ideologically, Coca-Cola, McDonald's, Walmart, Starbucks, and the NBA are everywhere, especially gaining popularity in China. As for technology, SpaceX just launched Falcon Heavy into outer space and recovered the rockets in Florida, and Windows and Microsoft are the most popular and dominant computer brands, with the exception of perhaps, Apple. So, what's left? "It's the economy, stupid!"

In this essay, I shall dwell on the institutional differences that can lead to major disputes and conflicts, from the point of view of economics. I shall focus on elements that have not been extensively talked about by others, such as State-owned enterprises (SOEs) and the dual system that results in low consumption ability in the vast hinterland, which in turn forces manufacturing firms to over export. It is important to lay out all problems and complaints in the open, so both sides know each other's demands and find mutual ground. I shall outline my suggestions to alleviate the disputes and conflicts, hoping to provide applicable strategies to improve international relations, expand bilateral and multilateral trade, and sustain economic growth.

## 2. Attitude Changes in the U.S.

While the U.S. formally imposed tariffs on China on July 6, 2018, the sentiment and preparation leading to the trade disputes began much earlier. Perhaps the election of Donald Trump as president is a good starting point for discussion. In his inauguration address, he stated that "for many decades, we've enriched foreign industry at the expense of American industry." He promised to "Make America Great Again", by building border

walls and using import tariffs. He hired anti-globalization advocates such as Peter Navarro as his top advisers, who point at foreigners for domestic unemployment and the widening inequality, especially China: China has taken our jobs away, China has stolen our technology, and Chinese firms compete unfairly because they receive government subsidies, etc. Navarro even published a book and made a movie of it, entitled *Death by China*. The U.S. trade representative, Mr. Robert Lighthizer, made a name for being tough and unyielding in negotiations with Japan in the 1980s under the Reagan administration. He believes that China should make structural changes to comply with WTO rules instead of just minor, level changes in trade volume and trade surplus. Trump's security adviser, Matt Pottinger, who is a China expert and is fluent in Mandarin, was once beaten in Beijing when interviewing workers for a case of corruption.

However, Trump himself repeatedly says that he does not blame China. Instead, he blames past U.S. leaders for letting China take advantage of them for so long. As a businessman and billionaire, his habit is aiming to accomplish with a deadline. He wants visible quantitative results instead of more fundamental structural changes that take much longer to materialize. Therefore he abandons multilateralism in favor of bilateralism in international negotiations. On his first day in the Oval Office, he quit TPP (Trans-Pacific Partnership), and then ordered to renegotiate NAFTA with Canada and Mexico, separately. Even now, he threatens to quit the WTO... No doubt, as the largest economy in the world, bilateral negotiation would give the U.S. the biggest bargaining power, as it can tower over any opponent, while in a multilateral relationship, smaller countries can form coalitions that may spoil U.S. plans.

It is well-known that the strongest supporters of Trump come from the Midwest and along "the rust belt," those blue-collar workers who have lost jobs in the wave of

globalization. Globalization is by default multilateral, involving many nations and regions. Trump's claim that America has been taken advantage of by foreign countries echoes with these supporters. The next group of supporters are the conservative religion and value defenders, farmers, and gun rights advocates; those who would be considered traditional GOP voters. In recent years, some U.S. firms and entrepreneurs who have businesses with China are turning to support Trump too, for the fact that it is getting harder for them to do business in China due to rising land prices, wages, corruption and diminishing policy support. Some foreign firms in China were even forced to establish Communist Party branches. There are also academic studies that show import competition from China had major impacts on U.S. unemployment, prices, income inequality, labor force participation and even political voting behavior such as the presidential election (see Autor, Dorn and Hanson, 2013; Che, Lu, Pierce, Schott and Tao, 2016). And finally, national security in the U.S. has been tightened overall against anything Chinese, including Chinese students and scholars whose fields of study are related to technology.

