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## Navigating US-China relations

US-China relations are back in focus. US desire to contain Chinese growth in strategic technologies combined with China’s foreign and domestic policy agenda will keep the relationship volatile.

### Key Takeaways

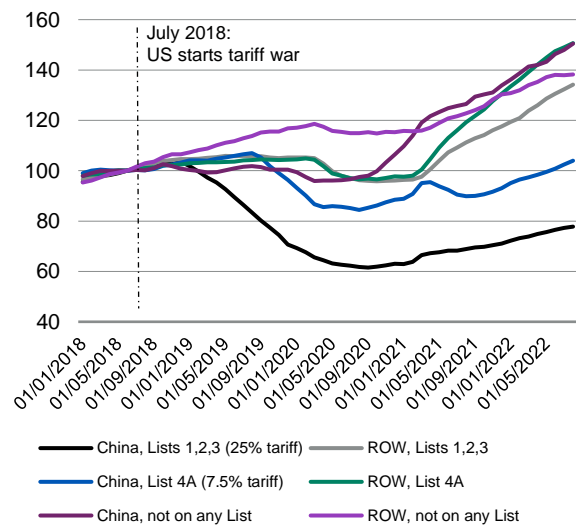
- Under President Biden, US national security and industrial strategy have become deeply intertwined. Decoupling across strategic sectors is likely to continue as national security and technology blur.
- US hawkishness on China is in part driven by the domestic political environment. Democrats are keen to match Republican talking points on China, particularly in the run up to the next presidential election. Current US policy is unlikely to be substantially altered by future presidents.
- China is primarily focused on domestic economic growth in the wake of reopening. But China’s technological self-sufficiency drive, efforts to expand its sphere of influence and its relationship with Russia will keep tensions with the US high.
- Periods of calm in US-China relations will be punctuated by volatility, which is likely to increase in the run-up to the US presidential election. This environment will keep risk premia on Chinese assets volatile, but creates opportunities for on the ground investors with deep knowledge of China.

on global challenges like climate change, public health, and debt relief for low-income countries.

Progress towards solving global collective action problems is likely to be patchy. The pandemic demonstrated the limits of US-China co-operation, which failed to mount a truly international response to the pandemic.

Biden’s strategy is manifesting itself in further politicisation of US-China goods trade. He did not roll back tariffs despite the ongoing economic distortions they cause, even when high inflation provided some political cover (see Figure 1).

Figure 1: US tariffs have distorted trade flows



Source: Peterson Institute, US Bureau of the Census, March 2023

### Biden has built upon Trump’s China strategy

Under President Trump, the US’ China policy moved away from the presumption that deeper economic integration would pull Beijing closer to US policy positions. Although the Biden administration’s China Strategy contains notable differences, it has continued the “tolerance of greater bilateral friction.” It also sets out the goal of “outcompeting China” on economic and military matters while co-operating



That said, tariffs are no longer the tool of choice. Policy has morphed into restrictions on China's ability to import advanced technology.

Alongside disruption to supply chains during Covid, and European reliance on Russian commodities, this has triggered a reassessment of dependences in strategically important sectors. Onshoring and 'friendshoring' have clear bipartisan support despite the cost to economic efficiency.

The West's wide-ranging sanctions on Russia suggest that the US and its allies are willing to take actions for national security reasons, even where they result in economic self-harm. However, sanctions against China would be considerably more costly for both sides, given its much greater integration into the global economy. Therefore, economic incentives remain a key constraint which should slow the pace of decoupling.

### **Industrial and security policy are now deeply intertwined**

There are two key features to the US' China policy. First, encouraging domestic production in advanced computing, semiconductor manufacturing and green technology. Second, restricting Chinese growth in these areas, focusing on export controls, investment screening and scrutiny of US Foreign Direct Investment (FDI) into China. Biden's strategy therefore strengthens the links between industrial policy and national security.

Two pieces of legislation are the cornerstones of this approach. One is the Inflation Reduction Act, which focuses on developing domestic clean energy industries with \$400 billion of government support, in part to reduce the dependency on Chinese manufacturing. The other is the CHIPS Act, which aims to increase the US semiconductor manufacturing base with \$52 billion in subsidies and tax breaks. It also includes provisions to bar companies building new factories in China if they benefit from US government funding. This effectively requires some manufacturers to pick a side in US-China competition, while domestic manufacturing capabilities (partially) guard against the risk that conflict over Taiwan disrupts supply.

Biden has also used executive orders to try to limit Chinese growth in advanced semiconductor manufacturing. In October 2022, he announced a series of export controls on chips crucial for artificial intelligence, chipmaking tools and supercomputers. This has an impact on US semiconductor manufacturers, which are forecasting significant 2023 revenue losses because of the loss of the Chinese market.

These efforts are targeted at *specific* industries and products. The Administration has shown no indication it is seeking a broader decoupling of US-China trade. Even limited decoupling will require the commitment of successive Administrations to achieve, and we expect that

investment restrictions are likely to be a feature of the US' China policy going forward.

### **Bipartisan support for a hawkish China policy risk increasing tensions**

It is unlikely the US will pivot from its current approach to China. Indeed, a 'tough on China' approach is one of the only policy areas enjoying bipartisan support. In the House, the newly established China committee is unusually united. The House and the Senate voted unanimously to condemn China over the balloon incursion.

The hawkishness of Congress means Biden is unlikely to forge a less confrontational path. Democrats remain keen to match Republican foreign policy ahead of the next election. Republican presidential candidates will try to outcompete each other on China, likely making inflammatory statements on issues like Taiwan.

