

US-CHINA SPECIAL REPORT:

INTENSIFYING GEOPOLITICAL RIVALRY WILL WORSEN IN 2019, OUTLASTING ANY TRADE DEAL

PREPARED BY EURASIA GROUP

21 OCTOBER 2018

The US-China relationship has entered a new phase, with President Donald Trump's administration broadening its confrontational approach beyond trade and technology issues into the wider realm of geopolitical competition.

Vice President Mike Pence gave the clearest signal of this turn with a hard-hitting speech in early October. He committed the US to a program of countering China's "aggression" in areas ranging from China's "debt-trap diplomacy" to interference in US domestic politics. He added a new ideological element by criticizing China on human rights. The US has matched this sharper rhetoric with a slew of provocative actions since September, including a new escalation of tariffs and investment restrictions, the extradition of an alleged Chinese security agent arrested in Europe for cyber based espionage, and sanctions on China's military for an arms deal with Russia.

This is not the start of a new cold war. That framework is more misleading than explanatory (please see text box below) and overstates the degree to which this latest pushback is finely orchestrated or a true departure from existing policy. Pence's speech was quickly cobbled together as administration officials scrambled to publicly explain Trump's earlier charges of Chinese interference in US politics. Recent actions taken had long been in the works in various parts of the bureaucracy and are largely extensions of the policies of past US administrations.

Rather than a cold war, we are at an inflection point in which the great power rivalry between the two countries is intensifying and overwhelming the more cooperative aspects of the relationship. The US political and business establishment has concluded that past modes of engagement with China have failed to check the increasingly assertive policies of President Xi Jinping. With the ballast of a vocal and effective pro-China lobby gone, there is little to mitigate against US policies that confront China as a strategic competitor across a growing range of fields and geographies. This shift would have taken place even under a Hilary Clinton presidency, but the potential for extreme volatility is particularly high under a Trump administration that is eager to project strength against China and is less encumbered by concern for the multilateral system and its rules.

This dynamic will likely cause continued deterioration in the relationship in 2019, even if Trump and Xi are able to reduce near-term tensions at the G20 meeting in late November. That is bad news for a lasting solution on trade and technology disputes and creates the more acute risk of a full-blown foreign policy crisis if either side miscalculates over flashpoints such as the South China Sea and Taiwan.



Don't call it a cold war

Pence's speech earlier this month has triggered comparisons (including in China) to Winston Churchill's Iron Curtain speech in 1946, as well as to Ronald Reagan's Evil Empire speech in 1983. These two addresses marked the start and the peak, respectively, of the Cold War between the US and the Soviet Union.

But this is a misleading framework for describing the current dynamic between the US and China, especially by the conventional understanding of this term.

First, the two sides are not on the verge of a hot war that could trigger mutually assured destruction. Military planners in both countries think a confrontation is possible but believe the near-term risks are remote. China is aware of the US military advantage in a sustained conflict, and while it is closing the gap within the first island chain, for now it would take action only if necessary to preserve domestic political stability or (at a future date) try to seize control of Taiwan. The US appetite to go to war with China over Taiwan, the South China Sea, or North Korea is very limited.

Second, the two sides are not fighting proxy battles in third countries. The closest example to this is the recent US threat to punish three Latin American countries (El Salvador, Panama, and the Dominican Republic) for switching diplomatic recognition from Taiwan to China. But this is the exception that proves the rule. Neither the US nor China is asking countries to declare sides in a potential conflict, and few countries would go along.



Another element of a true cold war is ideological competition, where the US-China rivalry is starting to become serious. Especially since last year's 19th Party Congress, China has become more comfortable explicitly identifying itself as an alternative model to Western liberal democracies. Moreover, the US and other Western countries are increasingly concerned about China's efforts to shape political and cultural debates in the West through Confucius Institutes, overseas state media, and the spread of Communist Party cells overseas. However, Beijing is not interested in replacing the current international system, which it has largely benefited from; it would rather shape it to accommodate China's policies and influence.