### 3. Chinese Responses

On the Chinese side, the year 2010 is of significance, when China's gross domestic product (GDP) surpassed that of Japan, becoming No. 2 in the world behind only the U.S. Two years later, China overtook the U.S. to become the world's largest country in goods trade, accumulating huge wealth. In 2011, China's foreign exchange reserves surpassed \$3 trillion USD, for the first time in human history and remained that high since then, and it even reached almost \$4 trillion USD in 2014. There is no doubt that these are all changes brought about by China's accession into the WTO and joining the global production and value chain. In 1999, the Chinese GDP was only \$1094 billion USD, but by 2010, it had increased by more than 6 fold to \$6101 billion USD, with an average annual growth of

more than 10%. Every Chinese was feeling rich and high. Sooner or later China would become the No. 1 power in the world, overtaking the U.S. whose economy was mired in the 2008 financial crisis. Scholars began to research on the “Chinese model” of development, prompting China to lavishly host consecutive international conferences such as the G-7, the BRICS, annual forums in Shanghai and Boao, the world congress of the internet, the world congress of political parties, etc.

It was then that an aircraft carrier was bought from Ukraine and renamed “Liaoning”. China also began to make claims to islands in the East and South seas, causing territorial disputes with neighboring countries such as Japan, the Philippines, Vietnam, etc. Media and Television programs were filled up with nationalistic content, talking about the rise of China, the humiliation of the past hundred years and the time for revenge. In the Deng era, “hide (ambition) and bide (time)” was the basic principle in foreign policy. But it seems the sleeping lion has suddenly woken up, intending to burst into different directions.

#### 4. Differences in Institutions

While the two countries are ideologically different, such differences turn out to be less important in influencing bilateral trade and economic relations, proven by the by-and-large friendly relationship that has existed for the past 40 years. What matters most is perhaps the ownership and organization of firms, markets, and governance. Under the federal system of the U.S., ownership is mostly private, and firms normally have no close ties with either the federal or local governments, except abiding by the law and paying taxes. In contrast, in China, land is owned by the government, and the most important firms are SOEs, including major banks, airlines, the railways, highways, electricity, gas, water, petroleum and mineral resources, not to mention the TV stations and newspapers.

As a matter of fact, these are praised as “the superiority of our system” in China, which enables “accomplishing big tasks by gathering power and resources.” As such, Chinese firms have a tendency to become bigger and stronger, driving out all competitors in the way. The general public happily accepts such concepts and phenomena, and they are even proud of and cheer for the fact that home firms can outcompete international rivals, without thinking about the reasons and possible consequences.

Being owned by the state, SOEs have a close relationship with the government. (i) Each SOE not only has a CEO as in western firms, but also a secretary of the Communist Party, and the top managers of major SOEs are appointed by the central or provincial government, which are mostly senior members of the Communist Party. The government may rotate officials to be CEOs, and vice versa. In many cases, the CEO and Party Secretary are even the same person.<sup>1</sup> They thus have the incentives to serve the demands from the government. (ii) SOEs have privileged access to more and cheaper capital and other regulatory benefits, including favorable taxation, government purchases, and preferential financing from government or state-owned commercial banks, preferential treatment in import licenses and foreign exchange controls (Dewenter and Malatesta, 2001). Studies show that over 75 percent of the country’s capital, which is largely provided by state-owned banks, flows to SOEs (Cull and Xu, 2003). Additionally, it is easy for the government to discriminate against non-SOEs and foreign firms in direct subsidies, government purchases, bank loans, foreign exchange control, import licenses, etc. Thus, one could argue that SOEs serve the political mandates of the State and align

---

<sup>1</sup> In China, two central organizations—the Central Organization Department (COD), the head of which is a member of the Politburo, and the State-Owned Assets Supervision and Administration Commission (SASAC), with the approval of COD—have the authority to appoint the leadership of the country’s 102 remaining centrally-owned SOEs.



their interests with particular social, economic, or political objectives deemed necessary for the government interest.

Many SOEs are the monopoly or the dominant firm in their respective sectors, possibly due to government-designed barriers that block entry and competition of other firms. Further, while maintaining domestic monopoly, SOEs could go out to international markets and strategically use their domestic monopoly rents to compete with foreign rivals. This is especially important in international bidding of large projects, such as the construction of air and sea ports, railways, highways, bridges, tunnels, and of course skyscrapers. In some cases, the government could provide direct subsidies to help the biddings.