Congress may also create tension in the US-China relationship independently of the Presidency. Trips to Taiwan are extremely likely, and the House China committee may make legislative proposals that would mark a significant escalation. Members of Congress are more willing to criticise Chinese domestic policy, including actions in Hong Kong and Xinjiang, framing competition with China in humanitarian and ideological terms. However, bills marking a significant departure from government policy are likely to be blocked in the Senate.

One area where Republicans and Democrats may disagree is the need to take a multilateral approach. In contrast to President Trump's distrust, Biden has worked to rebuild cooperation with US allies. 'Friendshoring,' including efforts to develop a semiconductor network with Japan, Taiwan and South Korea, is a prime example.

The US has also increased its military presence in the Pacific. The Aukus pact between the US, the UK and Australia aims to counter Chinese military power through the delivery of nuclear-powered submarines to Australia and the sharing of military capabilities and technology. The US has also increased its presence in the Philippines and has been a vocal supporter of Japanese plans to rearm.

All that said, there are still strong incentives for both sides to put a floor under relations. The Biden Administration has been keen to create diplomatic 'guard rails' to avoid unintentional escalation, while the Chinese Communist Party (CCP) is now more concerned about the economic impact that could be caused by a diplomatic fracturing.

Indeed, a desire to increase dialogue between the two countries remains. In the week after his visit to China was cancelled, US Secretary of State Blinken met with senior Chinese diplomat Wang Yi at the Munich Security Conference.



However, any future lack of US domestic tolerance for diplomacy with China, as well as China's limited interest in establishing meaningful guard rails, are key risks.

### **China suddenly reopened, but its US strategy has changed little in recent months**

Xi's China has been more prepared to assert its political and economic interests in regional and international affairs. It has also centralised further Party control, adding tensions with the West as China's governance model has diverged further from that of the West.

China's post-Covid reopening, a more pro-growth rhetoric and the side-lining of notable 'wolf warrior' diplomats hinted that China's foreign policy may be changing tack. However, while China is more focused on growth - and policy has evolved to reflect this - a fundamental foreign policy change does not appear to be underway.

First, there are limits to what China can achieve in the face of US policy changes. Recent steps have been more consistent with damage mitigation rather than confrontation: pressing the message that China is open for business to encourage FDI, for example.

Second, the 'Made in China 2025' strategy, which was a source of tension with the mercantilist Trump administration, now receives little attention in the US. But the desire to become more self-sufficient via 'dual circulation' — a combination of domestic consumption and international trade — is not without costs. Reinforcing critical sectors potentially adds to the 'technological arms race'. More generally, it is unclear what the CCP could promise to change the US approach.

Lastly, recent moves need to be considered in the context of China's overall foreign policy strategy. Admittedly, the Belt & Road Initiative is now much less ambitious, suggesting debt trap diplomacy concerns may not worsen. But the 'no limits' friendship signed with Russia just ahead of the invasion of Ukraine has added another major fault line. An assertive stance around the South China Sea, including little sign of wanting to engage with Biden's 'guard rails', despite the balloon incident, makes fundamental improvements in relations challenging to achieve.

Indeed, the CCP may see advantages in not having 'guard rails', namely the possibility to raise the cost for other countries operating in disputed territories.

### **Russia's invasion of Ukraine illustrates the tensions that China's foreign policy creates with the West**

While China is willing to bear some diplomatic cost for Russia, there does appear to be a hard limit to China's support. China is willing to fill the trading void left by

Russia's split with the West, but it is still being careful not to draw secondary sanctions. And there is no clear indication that direct military support is being considered, despite Secretary Blinken's accusations.

Regardless, China's unwillingness to rebuke Russia is further straining its relationship with the West. Some Western politicians have cast Russia's invasion as a warning on dealing with authoritarian regimes, adding momentum behind decoupling related to security issues.

Indeed, Ukraine adds unpredictability to the US' Taiwan strategy. The surprising resilience of Ukraine and the importance of Taiwan as the key hub for advanced semiconductors risk making support for Taiwan a greater US priority. As we have noted previously, the status quo is most likely to persist, but the potential for missteps is now higher, in part as there is a chance the US steps away from its 'One China' and 'strategic ambiguity' policies.

### **Investment implications**

- US-China relations remain volatile and are likely to come under additional pressure as candidates vie to appear 'tough on China' in the run up to US presidential election. Periods of improving relations are likely to be punctuated by episodes of heightened tensions. This will keep risk premia on Chinese assets volatile, but also creates opportunities for on the ground investors with deep knowledge of China.
- Decoupling across strategic sectors is likely to continue as national security and technology blur. Firms manufacturing products which could be classified as 'dual use' (i.e., amenable for military and civilian purposes) are at risk of falling foul of the changing boundaries of national security. Risk-return may be damaged for some 'growth' stocks, given technology often has security implications.
- Decoupling also implies a shifting distribution of winners and losers. A greater prominence of industrial policy and protectionism will help some firms boost pricing power, particularly those with strong connections to governments pursuing mercantilist agendas. But firms who benefited from globalisation will suffer. Infinitely scalable software is limited by technological fragmentation, for example.
- The weakening of globalisation via decoupling and regionalisation is likely to push down on potential growth and real equilibrium interest rates ( $r^*$ ). It may also steepen the 'Phillips's Curve', implying greater need to hedge inflation volatility as the relationship between slack and inflation becomes more sensitive.



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GB-270323-190006-1