The one area where "cold war" is an apt metaphor is the realm of technology competition between the US and China. This formed the basis of Eurasia Group's #3 global top risk for 2018, released at the start of the year, and has played out to an extent that has surprised even us. As noted, the innovation rivalry between the US and China is prompting both powers to erect barriers against each other's technology, and to battle for control over global standards and market share. This dynamic shows no sign of slowing in 2019, and in fact could force more companies and countries to effectively choose sides in areas such as 5G network deployment—with or without Chinese equipment.

A new attitude, but a shift long in the works

More than specific policies, what is new today is the Trump administration's comfort with a more openly confrontational and volatile bilateral relationship. Current officials believe that past US administrations erred in not publicly and vociferously confronting China on issues of concern, from trade practices and market access to Chinese influence efforts in the US and China's militarization of the South China Sea. In their view, years of quiet diplomacy failed to achieve US aims, and Beijing likely mistook US risk-avoidance for weakness.

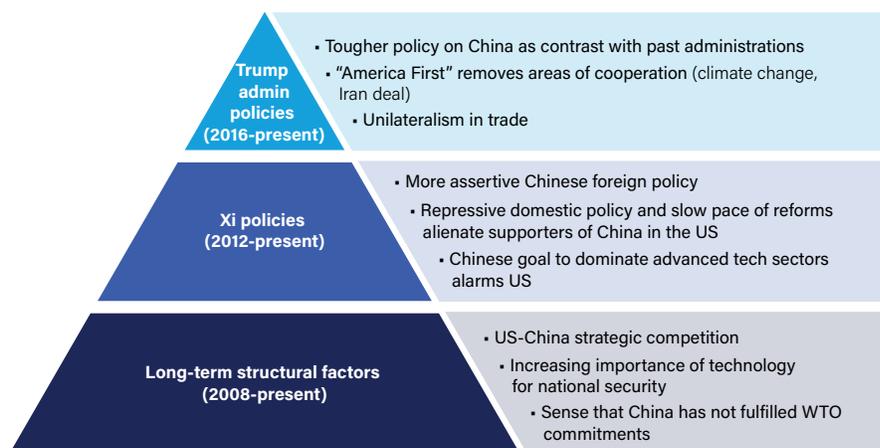
The White House is now giving agencies the green light to take strong action against China that past administrations avoided in hopes of cajoling rather than coercing China. National Security Advisor John Bolton is largely leaving the discretion on specific actions to individual cabinet heads, a highly risk-tolerant approach to coordination that creates a risk of overreach and mis-calibration if multiple agencies step go too far at the same time. What US officials see as a shift in attitude increasingly looks to Beijing like a coordinated strategy of containment.

A key administration objective is to puncture Xi's sense of confidence and impunity. US officials believe that imposing tariffs on China and demonstrating little fear of retaliation was a crucial victory in this regard. They believe that greater economic and diplomatic pressure on Xi will compel him to change course and initiate a serious and broad attempt to address US concerns, especially on trade.

This is not just about Trump

While the tactics used likely would have been different, a higher level of US-China confrontation likely would have come even if Clinton had won the 2016 presidential election.

Pressures in the relationship have been building for years, unfolding across three overlapping stages that we visualize as layers in a pyramid (please see graphic below). Structural factors driving US-China competition are the most important. The trajectory of China's policies under Xi are next in importance. The Trump administration is the sharp point on a foundation laid long before 2017.



Source: Eurasia Group



Structural drivers: Technology super-charges broadening competition

The key structural driver of today's geopolitical tensions is China's growing power, both in absolute terms and relative to the US, since the global financial crisis. The two countries now compete head-to-head across multiple dimensions: economic heft, diplomatic influence, innovation and advanced technology leadership, and military supremacy in Asia. They also compete across geographies, with the US increasingly worried about China's influence in Latin America and Africa. Recognizing China's rise does not imply the countries are caught in the so-called Thucydides Trap that makes war between a rising and declining power inevitable; nuclear deterrence remains in place, while China's rise will for the most part be deliberate and Trump will be averse to foreign ventures.