Take for example, Sinopec, PetroChina and CNOOC--dubbed “the three buckets of oil”, which are centrally owned SOEs, under the direct control of the Ministry of Fuel Industry. Their CEOs, Party secretaries and other top level managers are all appointed by the central government, who will most likely move up to government positions after finishing their terms of appointment. The main products/tasks of these SOEs are slightly different: Sinopec does everything including exploration, refinery, sales of petro and chemical products, PetroChina also conducts similar tasks but focuses on equipment and technology, and CNOOC specializes in overseas exploration. This way, competition among the three is loosened. In basic economics, such a structure is called different branches of a monopoly firm, or at least a cartel of major firms in an industry. It lowers competition among themselves, but increases market power against consumers as well as rival firms not in the cartel, including of course foreign firms.

In summary, if countries were closed, domestic monopolies would not have much impact on foreign firms and foreign economies. But in our globalized world, the economies of different countries are intertwined. Individual firms in market economies behave independently and non-cooperatively, which cannot compete with the government backed and sometimes directly subsidized State-owned monopolies. This is especially so, when the Chinese economy has become No. 2 in terms of GDP and its trade volume has become No. 1 in the world. Any action by a State monopoly would have externalities that affect firms in other countries and impact people's daily lives there, especially on employment and wages. Also, since the rule of law still leaves a lot to demand in China, firms may be addicted to bad behavior, such as evading taxes, emitting pollution, hiring child labor, applying lower labor and environmental standards, etc., which may be taken to other countries when firms go overseas. Finally, don't forget that due to the ideological and especially institutional differences, any unusual movement by the Chinese military on international waters would bring worry and suspicion in neighboring countries, as well as the current superpower.

##### 5. Hukou and Other Dual Regulations in China

While many blame government subsidies and SOEs for the ongoing trade disputes, here I am going to argue that there are more fundamental reasons in the labor market, namely, the *Hukou* system, which segments the population into two status groups: agriculture (rural) and non-agriculture (urban). Urban citizens enjoy a range of social, economic and cultural benefits that rural citizens do not receive. To be more exact, urban earnings include food and clothing rations, health care, retirement pension, housing benefits, utility subsidies, guaranteed admittance to an urban school up to high school, theaters, parks,

libraries, sports and other entertainment facilities, etc., which are privileges a resident with rural status is deprived of. We can call this type of discrimination the “urban-rural divide” of the *Hukou* system.

Apparently, *Hukou* was set up as a system to govern the whole country in 1958. The intended goal was threefold: to reduce urban unemployment caused by the regime changeover, to lock most of the population into agriculture in order to provide life support for the minority living in the cities, and to accumulate surplus for industrial development, especially heavy industries (see Lin et al. 1994; Lewis, 1954). In early 1958, urban population was 99.49 million, roughly about 15.4% of the total population in the country (China Statistics Yearbook, 1987, p.89). *Hukou* rationing in essence forces 85% of the country’s population to the subsistence level of living with rural status. Migration was banned and those who dared to move without official permit would be charged and even put into prison for serious offenses.

In the Deng era, control was gradually loosened in the labor market segmented by *Hukou*. Peasants were allowed to work in cities only, but were required to return home when their work was finished; that is, they worked in the urban sector but kept their rural status. As such, the loosening of *Hukou* control created large-scale rural-urban migration, which is responsible for the recent boom of Chinese exports, mainly because the remaining *Hukou* rationing keeps migrant wages at low levels, enabling manufacturing firms to increase output and to export at low costs.

Along with *Hukou* restrictions, residents in the countryside are discriminated in a number of ways. For instance, they have the privilege to use the small piece of land next to their home, but cannot claim ownership, which means they cannot sell the land even when land prices are high. Meanwhile in the urban sector, residents benefit from the

surging prices of real estate. Furthermore, due to the lack of land ownership (which cannot be used as a collateral), it is hard for rural status holders to obtain bank loans to help the production on the farm. All these discriminations keep income low in the vast countryside, lowering the consumption ability there. As a consequence, large proportions of manufacturing outputs must be exported or sometimes dumped onto the world market, generating trade frictions (see Zhao 2016a, 2016b).

#### 6. The Chinese Dream and Recent History

The concepts and slogans of “a rising China” and “the Chinese dream” stem from the so-called “hundred years of foreign humiliation.” In order to avoid the possible collision course, it is necessary to make a brief review of the history of that period.

