

Interview with Dr. Vinod K. Aggarwal, Travers Family Senior Faculty Fellow and Professor of Political Science & Director of the Berkeley APEC Study Center (BASC) at the University of California, Berkeley

# U S-China Rivalry: Implications for East Asia

By Japan SPOTLIGHT

With an apparent decline in US leadership and an increase in political rivalry between China and the United States in Asia, East Asian nations are expected to play new roles as they face more volatility in the region, both economically and politically. *Japan SPOTLIGHT* interviewed Dr. Vinod Aggarwal, Travers Family senior faculty fellow and professor of political science, and director of the Berkeley APEC Study Center at the University of California, Berkeley, to discuss how political-structural issues in the US could make the East Asian political economy more volatile and complex. Is there room for optimism about the future roles of East Asian nations in global governance and how can they use their soft power for economic cooperation?

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## Declining US Leadership

**JS:** The US seems to find it difficult to play a leading role in global governance today, due to its economic structural problems. How do you assess this decline in US leadership in global governance? Is it temporary or structural?

**Aggarwal:** In my view, this is a political structural problem, which in some ways is more important than an economic structural problem. By that I mean that there is a sharp divide in the US between those who support an isolationist policy and those who are more internationally oriented. I think that we see this in the transition from the Obama administration to the Trump administration. Part of the Republican Party is very isolationist, and part of the Democratic Party is also isolationist, and unfortunately the US bipartisan consensus has eroded over time. I think that this is more of a fundamental problem than US leadership. Although I think the US economy is still strong and going well, it faces several unresolved issues, such as the failure to have real structural adjustment to address changes in the global economy. The US has failed to bolster job transition, education at the lower levels is not as strong as it used to be, and I think that the lack of the ability to adjust the economy to the changing global system has led to unhappiness in various parts of the US. These problems help to explain why



Dr. Vinod K. Aggarwal

someone like Donald Trump has emerged. As a consequence, I think populism will last on and off for a decade – but not forever. I don't see that the political problem will be resolved very easily and we might see some alternation between an outward-looking US and an inward-looking US, which of course is not very good because it does not provide stability for the US in its engagement with international institutions.

**JS:** How do you think this structural problem in the US economy can be resolved?

**Aggarwal:** It's not just an economic problem, it's a political problem. There's no simple political solution, and ironically a political solution is more difficult than an economic solution. The US is still an extremely strong and dynamic economy with a strong stock market. So I don't think there's a fundamental economic problem with the US economy, but I think there is a fundamental problem with growing inequality, which has led to a lot of people feeling like they have been left by the wayside due to globalization. I think the real issue is whether we can move to some kind of political consensus on helping the US to adapt to the global economy. Unfortunately, I don't see any quick solution to this at this juncture.

## US-China Political Rivalry

**JS: Will the US-China trade war be a short-term problem or will it continue for many years and become an economic and cultural war?**

**Aggarwal:** I am not sure that a cultural war would develop. I think this is really a political and economic issue, and if you look at the Trump administration, advisors like Peter Navarro have made it very clear that they would like to – in my view – create a bipolar world similar to the Soviet Union-US relationship, which means there will be little trade between the US and China and relatively less investment between the two countries. We would then see countries aligning with either the US or China, and I think that China for its part is taking the initiative to develop a system based on its own economy. If you look at the kind of tariffs that we've seen – \$250 billion – I don't think they are going to go away anytime soon because it's not clear what the Chinese could do to make the Americans happy in the short run. The US has said it would like to see an elimination of China's "Made in 2025" industrial policy, but the Chinese show no inclination to do so because their whole development strategy has been based on aggressive industrial policy. I think that most economists are naive and fail to understand that the Chinese have been very successful in their industrial policy, and so in that sense Navarro is right that the Chinese have used their industrial policy successfully, just as the Japanese and the Koreans used industrial policy after the end of World War II. The difference is that when the Japanese and Koreans used industrial policy, they were both allies of the US, and were dependent on American security. As a result, the US could pressure both South Korea and Japan when the government faced domestic protectionist lobbying, but it's much less capable of doing that with China because it is not an ally or dependent on the US for its security. When people compare US-Japan and US-South Korea and US-China relations, they fail to understand the context in which US-China relations exist. The US and China are peer competitors in geopolitics, and not just the economic realm, and therefore the Chinese have no interest in getting rid of their industrial policy.