A second structural driver is the emergence of technology as a critical—even existential—concern, for reasons of economic competitiveness and national security. The contest in fields such as semiconductors, advanced manufacturing, and cloud services is at the center of the current Section 301 tariff dispute and will continue to play out through non-tariff barriers (such as investment restrictions) even if an eventual settlement on tariffs is reached. The potential for advanced emerging technologies like artificial intelligence (AI) and quantum computing to be game-changers in both commerce and military supremacy means that innovation will be a constant area of competition as long as the countries view them as zero-sum arenas.

Third, the blurring of technology and national security concerns is eroding what had been the key structural factor mitigating competition: the increasing integration of the US and Chinese economies. Both countries increasingly view integrated supply chains in areas such as semiconductors as a strategic vulnerability and are making efforts where possible to undo these links. In the US, the Pentagon has stepped up this year as a key player in the US debate over supply chain security, recently assuming a higher profile following the unconfirmed report in Bloomberg BusinessWeek about China's alleged hardware hack of US chips made in China. In China, the near-death experience of ZTE at the hands of US export controls earlier this year has crystallized fears of dependence on the US for critical technologies, fueling Xi's drive to develop "self-reliance" in areas such as semiconductors.

Finally, the US and other key trading partners are deeply frustrated with some of the consequences of China's accession to the WTO in 2001. Policymakers believe China has used loopholes to sidestep restrictions in areas like forced technology transfer and subsidies to state-owned enterprises. The US administration also views the WTO as ill-equipped to deal with these problems given China's unique features—the pervasive role of the state and party in its economy—and its growing leverage in international organizations. These factors breed deep skepticism about the ability of the multilateral system to effectively manage Chinese policies.

Xi's agenda is hardening competition with the US, and it is here to stay

Since Xi rose to power in 2012, his core policy agenda has fueled tensions further, including by isolating key US constituencies that favor a cooperative relationship.

First, Xi's economic policies have marginalized the US business community—the most important pro-China constituency in US politics—through weak support for liberalization and foreign investment and a penchant for ambitious industrial policies such as the Made in China 2025 initiative and the National AI Plan.

Second, Xi's tightening of the domestic political environment in China has dismayed civil society groups—human rights activists, other NGOs, and academics—and their supporters in Congress. Xi's latest crackdowns on the Uighur population in Xinjiang and on Christian organizations, and his campaign to remove "Western influences," have left Americans feeling less optimistic about engaging with China. His emphasis on "party control" in all spheres of China is also fueling concern that Chinese organizations in the US—from companies to Confucian institutes—are arms of Beijing.

Third, Xi's advocacy of a more assertive role for China on the global stage has exacerbated US concerns over geopolitical competition with China:

- In economic diplomacy, Xi seeks to extend China's soft power through the Belt and Road Initiative.



- In military affairs, he has alarmed US defense planners with his militarization of islands in the South China Sea and his ambitions to project force outside of the immediate region, including through a military base in Djibouti and ports throughout the Indian Ocean.
- Xi's willingness at the 19th Party Congress last October to explicitly hold out China as an alternative model for developing countries is now adding ideological competition with the US to this already heady mix.

Finally, Xi's consolidation of power and his move earlier this year to remove term limits for the role of president, signaling that he will likely stay in office until at least 2027, is compounding the above concerns. US officials see few checks on Xi's power or internal factors that will lead him to change course, meaning that the US needs to increase external pressure on Xi to alter the trajectory of China's policies.

The Trump factor

Trump represents a wild card when it comes to geopolitical competition with China, given his lack of concern for traditional areas of global leadership, including safeguarding the liberal international order. He has certainly not signed on to the idea of a new cold war, or to the costs of supporting allies that this approach would entail for the US, and he is hardly animated by concerns over China's human rights abuses. Trade is his first priority. Moreover, Trump is a deal-maker, and he will be in search of an agreement. But his threshold for a "good deal" is far higher than it was at the Mar-a-Lago meeting with Xi in early 2017, the high point of US-China relations in the Trump era.

Similarly, Trump's style of personal diplomacy favors a working relationship with and respect for strong leaders such as Xi. As North Korea shows, Trump is susceptible to superficial understandings. US officials admit that when Trump and Xi next meet—likely at G20—there is no guarantee that he will not agree to Chinese proposals that run against the advice of his counselors.