Modern China has been shaped by mainly five actors: three foreign countries (the former Soviet Union, Japan and the U.S.) and two domestic parties (the Communists and the Kuomintang). Near the end of the Qing dynasty (around 1900 AD), Russia controlled Northeastern China (Manchuria) and Japan occupied Taiwan. Because Manchuria was the hometown of the Qing rulers, it was motherland that must be brought back. However, the Qing regime simply did not have enough might by itself to fight Russia and regain control of the stolen land. The rulers therefore negotiated with Japan to drive Russia out, even though Japan humiliated them by defeating its whole fleet in the Yellow Sea not long ago (1894-95, the First Sino-Japanese war). Japan, meanwhile, wanted to expand its own influence in China, more than willingly agreed and successfully drove Russia out (1904-05, the Russo-Japanese War). As a result, Japan gained control of some of the privileges Russia enjoyed (e.g., managing Southern Manchurian railway and Lvshun port), in addition to the Korean peninsula that it had colonized before the first Sino-Japanese war.

Through the Russo-Japanese War, Japan became the first Asian country to defeat a European power in modern times. Its impact would be tremendous both on the Chinese continent and in Russia. Many Chinese revolutionary pioneers flocked into Japanese schools to learn modern civilization, science, technology and military tactics, including Sun Yat-Sen, Chiang Kai-Shek, Zhou Enlai, Wang Jingwei, Lu Xun, and Qiu Jin. Two students deserve special mentioning: Chen Duxiu and Li Dazhao, who studied for more than 10 years in Waseda University and brought communism back to China. Upon returning, they immediately jumped into action in spreading communism, by writing articles, publishing magazines, and organizing student movements, etc.

Meanwhile, in Russia, the war with Japan inflicted heavy costs on the Tsar regime: about 100,000 military casualties, the entire far-eastern navy fleet, in addition to other costs and losing control of Northeastern China. These gave grave opportunity for its opponents, in particular, the Bolsheviks, who launched an uprising and seized the government buildings in October 1917. Some suspected that the Bolsheviks were aided by the Tsar's enemy in the west, namely Germany, which helped smuggle Vladimir Lenin back to Russia to lead the revolution. As a result, the Tsar regime was overthrown a few months later, and in a few years, the Soviet Union was formed (1922).

However, regardless being the Tsar or the Soviets, the Russian leadership would not give up influencing and controlling China. The Soviets quickly got connected with the young communists in China, who admired the Bolsheviks and took the October Revolution as the example to learn, and in fact, Li Dazhao even became a Soviet communist party member. With the monetary, personnel and advisory aid from the Soviets, the revolutionary activities quickly spread out to the whole country: overthrow the futile Beiyang government and drive out Japanese influences.

The dog fight for influence between Russia and Japan remained reasonably even, until 1931, when Japanese troops invaded and occupied the whole Northeastern region of China. This sudden and extremely successful aggression fed Japan's appetite, inducing it to eventually invade the whole country, marked by the seizure of the Lugou Bridge in 1937, leading to the second Sino-Japanese war. Japan became China's archenemy, and different Chinese forces gradually regrouped. The all-out war became chronic and drained resources in both countries. In order to secure oil and other supplies that were mostly transported on the west side of the Pacific Ocean, Japan launched a sudden attack on Pearl Harbor in 1941 and thus dragged the U.S. into the Sino-Japanese war, when the Chinese side was led by Chiang Kai-Shek and the Kuomintang.

Immediately after the U.S. helped China defeat Japanese invaders, it pulled out its troops and military support. However, civil war broke out inside China, between the Kuomintang and the Communists. While the U.S. aided the Kuomintang in the fight against Japanese aggression, it was no longer there against the Chinese Communist forces which were backed by the Soviet Communists. Without U.S. help, the corrupt Kuomintang eroded, lost battle after battle and retreated to Taiwan. Eventually the whole country was liberated and in 1949, the People's Republic of China was born. It was then natural that the newly born Republic became a close ally of the Soviet Union, and during the Korean War (1950-53), it even sent troops to fight against the U.S. led UN troops. China thus turned into an enemy of the U.S. led West camp, from a close ally during the Kuomintang era.

