Irresistible Force Vs. Immovable Object, Round Two

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President Biden is striking a pugnacious tone with China. At last weekend's G7 summit, he renewed his call for the world's democracies to take joint action to oppose Beijing's alleged use of forced labor in Xinjiang, and to fund an alternative global infrastructure program to China's Belt and Road Initiative. At home, he has used the specter of Chinese competition to justify big government investments in infrastructure and R&D. But even as Biden keeps rattling the sabers he inherited from Donald Trump, trade, technology and investment flows between the world's two biggest economies remain resilient. Which matters more, economic data or political bad-mouthing?

US policy on China is defined by a struggle between a desire to tame a rising rival and the financial interests of multinationals

As we noted a few years ago, US policy on China is now defined by a struggle between an irresistible force and an immovable object. The force is the US government's desire to tame the threat to national and economic security it sees from a rising China. The object is the financial interests of multinational companies in China (see **An Irresistible Trade Policy Meets Immovable Interests**). This conflict will be a permanent feature of the global landscape over the next decade.

The death of engagement

Biden and his team have accepted Trump's core policy innovation: that America's stance towards China is no longer "constructive engagement," but strategic competition. (Any doubts on that score were scotched on in late May when Kurt Campbell, who runs Asia affairs on the National Security Council, declared the era of engagement dead.) But they claim they will pursue this competition more efficiently than Trump did. There are two ways to understand what this will mean in practice.

Trump catered to two groups: national-security hawks and economic nationalists

First, look at the domestic interests Biden is trying to address. Trump essentially catered to two groups: national-security hawks worried about China's rising technological and military might, and economic nationalists who wanted to re-shore as much traditional industry as possible and conduct trade policy in a purely unilateral way.

Biden wants to satisfy these two but has also added a "democratic values" group

Biden evidently wants to satisfy these groups, but has added a third: a "democratic values" constituency, which would like to stem the supposed advance of authoritarianism of which China—by virtue of its economic success—is the most effective exponent. Biden has made the struggle between democracy and authoritarianism a cornerstone of his public messaging. The addition of this ideological element creates the possibility that Biden's China policy will be more consistently hawkish than Trump's, since it is hard to justify pragmatic compromises with ideological foes.

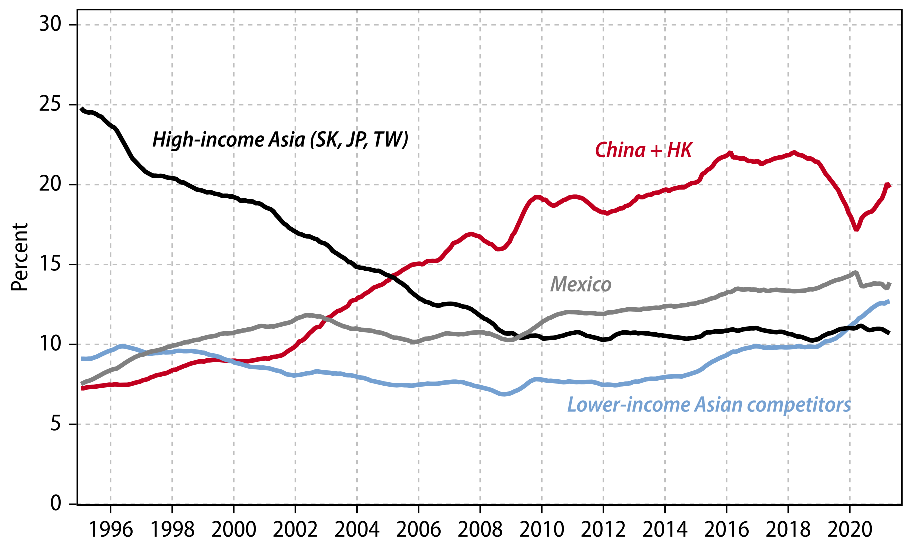
The other major interest group that Biden could address—or at least be constrained by—is the business and financial community. Despite complaints about Chinese regulation, multinationals generally see access to China as essential to their global competitiveness. China is a big, fast-growing market

For multinationals, China remains a fast-growing market with a uniquely efficient and resilient production base

with a uniquely efficient and resilient production base—a virtue underscored last year, when China contained Covid, swiftly returned its production chains to normal and regained half of the US import market share that it had lost during the trade war (see [The World's Best Manufacturer]). And it is, along with the US, one of the world's two leading innovation hubs.