However, the balance of factors driving Trump and US policy suggest a continued willingness to push the envelope with China in 2019.

First, the deeper structural drivers previously mentioned have a momentum that will often outweigh Trump's proclivities. Any administration would need to respond to issues such as China's militarization of the South China Sea, especially when such moves are highly visible to Congress and the broader public. So even if an agreement on tariffs comes within reach, an assortment of other wedge issues will continue to drive the US and China apart. It will be difficult to deal with trade in isolation.

Second, Trump's disdain for multilateralism reduces the need for cooperation with China on other matters, enabling his hawkish foreign policy team to take a more aggressive approach. Trump cares little about the global challenges—climate change, the health of the multilateral trading system, the Iran nuclear deal—that sometimes led former president Barack Obama and his predecessors to pull their punches with China.

For Trump, cooperation with China is largely limited to North Korea, and the administration has concluded that China will continue to work with the US, at least to a minimally acceptable degree, because of its own interest in avoiding US sanctions or a US military strike on Kim Jong-un's regime.

Third, the hardline "containment" faction is on the rise in the administration. Its leaders are Bolton and top trade adviser Peter Navarro. The pro-deal faction is led by Treasury Secretary Steven Mnuchin. Trump's views most closely align with USTR head Robert Lighthizer, a pragmatist who runs closer to the hardline group. Lighthizer is open to an eventual deal if it includes deep concessions from China but is also perfectly content to keep tariffs in place indefinitely and force US companies to remove parts of their supply chains from China; Lighthizer, like Navarro, believes that these supply chains give Beijing too much leverage over US companies and represent a strategic vulnerability. US bureaucratic politics and Trump's evolving views will be key.

Fourth, US domestic politics will continue to push Trump toward a tough approach on China. He believes that tariffs on China are a winning political strategy. That could change if the economic costs of tariffs mount steeply over the next year. It is also possible that Trump will try to tag China as a scapegoat for any Republican losses (given his recent charges of China's interference in US politics) and use the bilateral tensions to distract from domestic political and legal troubles.



More importantly, Trump is constrained by the broad bipartisan support for standing up to China, especially on matters of national security. Trump discovered the depth of this sentiment when his decision to save ZTE in mid-May led to fierce blowback from both parties in Congress. In the longer term, most Democrats will likely also advocate for a tougher stance against China, meaning there may be little advantage for Trump in conciliation as he heads towards a reelection campaign in 2020.

Difficult choices for Xi and for China

Beijing is deeply worried by the shift in the US approach and is searching for the appropriate response.

The more hostile tone from the US is daily validating views within Chinese policy circles that Washington seeks to “contain” China. But Beijing is not ready to translate this suspicion into action and to formally shift towards an openly confrontational relationship with the US. Doing so poses unacceptably high risks for China, especially with economic growth slowing. Beijing prefers a status quo approach of engagement as it bides its time.

The political stakes are very high for Xi, who faces a difficult balancing act. Xi has based his consolidation of power on the premise that he needs it to carry out the “Chinese dream” of a strong country and advanced economy. He has played up China’s military expansion, and his own role as “commander in chief,” as part of his personal propaganda campaign. All of this will make it difficult for Xi to back down when challenged by the US on sensitive foreign policy issues such as Taiwan and the South China Sea, both of which Beijing regards as “core interests.”

At the same time, Xi is under increasing scrutiny in China for his assertive approach to the US, which critics blame for unnecessarily exacerbating tensions. These critics are largely outside the core party elite, which remains loyal to Xi, but growing numbers of senior officials will react with alarm if there are signs that China is close to outright conflict with the US. The trade war will add considerable economic pressure to China in 2019, further complicating his job of maintaining confidence in his leadership.

The balance of factors suggests that Xi will favor a policy of relative restraint, as long as it does not look like abject surrender to the Trump administration. This means that he will continue to try to find ways to mend relations with the US, and explore a trade deal, including through his personal relationship with Trump. Chinese diplomats are likely to try to defuse US/Western concerns with some of China’s policies, including influence in US politics, treatment of Uighurs, and the debt sustainability issues associated with the Belt and Road Initiative. But Xi will not reverse course on highly visible issues, including Taiwan, South China Sea, and some core aspects of China’s innovation and industrial policies, leaving these as continued sources of friction.