Let us make a brief summary of the foreign influences up to the 1950s, which form the major part of the "hundred years of humiliation." Japan invaded, but surrendered and retreated; U.S. forces came as help, but withdrew; Tsar Russia invaded, got driven away

by Japanese forces, but came back in a new uniform—as Godfather of the Chinese Communists and a central ally of the new Republic. It seems as though Russia has always been there, only temporarily interrupted by Japanese invasion. As for domestic forces, the Kuomintang retreated to Taiwan, and the Communists liberated the whole country and established the new Republic.

The Russo-Chinese alliance became closest around the end of the Korean War, when the Soviet Union not only gave monetary aid but also sent experts to help China construct infrastructure, notably the buildings surrounding the Tian An Men Square, the Friendship Hotel, and the bridge over the Yangtze River in Nanjing. The relationship turned sour, however, when Khrushchev started de-Stalinization and reform, which was criticized as “revisionism” not Marxism by Mao and his followers, since Mao was worried that his colleagues might follow suit in correcting him after his death. The U.S. noticed the crack in the Russo-Chinese relationship, and quickly persuaded China to join its camp in the Cold War to fight against the Soviets. Through the famous “ping pong diplomacy”, the U.S. and China normalized diplomatic relationship in 1979, when President Carter visited China, the first of its kind since the birth of the new Republic.

In the next ten years, the Sino-U.S. relationship became the warmest. The heads of both countries paid mutual visits, and China started the economic reform that lasted for 40 years and counting. Famous American scholars were invited in to give advice and Chinese students flocked to study in American universities. The warm relationship continued until 1991, when the Soviet Union suddenly collapsed, and the relationship faced challenges because both countries lost a common enemy.

Fortunately, the reform leader, Deng Xiaoping was still healthy and made the famous “southern tour”, which kept China on course of reform and opening, and the U.S.

also responded by cooperating and helping China to reform. There were interruptions, such as the accidental bombing of the Chinese Embassy in the former Yugoslavia by the U.S. military, but by and large, the relationship remained smooth and constructive, especially after 2001, when both needed to unite in the fight against terrorism after the 911 attacks—the second common enemy of both countries. Without the help of the U.S., China’s accession into the WTO would not have been possible. During this period, U.S. attitude and policy are roughly engaging China, changing China and benefiting from Chinese development, while on the Chinese side, it was to cooperate with the U.S., but guard against “peaceful transformation (into capitalism)”.

However, problems arose when the urgency against terrorism was also over, eliminating the common enemy of both countries. For the two countries that are so different in institutions to cooperate without eminent urgency, there must be huge common benefits, such as the enlarged market when China entered the WTO and joined the global production and value chain, through which China could sell its products to the U.S. market, and U.S. firms could come and produce directly in China using its own technology and Chinese cheap labor and resources. These came to an end though in the second term of the Obama administration, when both unemployment and inequality rose to a point that forced many to ask why. The usual answer was foreign competition, especially immigration from Mexico and imports from China. After hearing alarms of foreign competition so many times, the Obama administration began to focus on Asia and the Pacific, henceforth the so-called “pivotal to Asia” and “rebalancing Asia.”

## 7. The Trump Administration

Donald Trump followed suit and even took things a step further. It is a fact that the U.S. is the world’s No. 1 power and has been the sole superpower since the Cold War



ended in the late 1980s. One could imagine that as the sole superpower and “world police,” every president immediately after assuming the presidency, must identify the No. 1 rival in foreign policy: “Which country could potentially challenge our No. 1 position?” This could be called the strategy of “beating the No. 2,” and it is exactly what leads to the Thucydides trap.

When Trump took over the presidency, he was faced with the same question: is it Islamic terrorism, or Russia, or North Korea, or Syria, or Iran, or China? From his initial policies, it seemed Islamic terrorism was the target, since he issued an executive order to stop immigration from some Islamic countries (the so-called “Muslim ban”), although the order was soon dismissed by some State courts.