Since Covid, China has regained import market share in the US

Share of total goods imports, 12mma



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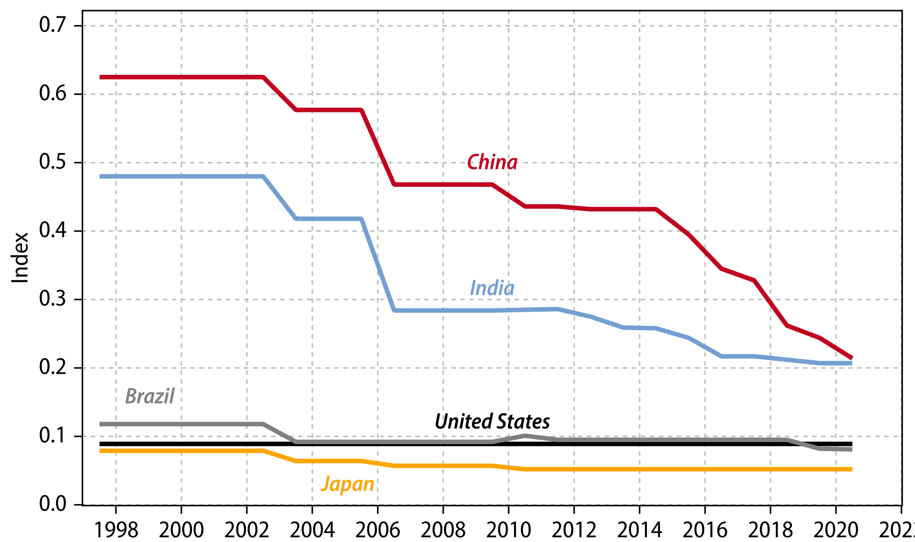
China wants to keep multinationals on its side because it still requires both their technology and their advocacy

China knows these strengths, and wants to keep multinationals on side because it still requires both their technology and their ability to act as a counterweight to increasingly hostile politicians in Washington. Beijing has significantly relaxed restrictions on inward investment in key sectors such as finance, pharmaceuticals and autos.

China's barriers to inward FDI have fallen significantly

OECD index of regulatory restrictions on foreign direct investment



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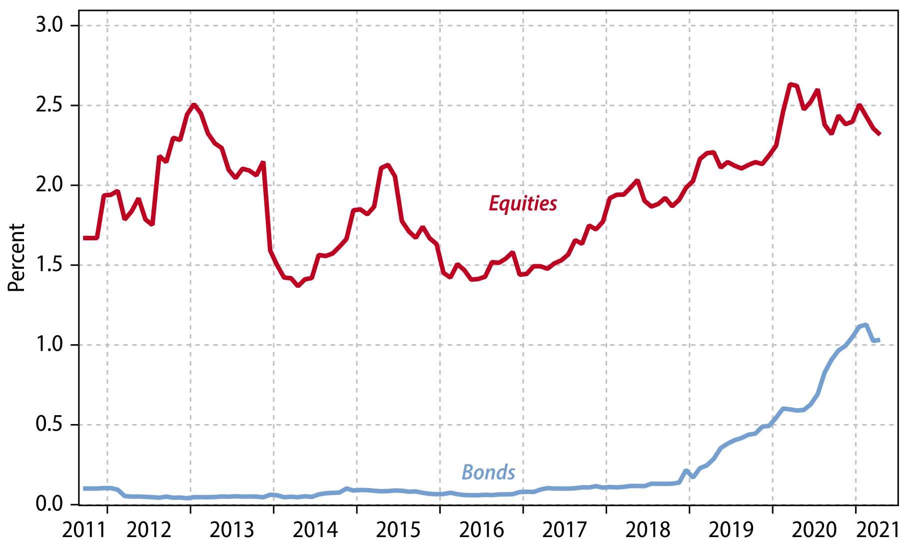
For financial institutions, the logic is equally compelling. China now accounts for about 17% of the world economy. In aggregate, the weight of China in global financial portfolios is quite a bit less. China represents just 3% of the total foreign equity holdings of US investors, and 1% of foreign bond holdings. These figures have risen in the past few years as China opened up its capital markets; over the long run there will be pressure for them to rise much more. Despite escalating political tensions, America's biggest asset manager, BlackRock, this month opened a wholly-owned mutual-fund business in China.