**JS: The US and China are political rivals in the security system. Does this mean that this trade war is to be interpreted not as a simple economic conflict, but a competition for political hegemony in the world?**

**Aggarwal:** Yes, I think that is the way the Trump administration sees it: the more we have trade and investment with China and the more

the Chinese use various policies to get technology from the US, Europeans and other countries, the more it gives them a geopolitical advantage. The Chinese have been using their growing military capabilities to be more aggressive in the East and South China Seas, and the Americans are now very concerned about this kind of "technology-based Cold War". One American response has been the passage of FIRRMA – the Foreign Investment Risk Review Modernization Act – that will enhance the review process of the Committee of Foreign Investment of the US. I think that the US remains skeptical about some of the Chinese investment coming in, because they view it as Chinese companies coming in and trying to take American technology. Whether that is true or not, that is the view of the Trump administration. In that sense, my prediction is the US-China trade tension will continue for a while.

**JS: On the issue of a US-China technology-based Cold War, do you think security risks form the main perspective in thinking about future risks to trade and investment?**

**Aggarwal:** I think that what the Trump administration is trying to do – and the Department of Defense has just issued a planning document in September 2018 called "Assessing and Strengthening the Manufacturing and Defense Industrial Base and Supply Chain Resiliency of the United States" – is to argue that the US supply chain has lots of vulnerabilities, including its reliance on foreign firms. These vulnerabilities mean that we are reliant on China and other countries that are not friendly to the US. In this way, they are trying to frame the debate in a way that makes it look like we need to decrease trade and investment with a lot of these countries because of security risks. The problem I see is that it is very popular to look at every import or investment as a security risk and I think that what that leads to is a lot of American firms seeking protection, claiming that there is a security risk where there isn't one. So I think that the danger is that all imports will be seen to be a security risk. In the 1950s, for example, the woolen blanket industry argued that the US had too much dependence on Japan as a supplier because woolen blankets would be needed to protect people against radiation in case of an atomic war! I think there is also a kind of false framing of security when it comes to trade and investment. It is very likely that while there are some important security risks in some parts of trade and investment. I don't think that for basic steel, for example, there are many security risks given that there are many suppliers of steel outside of China. One could argue that much of the trade war is really a domestic protectionist effort on the part of American firms.

**JS: In my understanding, no international rules body**

**like the WTO or regional free trade agreements have mentioned security risks. From now on, do you think trade negotiations for international treaties will touch on the issue of security risks much more?**

**Aggarwal:** That's not accurate because the GATT already had a provision for national security risks (Article XXI). There are generally provisions for national security in trade agreements so I don't think that is new. What is new is that the US and possibly other countries will use the security argument to get protection, to avoid retaliation, and to basically maneuver around the rules of the WTO by saying that all of these things are security issues and not just economic issues. In simple terms, there is a reframing of import competition as security competition.

**JS: You mentioned that the US has become concerned about Chinese or other countries' investment in the US usurping the industrial or technological base of the US. Has that concern resulted in a significant decrease in US internal FDI in 2017?**

**Aggarwal:** I think that it's difficult to attribute the decline in investment in the US to these new rules because there was also a decline from 2016 to 2017. Inward foreign investment into the US was \$146 billion in 2016, and in the first quarter of 2017 it was \$90 billion, and this was when Trump was just elected. So I don't think we can attribute all of this to Trump's policies. Over the long run, if there is growing anti-globalization sentiment then we will see less FDI. But looking at any one year-to-year decline of \$51 billion and immediately claiming that this is a transformation of the global economy and that investment is stopping is not good analysis. It is also worth remembering that the rules have really gone into effect immediately, and have not blocked large amounts of investment. These developments are also complicated by new tax laws and concerns about Chinese investing more in Asia, so I don't think we can attribute all of this to anti-globalization.

## **Role of East Asia in Mitigating Trade Wars**

**JS: On the economic side, given increased interdependencies among nations, the policy implications of protectionism by big countries like the US and China would be enormous. Assuming this friction continues, how can we mitigate this negative impact?**