It was when China released a documentary *Amazing China* and “Strategy 2025” that awoke the Trump administration of their true target. Before these, China started the “one belt and one road initiative” in 2013, intending to unite more than 60 countries. Anecdotes say this initiative began as a reaction to the U.S. ignorance to China’s call that “the Pacific Ocean is wide enough for the two (of us).” Apparently China was hoping to share leadership with the U.S. on the world stage, forming a duopoly for a new era to come. However, the Obama administration did not take the baton, and China started to look elsewhere with the “belt and road initiative.” Xi Jinping himself likes to use phrases such as “the rising of China,” “the Chinese dream,” and “a community of common destiny,” while the detailed contents of them are not specified.

It seems now a consensus in the U.S. that China has unfairly benefited and grew under the WTO system, to be so strong and powerful that it should no longer be treated as a developing country, and should not enjoy the privileges accorded to developing countries, such as imposing relatively high tariffs against imports, protecting some sectors

of the domestic market by erecting entry barriers, being relatively lax on intellectual property rights protection and environmental and labor standards, and providing subsidies in visible or tacit forms to SOEs, etc. Moreover, EU countries also come to such a belief. Policy makers and elites alike had hoped to change China in the Clinton, Bush and Obama administrations, by engaging through trade and investment, to become more like the West in institutions and markets. However, they now believe their efforts had failed or at least not paid off. Instead, they were considered “peaceful transformation” by China as a plot to change the Chinese system, and therefore rejected. Gallup polls show that more and more American people think China is becoming a threat. As such, the Trump administration is trying a different approach, which is to demand structural changes, including changes in policy biases for SOEs, market entry barriers against American companies, lack of intellectual property rights protection, and perhaps abolition of internet blockade, etc. President Trump repeatedly insists on reciprocal or mirror treatment; vice president Mike Pence, State secretary Mike Pompeo and economic adviser Larry Kudlow have mentioned these demands on a number of occasions.

#### 8. Suggestions for Future Cooperation

Based on the issues and problems laid out above, I’d like to make the following policy suggestions, especially for China.

- i. Think like a leader and be confident. China is no longer a small economy like 40 years ago, but a giant as No. 2 in GDP, and No. 1 in both trade volume and foreign exchange reserves. Any action it takes will have externalities on others, especially affecting neighbors and trading partners. It is vital that China realize this point and take responsibility and externality into consideration when making decisions. Realize that the externalities will break the status quo, and may affect some countries positively

but others negatively. As such, it is important for China to participate in rules making and express its voices as well as hear the concerns of others. Once international rules are set and China signs to abide by them, then keep your promises as a leader. Do not try to cheat and take advantage as a marginal player.

- ii. Start from listening, instead of talking to oneself. If you travel to other countries enough, you'd often hear praises: "China is so big, China is so rich, China is growing so fast, China is so modern" etc. Yet, you'd also hear worries: "What does China want? Is it going to step over us like the foot of an elephant? What can China bring to world peace and civilization?" In this sense, a trade war might be good, because it forces countries to hear what others are saying.
- iii. Balance geopolitical ambitions and economic benefits. A global leader certainly has political ambitions, which is what we are witnessing through the ongoing trade disputes. Balancing these ambitions with economic benefits is not easy. While China's biggest trading partners are the U.S., Hong Kong, Taiwan, Japan and South Korea, the Chinese political ambition seems to lie elsewhere, through projects such as "One belt & one road", when China is eager to cooperate with countries in Africa, Eastern Europe, etc. Will such political moves divert Chinese trade & investment, waste Chinese resources, and cause distortion which eventually may come back to haunt the Chinese? Also, unlike the U.S. which has friendly relations with its neighbors, uncertainty and danger surround Chinese borders from different directions, especially western China which has a huge Muslim population. In ancient China, the Great Wall had built many times to guard against their invasion.
- iv. Think of symmetry and reciprocity. In a fair and free market system, if firm A can do certain things, firm B should be able to do the same. The same principle should apply

everywhere in a fair world trading system. In this sense, reciprocity is a reasonable and rational demand. Chinese should not be surprised when other countries demand for the same treatment of foreign firms in the Chinese market.