The basic demand of businesses is that the US be more predictable and selective in its China restrictions

The basic demand of businesses and financial institutions is that the US government be more predictable and selective in its curbs on China-related trade and investment flows, so that they can take maximum advantage of the commercial opportunities. The Biden administration is clearly trying to make its restrictions more predictable and better based in law than was the case under Trump. But it is an open question whether it will keep the list of restrictions short, or seek to widen them over time.

China's weight in US portfolios is low, but rising

US holdings of Chinese securities, share of total foreign holdings



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The other way of understanding the Biden strategy is to think about the possible responses of a country like the US to the rise of an authoritarian mercantilist power like China. There are basically three:

1) Do things to harm or hobble China.
2) Do things with allies and multilateral mechanisms to constrain China's room for maneuver.
3) Do things at home to strengthen the US capacity to compete.

Trump wanted to hurt China, but it was hard to do so without hurting US companies as well

The Trump administration method was to expend most of its energy on hurting China, attack allies and multilateral institutions so that concerted international action was impossible, and talk a lot but do little to strengthen US capacities. The flaw was that it was hard to find ways to hurt China without hurting US companies at least as much, due to their reliance on the Chinese market. And so far, US technology trade with China is booming, despite efforts to cut off supplies to Huawei and other Chinese firms. At the moment, Biden seems to be shifting the priorities: reducing emphasis on measures to harm China and increasing the focus on self-strengthening. Spending money on R&D and industrial policy to counter a supposed Chinese threat jibes with Biden's broader interest in a bigger government role in the economy. The Innovation and Competition Act, recently passed by the Senate, authorizes US$250bn in funding for R&D and tech industry support, and clearly reflects the administration's priorities.

Biden seems to be reducing emphasis on hurting China and increasing focus on self-strengthening

US semiconductor exports to China are surging

US exports of semiconductors and related equipment to China, 12m cma

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Working with allies is a constant talking point, but faces constraints. The lack of domestic political support for new trade deals precludes Biden from pursuing multilateral economic pacts that most analysts agree would be effective in countering China—such as a revived Trans-Pacific Partnership, or a new digital trade and investment agreement, as proposed by a big group of US trade experts. Most US allies and friends see continued access to the China market as essential, and will be reluctant to sign on to a security-driven US agenda.

The lack of domestic support for new trade deals precludes Biden from pursuing multilateral economic pacts

Nonetheless, Biden has mended some fences with Europe, notably by crafting agreement over a global minimum corporate income tax and resolving a long-running trade dispute over subsidies to Airbus and Boeing. The latter seems driven by concern that China's aircraft maker COMAC could become a serious competitor in several years and that the US and EU have a common interest in beating it back.

Finally, in the hurt-China basket, the aim seems to be to leave most of Trump's export and investment restrictions in place, walk back ill-considered actions such as the bans on WeChat and TikTok, and devise more careful and systematic rules for future curbs on flows of technology, finance and data from the US to China. The big—and so far unanswerable—question is about the underlying intent. Is the idea to create a well-defined, narrow set of national-security limits? Or is it to create more effective tools for constraining China's economic rise? A recent flurry of executive actions provides some initial clues.

Biden's first substantive regulatory action against Chinese firms came in a June 3 executive order refining a Trump-era ban on buying shares of Chinese companies with alleged military ties. This made some significant adjustments, starting with terminology: the targets, previously known as "Communist Chinese Military Companies" are now called "Chinese Military-Industrial Complex" firms.

The Trump-era ban on buying shares of certain Chinese companies penalized US investors without hurting the companies