**Aggarwal:** That is right to some extent, but I think that this is really

an issue for countries that are middle powers like South Korea. For its part, Japan is bigger than a middle power but not a superpower. I think these countries are trying to make accommodations. If you look at South Korea, for example, it has agreed to revise the South Korea-US Free Trade Agreement and has made some concessions with regard to auto exports. At the same time, South Korea has good relations with the China. So if we move to what the Trump administration wants in terms of protectionism and industrial policy, it may not necessarily be directed against every country in the world. Indeed, a lot of the protectionism may be focused on trade and investment between the US and China. At the beginning of the Trump administration, US policy targeted a large number of countries on steel and aluminum and autos, but I think we are slowly evolving to a policy where the main focus of the US is on China. So the real question is, will the middle, small, and large countries be able to play a game where they can work with the US and continue to trade and invest in China without the US balking? This raises a big issue for these middle powers in terms of policy. At UC Berkeley we are doing a major project collaborating with scholars from South Korea, Taiwan and others on middle power strategies in a rapidly evolving geopolitical and economic landscape. Although US-China tension will have a global impact, that does not rule out that countries can sell to both the US and China and receive investment from both countries. So, while I am not advocating a bipolar economic world between the US and China because there will obviously be damage to supply chains, one can imagine that there will be a kind of restructuring of the global economy so that some of the supply chains will be tied to each of these two poles.

**JS: As you said, most of the East Asian countries are middle powers. How do you see the role of East Asia in mitigating the negative impact on the global economy?**

**Aggarwal:** When you say East Asia, I assume you mean East Asia without China. If we look, for example, at Japan and South Korea, I think these countries are now in a difficult situation because they have a lot of economic interdependence with China. The Chinese have been buying products from these countries and often are subsequently transforming these products for export to the US. You may recall that during the 2008 financial crisis there was a lot of impact on the non-Chinese East Asian economies due to the recession in the US through this supply chain. So I think there will be some wrenching of supply chains, and if South Korea and other countries were selling to the Chinese and the Chinese were not selling to the US, these supply chains would no longer exist to the same extent. So I think that there will be a reorientation of these

supply chains for domestic demand in China and in the US. I think that what people are missing is the new NAFTA agreement, which is now called the US-Mexico-Canada agreement. This is an example of trying to create more supply chains within North America. I think that part of the strategy of East Asian countries including Japan and South Korea is to invest in Mexico or invest in the US and be part of those supply chains for American-oriented economies. That will have to continue if the US becomes more protectionist, but in general it has not been very protectionist against Japan or South Korea or European countries. Indeed, the Japanese have agreed to start negotiating with the US on a bilateral FTA and this serves as an example by which Japan can get around some of the conflicts between the US and China.

I should mention that I don't think this is a great outcome; I am just giving a realistic assessment of what is likely to happen. Restructuring of supply chains would be costly to the middle power economies, for American, Chinese, and Japanese corporations, and for firms in the supply chains in both Asia and North America. We should also remember that ASEAN countries comprise a market of over 600 million people, and that Japan and South Korea may be paying more attention to ASEAN countries given its relative size and geographical proximity.

There are also alternatives to looking to North American or East Asian markets. India, for example, has approximately the same population as China and will eventually surpass China in terms of market size, so I think there are other important markets that middle powers in Southeast and Northeast Asian countries can focus on. Africa, where the Chinese have had a free hand and invested aggressively, also represents an untapped market for these players.

**JS: Another way might be to persuade China and the US to accept the idea of free trade as being important to achieve global economic prosperity. It is a classical economics textbook argument.**

**Aggarwal:** I think this argument is ridiculous. I think economists have created this problem, because they have been naive about the geopolitical implications of trade. The other problem is that countries have continued to pursue industrial policy and the WTO has not been set up to deal with these countries. There are regulatory measures that can be taken on a global basis, but if you are a small country pursuing industrial policy, the US and other countries may ignore it. If you are a heavy rider such as China with industrial policies fundamentally in contradiction with the WTO and with free market economics – economists cannot understand this. Economists simply claim the Chinese are inefficient, and that industrial policy is a failure, all the while ignoring the fact that Japan became a great economic

power after the war by pursuing an aggressive industrial policy in shipping and steel. From the 1950s to the 1980s it served as an extremely successful development strategy for both Japan and South Korea. Contrary to what most economists claim, their strategy was not just good macroeconomics. Liberal market economics simply ignores the large amount of literature that shows the interconnectedness between politics and economics and the fact that some countries under some circumstances successfully pursue industrial policy – and that the WTO is not structured to cope with that, especially when a large country is doing it. So it's not that the Chinese don't understand free trade, but that their interpretation of free trade is very different from neoclassical economists.