Outlook for 2019

The Trump administration has signaled a new approach to China and is unlikely to back down. Over the next year, we expect the US to continue to challenge China with actions on a variety of fronts outside trade (please see text box on next page).

The critical question for 2019 is where the new equilibrium in the relationship will settle and when or whether the two sides can resume some level of productive engagement. Both will try to satisfy their strategic and domestic political objectives by showing resolve but will need to do so within acceptable risk tolerances. Our basecase is that the US and China will avoid a serious foreign policy crisis or military confrontation, but the overall relationship will continue to deteriorate.

The key variable here is on the US side—the relatively loose coordination within the Trump administration. There is a danger that, with US agencies treating this period as open season on China, they will collectively overreach and provoke a sharper-than-expected response from China.

Broader tensions buttress our call that a lasting settlement on trade and investment is possible in the first half of 2019, but not probable (please see Eurasia Group special report: [Tariff dispute will escalate through the first half of 2019](#), 27 September 2018). We expect new rounds of measures absent Chinese concessions as the US ups tariffs from 10% to 25% on \$200 billion in Chinese exports in January 2019. There is also a 45% chance that Trump will



Foreign policy and national security

- **Naming-and-shaming China** for influence and espionage operations in the US. The Trump administration will continue to charge China with trying to undermine Republican prospects in the midterm elections, though it is difficult now to determine whether such claims are credible or designed instead to deflect pressure from Robert Mueller's investigation.
- **Stepping up the pace of freedom of navigation operations** in the South China Sea, and deliberately testing China's red lines in areas where the US feels international law is on its side.
- **Demonstrating public support for the Tsai administration** in Taiwan.
- **Challenging China's economic diplomacy** through continued critiques of the Belt and Road Strategy, and through stepped up US efforts through the proposed US International Development Finance Corporation (pending as legislation and likely to be signed by the president).
- **Sanctioning Chinese entities** if Beijing substantially reduces cooperation over either North Korea or Iran in sanctions enforcement.
- **Considering sanctions against named Chinese officials for human rights abuses** against Christian or Muslim groups. Increasing numbers of US officials are calling for sanctions against Chinese officials involved in a major re-education campaign in Xinjiang, for example.



Technology

- Exerting formal and informal pressure on US companies to **separate ICT supply chains**, particularly in high-tech sectors, from operations in China. This may include further tariffs and quiet pressure on US firms to consider moving major portions of critical supply chains, particularly those with substantial US military equities.
- A steady ratcheting up of **restrictions on technology transfer** via investment reviews under the new CFIUS legislation, and the building out of a potentially sweeping export control regime. Over time this could essentially exclude all Chinese investment in US high-tech sectors, and prevent US companies from starting new or expanding existing joint ventures in China involving technology transfer of critical or "foundational" technologies. This effort will irk Beijing in part because it is directed squarely at Made in China 2025, and it will complicate negotiations to open up key sectors of the Chinese economy that are part of US demands related to the Section 301 investigation.
- **New executive actions against China's leading telecommunications equipment suppliers**, Huawei and ZTE, including a pending executive order that would grant the Commerce Department the power to declare an economic emergency and bar US carriers from buying Chinese equipment. The Department of Justice is also considering action against Huawei related to violations of Iran sanctions, akin to the case that generated the ZTE denial order. The White House, meanwhile, has asked government agencies to devise options for limiting Chinese company involvement in 5G more broadly.
- **Considering further restrictions on Chinese student and professional visas** in the US in sensitive technology sectors, such as semiconductors, AI, telecommunications, and biotechnology. Any new restrictions will likely be directly tied to Made in China 2025.
- **Encouraging like-minded allies**, particularly in the EU, to take similar actions against Chinese investment in high-tech sectors, and restrict certain categories of technology transfers to Chinese firms. This effort already includes exerting further pressure on allies to formally ban Chinese equipment suppliers from 5G networks.
- **Considering new government and military procurement rules** that could bar Chinese components further back in critical supply chains. Recent Bloomberg reports alleging Chinese military involvement in coercing subcontractors of a US computer board company to include malicious hardware are fueling supply chain concerns.

implement part if not all of the threatened tariffs on the remaining \$267 billion in Chinese exports in the first half of next year. But even if a deal to lift tariffs emerges, the battle over industrial policy and innovation issues will continue to play out through non-tariff measures such as investment restrictions.