- v. Think of multiple-player games instead of two-player games: There are close to 200 hundred countries in the world. Disputes between two large countries will always affect other countries, who are actually watching you and are prepared to move based on your actions. If the disputes become chronic, trade between China and the U.S. will inevitably be diverted to other countries, worse still, some countries may like to see this happen. For instance, last year after China imposed tariffs on U.S. soybeans, prices in China increased but decreased in the U.S. Brazilian importers immediately bought the soybeans from the U.S. and then re-exported to China. This is a classic case of trade diversion and distortion, causing welfare losses in both the U.S. and China! Also, we are seeing U.S. investments flocking into Vietnam and Vietnamese exports pouring into U.S. markets, and Trump has been even wooing North Korea to join his camp.
- vi. Think dynamically instead of shortsightedly. The Chinese economy has grown at double digit speeds for the past 20 years also, but this is growth based mostly on the scale of its population (the so-called “demographic dividend”), cheap resources (land, water and other natural resources) and weak institutions (lax environmental and labor standards, etc.). However, there are limits to these elements. Population aging is in sight, the country is running out of resources, including water in many parts of northern China, and the young generation does not want to live and work under weak institutions. Innovation is essential for future growth and political stability. Therefore, instead of lavish spending on political ambitions, guaranteed investments in

innovation are necessary. Moreover, innovation occurs based on past innovations and experiences. It is vital for China to learn from more advanced countries such as the U.S., Japan, Germany, the U.K., etc. Diverting trade and friendly relationships away from them is again not a very good strategy, this time dynamically.

vii. Think of the whole country instead of only coastal cities. China is a large country.

While the coastal cities and regions are as rich as European countries, the vast countryside remains poor and underdeveloped, whose residents are tied to the *hukou* control. According to United Nations data, about 500 million Chinese people still live on less than \$6 a day. Instead of acquiring foreign businesses and arousing suspicion, why not invest in the vast hinterland? When the income of the peasant residents is raised, so will their consumption levels of various goods and services, and the country would not have to export so much to other countries causing trade frictions.

viii. Nationalism is a double-edged sword. The international community understands

that often the government needs to have a strong international image to quiet domestic critiques, to unite and govern the whole country. Thus nationalism is used time and again to justify the legacy of the regime, which can be effective under autocracy and internet isolation from the rest of the world, such as the anti-Japanese TV programs aired everyday. However, nationalism is a double edge sword. One can only be a leader when he is strong and confident. Hatred education is whining and crying. When a child is raised up under hatred education, he always looks at the world with doubt, suspecting that others may be plotting to take advantage of him. If there are outside enemies, hatred may be geared toward foreigners; but when foreign enemies disappear, the built-up hatred will turn inward, bursting into anger, violence and possible riot. Also, now we are big and strong as No. 2 in GDP. What shall we do

with this economic power? Do we still hide and bide, or conquer as far as possible as nationalism would point to? If so, neighboring countries will call for the help of the American troops for sure, as is evidenced by the fact that recently THAAD was deployed in South Korea, and F35-fighters were stationed in both Japan and South Korea. Can we change hatred education into civilization education, and contribute to mankind, such as space exploration, poverty eradication, inequality reduction, etc.?

ix. Remember how we got to No. 2 in GDP, and No. 1 in both trade volume and foreign reserves. Forty years ago, China started the reform by cutting away from the Soviet style command economy and introducing the market economy. In the early years especially, it benefited from recovering diplomatic ties with the U.S., borrowing Japanese funds and using its technology, hosting investments by entrepreneurs from Hong Kong and Taiwan. And in 2001 China finally joined the WTO and the global production and value chain. Now that we have become big and powerful, shall we cut away from these countries and challenge them?

## 9. Conclusions

In the first two months of 2019, about 1.5 million Chinese visited the country they traditionally hated the most---Japan, and they poured in more than 2 billion U\$ dollar for the sluggish Japanese economy still mired in its “lost decades”. Some bought souvenirs with containers, filled with rice cookers, medicine, perfume, air cleaners and even toilet seats. Still many visited Japan to enjoy the Sakura blossoms and tranquil neighborhoods with ancient Tang-Song flavor.