**JS: I read an article by Harvard Professor Dani Rodrik in the *Financial Times* recently, in which he seems to be advocating the idea of global trade rules being adapted to economic diversity. Since emerging economies play an important role in the global economy, we cannot force them to accept the values of OECD nations unanimously.**

**Aggarwal:** This is hardly a new idea. In 1964 we had the creation of United Nations Conference on Trade and Development (UNCTAD) and since then developing countries have received special and differential treatment. In many of the multilateral agreements, developing countries are treated differently. The real problem here is that China is not a developing country, so to say that we should give developing states benefits and help is fine, but that's not the same thing with massive, successful economies that now pose a threat to the global trading system. So I think we have had special rules for emerging economies and I support those rules by and large, but I think that's very different from saying we should have special rules for China or Japan or India, which are large, dynamic economies.

**JS: As you mentioned, China understands free trade very well. But what seems to be lacking in Chinese foreign policy is the idea of reciprocity. Could APEC or a more free and open approach towards international rules be a good way for China to participate in the discussion.**

**Aggarwal:** I think this is a good point but fundamentally misunderstands the Chinese view. The Chinese understand reciprocity completely; they simply don't want to pursue it. It's not that someone has to teach them economics and how countries should behave; they have some of the leading economists and political scientists in the world. It is a matter of choice, and the

Chinese choose not to have reciprocity because having an aggressive industrial policy in which they support domestic firms over foreign competitors is fundamentally incompatible with an open market-based global trading system. In a global trading system designed by the GATT and the successor organization, the WTO, the logic was market-based players with minimal government support. The level of government support and the use of regulations in China and other countries pursuing industrial policy are fundamentally incompatible with the WTO.

**JS: How about the TPP11? Could it encourage competitive trade liberalization and even induce China and the US to join?**

**Aggarwal:** Competitive liberalization is completely nonsense. It is disastrous because it encourages the US to pursue bilateral trade agreements, to pursue sectoral trade agreements, and to essentially ignore the WTO. The Peterson Institute for International Economics kept thinking that somehow, competitive liberalization would lead to a conclusion of the Doha Round by 2007 if the George W. Bush administration pursued bilateral trade agreements. That is completely incorrect – the US pursued bilateral trade agreements that simply undermined the coalition for free trade that would have supported the WTO. I am a big fan of the WTO, and I believe it is a very important organization that manages disputes.

As far as the TPP11 is concerned, I support it too, although I prefer the WTO as a forum. Just because the US has pulled out, it does not mean that Japan and other countries like Singapore should not trade within a minilateral framework. If the US and China decide to join the TPP11, I think it would be great, but I don't think we can call that competitive liberalization. The Chinese and Americans understand TPP well and, in fact, the US tried to convert it into a political security instrument for domestic political reasons. Initially, the US was not blocking China's membership but then it became popular to use security arguments and create a TPP without China. We must also bear in mind the Transatlantic Trade and Investment Partnership (TTIP) effort between the EU and US – which also of course does not include China. The Obama administration's goal became to create two institutions, the TPP and TTIP, which both excluded China and set the rules for the global trading system. That has now been replaced by a direct bipolar strategy of the Trump administration, which is to ignore the TPP, pretty much ignore the TTIP, and simply focus on blocking trade and investment with China as a way of punishing the Chinese for their industrial policy strategy that they have pursued successfully for many years.

**JS: I think East Asia, including China, needs to take**

**some initiatives regarding good global governance. Unfortunately, this seems unrealistic in terms of politics, but in terms of the economy or culture it might be possible to achieve a more meaningful foreign policy among countries in East Asia, namely Japan, South Korea and China. How do you think we can achieve such good relations and a good foreign policy among these three countries?**

**Aggarwal:** I think it is simply impossible, and I think the reason that there is no Northeast Asian agreement of any significance is because of political disagreements between the three countries. There's the Japan-South Korea dispute over islands and Japan's conduct during WWII, there's a similar China-Japan dispute over territory, and the South China Sea controversy has continued in the broader region. I think it is naive to believe that economics and politics can continue on separate paths without colliding. We had that for some time, but there was always a lot of tension, and the Chinese have stopped following Deng Xiaoping's view of the world which was "Let's have a peaceful rise" and have now decided to be much more aggressive in the political and security realms. I don't think you can have very good economic and open relations when the political system and the security system start closing down. I think we had that for some time because the US was very much involved in East Asia and China was following a policy of trying to develop its supply chains and buying products from all over Southeast Asia to sell to the US, but I believe that world is coming to an end.