Economics aside, the most acute risk is of an accident that becomes a full-blown foreign policy crisis. The two sides have come close to this point several times before, including the collision of the E3 spy plane with a Chinese fighter jet in 2001 and the accidental bombing of China's embassy in Belgrade in 1999. In both cases, the two sides managed to defuse a crisis. That will become much more difficult in today's highly charged atmosphere, with neither leader inclined to look weak.

Of the potential flashpoints, the most likely is in the South China Sea. While neither side is undertaking a major shift in policy, the US will continue conducting freedom of navigation operations and will likely be challenged by China's navy. The risk of harassment leading to escalation, or a collision, is significant.

It is important to note that Washington is likely to stay within two very important guardrails in the relationship. First, Pence's speech indicates that the US is not straying from observance of the "One China" policy between China and Taiwan, the most provocative possible move from Beijing's point of view. Trump and his cabinet advisers are aware of the risks of such a step and are unlikely to deviate from established policy on this issue, although they will push the envelope with support for Tsai's regime and actions like continued military sales. Taiwan will be a source of risk, but probably not a full-blown crisis.

Second, the Trump administration is unlikely to make human rights or democracy a major part of the relationship, though it will selectively ratchet up pressure. The administration could well sanction Chinese officials for Beijing's crackdowns on Muslim Uighurs in Xinjiang province and on Christian groups, but the priority will be on strategically more important areas of the rivalry.

A G20 meeting would provide only a short-term fix

The most important signpost for the relationship in the next two months is the possibility that presidents Trump and Xi meet at the G20 leaders' summit in Buenos Aires on November 30 through 1 December. A meeting is not assured. The US wants to use a meeting as leverage to drive concessions from Beijing on trade. Beijing is balking at steps without assurances that they will satisfy the US and is worried about Xi looking weak in response to bullying by Trump. Nonetheless, the meeting is likely to happen, given Beijing's eagerness to try to de-escalate tensions and Trump's interest in sounding out Xi on a possible trade deal. If sensitive discussions to pave the way for potential Chinese concessions fail and a meeting does not take place, it will be an important indication of the depth of strains in the relationship.

Trump's personal affinity for Xi and desire to be seen as a deal-maker make for an unpredictable outcome if a meeting does take place, but the results are likely to disappoint. Differences on key issues remain great. Trump is emboldened by tariffs, and his top advisers believe that if he agrees to a weak deal, he will quickly be attacked by Democrats and criticized by members of his own party. Markets will likely greet any positive messaging with optimism that a deal on trade is within reach. But we believe there should be a high bar to concluding that tensions on trade or other areas of the relationship are on a path toward de-escalation.

Contacts

Michael Hiron

Director, Asia
+1 646.291.4037
hiron@eurasiagroup.net

Paul Triolo

Practice Head, Geo-technology
+1 202.903.0006
triolo@eurasiagroup.net

Jeffrey Wright

Analyst, United States
+1 202.903.0012
wright@eurasiagroup.net

Kelsey Broderick

Associate, Asia
+1 202.552.5398
broderick@eurasiagroup.net

Cliff Kupchan

Chairman
+1 202.903.0013
kupchan@eurasiagroup.net

Meredith Sumpter

Head, Research Strategy & Operations
+1 202.903.0019
sumpter@eurasiagroup.net

Brasília London New York San Francisco São Paulo Singapore Tokyo Washington D.C.

This confidential report is intended solely for the internal use of the client and is based on the opinions of Eurasia Group analysts and various in-country specialists. Eurasia Group is a private research and consulting firm that maintains no affiliations with governments or political parties.

Photo credit: Reuters

Report issued 21 October 2018 | © 2018 Eurasia Group