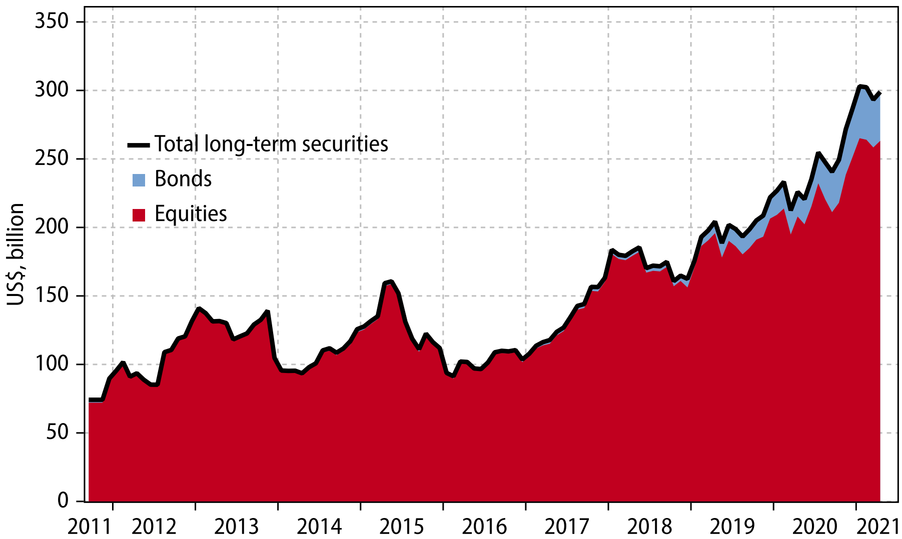
The vague Trump-era rule produced many uncertainties and court challenges. Handset maker Xiaomi and big-data firm Luokong Technology Corp. successfully sued to get removed from the list—a rare result given US courts' traditional deference to government national security claims. And since the investment ban was not paired with export controls or other sanctions, it simply penalized US investors without hurting the target companies.

The new rule is clearer. It names all the companies whose shares cannot be bought; the previous order also banned investments in any company whose name "closely matched" that of a designated firm. It permits US individuals working at non-US funds to keep buying these shares. And the order gives Treasury final authority for maintaining the list of banned companies and reduces the Defense Department to a consulting role.

Biden's refinement to the Trump rules offered more clarity to investors on what can and cannot be bought

US investors are still increasing exposure to China

US holdings of foreign securities, mainland China



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The new rule is also tighter in its definition of the activities of concern, which are defense and surveillance. It thus distinguishes more clearly between banned companies like HikVision (which produces surveillance cameras) and internet companies like Tencent or Alibaba, whose troves of user data may incidentally aid government surveillance efforts but which are manifestly not defense-related firms. This greater clarity may make it easier for US investors to keep raising their exposure to Chinese equities without having to worry as much about falling afoul of a blacklist.

A week after the CMIC order, Biden revoked Trump's earlier bans on Tencent's WeChat and ByteDance's TikTok—both of which had previously been blocked by federal courts. At the same time, Biden gave the Commerce Department four months to compile a report reviewing security risks from foreign software programs. It remains to be seen whether this review is a tactic for defusing the concern over Chinese apps, or an effort to craft rules for restricting Chinese phone apps that will have a better chance of standing up in court.

Finally, a White House review of critical supply chains emphasized the need to build up America's manufacturing capabilities, but dispensed with Trump-style rhetoric about forcing US companies shut down Chinese or other foreign operations and move back home.

Striking a balance

These actions could indicate that Biden is trying to strike a balance between national security and business interests, by establishing narrower definitions of what is off-limits and more predictable rules about how restrictions will be imposed. But simply being more rules-based does not preclude him (or a future president) from extending these restrictions to more firms and activities. And the incentive to impose sanctions on more China-related activities may rise as the 2022 midterm elections get closer and Biden feels a need to burnish his tough-on-China credentials.

Being more rules-based does not preclude Biden from extending restrictions to more firms and activities

A comparable shift in emphasis, from "punish China" to "strengthen the US" is visible in Congress. This Congressional session, like the last one, is rife with symbolic anti-China legislation. But the main substantive China-related bill that has actually passed is the Innovation and Competition Act, which reflects the administration's priorities in focusing almost entirely on a US$250bn package for government-funded R&D and policy support to key industries. Amendments that would have imposed national-security screening on US company investments in China and expanded the use of anti-dumping duties were voted down. The bill could change in the House of Representatives, where several committees will review it, and possibly merge it with another bill that puts more emphasis on human rights.

None of this means that uncertainty has been banished. Quite the reverse: uncertainty is now baked in. There is an acute and permanent tension between the goals of national security, economic self-sufficiency and democratic values on the one hand, and maximizing China-related business opportunities on the other. The forces arrayed on both sides are powerful. The pressure to impose new controls on technology and financial flows will rise as the 2022 midterm elections approach. The US-China relationship will be much less erratic under Biden than under Trump, but it is still far from finding a stable equilibrium point.

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