**Role of Economic Relations & Soft Power in Mitigating Political Confrontation**

**JS: Wouldn't a recognition of the merits of economic relations be to some extent helpful in mitigating political conflicts?**

**Aggarwal:** I think that sounds good, but I am not a believer in the theory of "commercial peace", which argues that growing economic interdependence leads to global peace. I simply don't believe that proposition. Norman Angell expounded this in 1913, and then World War I took place in 1914 shortly after the book was published. The notion that trade and cultural relations will help overcome fundamental political problems is unrealistic. I don't think that economic cooperation will suddenly lead to peace and harmony. Until there is a fundamental approach to dealing with these political and security problems including their territorial disputes and China's unwillingness to abide by judicial rulings from the Permanent Court of Arbitration, states in East Asia have little reason to shift their

policy. In fact, by continuing with economic exchanges with China and closing one's eyes to what the Chinese are doing, I think it just convinces the Chinese that they can continue what they have been doing, which is being aggressive in terms of their territorial demands and guaranteeing their economic supply chains.

Instead, the Trump administration has set out to address China's industrial policy. I am not a great fan of the Trump administration with regard to other policies so I am not advocating that it is doing a good job. We should remember that the Obama administration was also very concerned about China – as evidenced in several WTO filings arguing that the Chinese are undermining American industry and engaging in behavior detrimental to the global trade regime. The fundamental difference is that the Trump administration is much more aggressive. Ironically, there is much more continuity in US policy toward China with respect to trade and investment than we might think.

**JS: I'd like to ask about soft power. What do you think in general about the role of soft power? For example, there are many tourists coming to Japan from China today. They seem to have a good impression of Japan, and so could this to some extent have some effect in mitigating political confrontation?**

**Aggarwal:** My view on this is very negative. I am a strong believer in cultural exchanges and in educational exchanges and I think tourism is a good thing. However, if we believe that these educational exchanges and tourism will lead to global peace, then that is very naive. I don't think that Japan or South Korea or any state should base their policy on hoping that more Chinese tourism will lead the Chinese to have a more favorable impression of their country. Tourism is undertaken by individuals, while policy is made at a high level by Chinese government officials. In a strong authoritarian state like China, there is a strong disjuncture between the population and the government. I support tourism, but I don't think it will do much in terms of changing Chinese policies.

## WTO's Role in Global Trade Conflicts

**JS: Finally, I would like to ask about the WTO. You seem to support the WTO strongly, but unfortunately it does not seem to be working very well today.**

**Aggarwal:** The problem is that the GATT/WTO was designed for a system of free market economics where countries would by and large desist from intervening in their economies. When the US did not want to use the GATT against Japan, the US simply used

unilateral power to push the Japanese into voluntary export restraints in textiles, in steel, in televisions, and automobiles during both Republican and Democratic administrations. The problem now is that the Chinese have no inclination to do this because they are not dependent on US security. My problem is that the WTO, which I strongly support, is not designed for countries like China or even countries like Japan. But with respect to the latter, Japan's reliance on the US led to bilaterally agreed-upon policies that helped to overcome the problem. I don't see that happening in the case of China. The WTO works well for countries that are willing to abide not just by the rules of the WTO, but by the norms. The norms are very important and while I don't care much for soft power, there are norms that influence behavior, and I don't think the Chinese are interested in these norms.

**JS: How do you think the WTO could be strengthened?**

**Aggarwal:** It is very difficult to strengthen the WTO in the current environment. China is a member of the WTO and the WTO operates in terms of unanimity, and so I really don't see any particular strategy to strengthen it at this point beyond procedural improvements such as expedited rulings. In general, I support WTO rules and believe that the dispute resolution process is very useful, despite it being slow and easily circumvented.

As I noted, I am not sure if you could design a better WTO in the current environment, although in practice I wish we could. There has been talk of majority rule and I am not against such an idea, but how do you reconcile countries pursuing aggressive industrial policy with an institution that is explicitly designed to punish state intervention in the market? This question has fundamentally not been resolved by the WTO and its member states. I think that one can talk about ways to fix the WTO but until the Chinese make some commitment to it in a serious way, I think the US will remain skeptical of it, as already demonstrated by the Trump administration. In my mind, the GATT and WTO were the greatest trade institutions in the postwar era, and unfortunately they have been undermined by countries seeking a free ride. **JS**

Edited with the cooperation of Joel Challenger, who is a translator, interpreter, researcher and writer specializing in Japanese disaster preparedness.