Globalization has brought rapid changes and new challenges to East Asia. China and Japan, the world’s 2<sup>nd</sup> and 3<sup>rd</sup> biggest economies, each is the other’s major trading

partner. China, since joining in the WTO in 2001, has tripled its GDP, and neighboring countries and regions such as Hong Kong, Taiwan, South Korea, Vietnam, etc., have benefited from an economic network based on Chinese labor and resources, some by producing parts and accessories Chinese manufacturers need to complete their products to be sold on the global market, others by the scale economies this network brought about. Hundreds and thousands of Japanese, Korean and Taiwanese firms have production facilities in China. It is clear that the trade volume among the countries in East Asia outweighs those in either North America or the European Union. If these countries could set aside historical and territorial disputes and focus on economic development, they could form the biggest and most thriving economic region or entity. In Europe, there is EU, in America, there is USMCA (formerly NAFTA). Would something similar emerge in East Asia?

I'd like to end this essay with several questions that I asked Professor Ezra Feivel Vogel and several other speakers during a conference in Beijing (Tsinghua PBCSF) in early December 2018. The first is whether the long-term strategy of the United States were to beat the No. 2 country, which might have been the U.S.S.R. and Japan not long ago, but now it may be China (I would believe it to be rational to have such a long-term strategy, even though this strategy might be interrupted by short-term urgencies such fighting terrorism); the second is if 20 years later East-Asian countries such as China, Japan, Korea, Vietnam, Singapore, etc. could unite and act together in important matters, would the U.S. allow it to happen? Professor Vogel first denies that the U.S. has any long-term strategy, the main argument of which being that even the president is elected every four years. Then he said that East-Asian countries cannot unite and act together. Instead, he believed that other countries are watching China, whose current actions might push

them closer toward the U.S.

In fact, I also asked a third question, mainly to the Chinese speakers and the audience: Does anybody think “tao guang yang hui (hide and bide)” is not good? “Tao guang yang hui” literally means we should lower our heads and be humble when we are weak. It may have been a good strategy in the past. But today China is big and powerful and therefore cannot hide anymore. Shall we take revenge, in particular for the 100 years of historical humiliation by foreigners? Shall we destroy any country we do not like, such as Japan which invaded and devastated China during WWII, and Britain which brought two opium wars upon China that since then had to sign a series of unequal treaties? Can we learn to change the widespread hatred education to civilization education, such as exploring outer space, where we might land on a planet that is farther away than Mars? These will surely benefit all mankind.

China, the U.S. and Japan are simultaneously seeing hawkish leaders. History says only hawkish leaders are brave enough to make peace. Can they maximize the long-term welfare of their countries, everybody in the country, especially their children and grandchildren, not only the special interest groups in power, not only for now or their ancestors? Citizens like me are looking on.

#### References

Allison, Graham, The Thucydides Trap: Are the U.S. and China Headed for War? *The Atlantic*, 2015/9/24.

Allison, Graham, 2017: *Destined for War: Can America and China Escape Thucydides Trap?* Houghton Mifflin Harcourt.

Autor, David H., David Dorn and Gordon H. Hanson, 2013, The China Syndrome: Local Labor Market Effects of Import Competition in the United States, *American Economic*



- Review* 103(6), 2121-68.
- Che, Y., Y. Lu, J.R. Pierce, P.K. Schott and Z. Tao, 2016. Does Trade Liberalization with China Influence U.S. Elections? NBER Working Paper No. 22178.
- Cull, Robert, Xu, Lixin Colin, 2003. Who gets credit? The behavior of bureaucrats and state banks in allocating credit to Chinese state-owned enterprises. *Journal of Development Economics* 71 (2), 533–559.
- Dewenter, Kathryn L., Malatesta, Paul H., 2001. State-owned and privately owned firms: An empirical analysis of profitability, leverage, and labor intensity. *American Economic Review* 91 (1), 320–334.
- Ju, Jiandong, 2018, U.S.-China Trade Disputes and a Tripolar Economic Order, presentation at RIEB, Kobe University, Nov. 19, 2018.
- Lewis, W. Arthur. 1954. Economic Development with Unlimited Supplies of Labour. *Manchester School* 22: 139-191.
- Lin, Y., F. Cai, and Z. Li, 1994, *The Chinese Miracle: Development Strategy and Economic Reform*, Shanghai: Shanghai People' s Press.
- Zhao, L., 2016, A simple model of the Chinese *Hukou* system and some ongoing reforms, *RIEB Discussion Paper #2016-2*.
- Zhao, L., 2016, Inequality in the BRICS, *Japan SPOTLIGHT*, November/December 2016.