SOLUTIONS BRIEFS

COMMITTEE FOR ECONOMIC DEVELOPMENT
THE PUBLIC POLICY CENTER OF
THE CONFERENCE BOARD

SUSTAINING CAPITALISM

A series focused on nonpartisan reasoned solutions in the nation's interest to the central challenges we face in order to provide prosperity for all Americans.

US-China Trade and Investment

Challenges & Solutions

Overview

Insights for What's Ahead

China is more than our principal economic competitor. It is our principal strategic competitor, with the capability to attempt to alter the international, rules-based order. The Defense Department describes China as our "pacing challenge," seeking to shift diplomatic, military, and trade patterns in its favor, even as our economies remain strongly interdependent.

- Despite the growing tensions, the US trade in goods with China, the US's third largest trading partner, hit a record in 2022 of $690.6 billion, topping the 2018 record of $658.8 billion, demonstrating the continuing demand on the part of business and consumers for trade with China and, consequently, the need for mutual cooperation.
- The US trade deficit with China reached $382.9 billion in 2022, above the prepandemic 2019 level of $344.1 billion,[1] despite China's lockdowns in key manufacturing areas. The trade deficit remains a major point of contention between the two nations, having become the most tangible representation of China's continuing unfair trade practices.
- At the end of 2022, China held at least $867.1 billion of US debt,[2] a consequence of trade imbalances, making the US vulnerable to refinancing it at higher rates should China decide to sell this debt or reduce purchases of it.

The challenges are intensifying. The war in Ukraine has accelerated China's efforts, in concert with Russia, to shift the international order away from the dominance of the US and the US dollar and has compounded the already existing challenges in the economic arena.

The US continues to impose tariffs worth several hundred billion dollars on Chinese goods. While a review of the tariffs has been underway since September 2022 and the inflationary impact of tariffs has opened the door for reconsideration, there has been no indication yet that lifting the tariffs is a probability in the near term.

The US is increasingly cautious in accepting Chinese investment in areas ranging from ports to agriculture to telecommunications and apps and has imposed restraints on advanced semiconductors, along with other advanced technology with military applications going to China. The US and its allies are considering further restrictions on investment in key technologies. And both policy and private sector leaders are reconsidering the degree to which they want to be (or should remain) dependent on China for important components in supply chains. China remains central in a number of key areas, including semiconductors, critical minerals, batteries, solar panels, and pharmaceuticals. Last summer, Treasury Secretary Janet Yellen stated that "[W]e cannot allow countries like China to use their market positions in key raw materials, technologies, or products to disrupt our economy or exercise unwanted geopolitical leverage."[3]

But all this does not mean abandoning a relationship with China—far from it. Our economies are deeply intertwined. More broadly, we would not want to decouple from China as there remain advantages both for US exporters and US companies to do business there. And there are many areas—in particular, climate, global macroeconomic policy, global trade, and perhaps others—in which the US and China can and should cooperate to be a force for good, global economic growth, and geopolitical stability.

The principal solution to the China challenge is to reassert US leadership, particularly in the Indo-Pacific region, through building stronger trade relations and better trade resilience in the region and deeper economic integration. More specific detailed solutions involve working closely with US businesses to build robust and resilient supply chains that may be less dependent on one source (such as China), promoting US "friend-shoring" investment, focusing in particular on key economic inputs such as semiconductors and critical minerals, and taking steps to deter a Chinese invasion of Taiwan. Currently, the US imports 92 percent of the most advanced chips from Taiwan, supplies that would be unavailable in the event of a conflict involving Taiwan. If an invasion occurred, US businesses would also be vulnerable from the impact of sanctions on China, such as the US and the G7 countries imposed on Russia.

This Solutions Brief will examine how US companies can take steps to protect themselves against the risk of a severe event and how leaders in the public and private sectors can work together more effectively to meet the challenge of managing our trade and investment relations with China.

Recommendations

Managing the US-China relationship is perhaps the principal geopolitical and economic challenge of our time. The following recommendations focus on the trade and investment relationship, the main area of US-China interdependence, and seek to address the challenges through private and public sector collaboration:

- **Develop a strategic plan on trade and investment.** The principal solution to the China challenge is to respond strategically with a comprehensive policy that leaders in the US government develop in consultation with business leadership. The strategy should first and foremost develop a coordinated, comprehensive approach to trade and investment, which identifies the scope of trade and investment restrictions required based on national security and national priorities, incorporating the recommendations below.
- **Adopt sound economic policies that help preserve the US dollar's preeminent role in the global economy.** The US dollar's status as the global reserve currency is supported by the size and strength of the US economy, its stability and openness to trade and capital flows, and strong property rights and the rule of law. These are all areas that fiscal and monetary policymakers in collaboration with business leaders should target to bolster in order to help preserve the US dollar's preeminent global role.
- **Reinvigorate trade negotiations with China.**
  US policy leaders, with the support of private sector leaders, should:
  - Work with the international community to reinforce the WTO trading guidelines;
  - Reach a comprehensive agreement with China on trade and intellectual property rights;
  - Increase US market access and intellectual property protection, in exchange for removing the current tariffs; and
  - Short of a comprehensive agreement, reinvigorate negotiations on phase two of the US-China trade deal.
- **Reinvigorate the World Trade Organization.** The US should work with its allies and partners to reform the World Trade Organization, in particular its dispute resolution mechanisms, and continue to promote the benefits of an open global trading system.
- **Continue US support for Taiwan,** which is guided by the Taiwan Relations Act, the three US-China Joint Communiques, and the Six Assurances, as a deterrent to Chinese aggression and as a means to prevent war, while also encouraging Taiwanese investment in microchip and advanced technologies in the US.
- **Bolster cybersecurity defense and resilience.** Businesses should bolster their cybersecurity protection and resilience and exercise vigilance against economic espionage and protect their intellectual property.
- **Bolster supply chains for resilience and redundance.**
  - **Business leaders should:**
    - Understand the full extent and costs of supply chains, with an immediate focus on China and Taiwan;

    - Evaluate supply chains in terms of financial and geo-strategic risk and seek to diversify for resilience where possible;
    - Strongly consider reshoring, near-shoring, and friend-shoring opportunities;
    - Consult with US policy leaders to develop policies that address supply chain challenges, risks, and bottlenecks.
  - **Public policy leaders should:**
    - Increase public/private collaboration to solve supply chain disruptions, particularly in strategic sectors;
    - Modernize customs procedures and consider ways to facilitate trade, including user fees for dedicated and express access;
    - Negotiate bilateral and regional trade agreements to address and ameliorate supply chain challenges;
    - Develop alternative and secure supply chains for critical minerals and materials; and
    - Streamline regulation and implement policies to promote investment in the US.
- **Develop guideposts for foreign investment and export controls.**
  - Support foreign investment, which increases job opportunity and exports and improves productivity, provided it meets national security standards, and take action against particular companies only on grounds of national security or intellectual property theft.
  - Continue working with partner countries on assessing the national security implications of investment in key technological sectors and the possible need for further restrictions.
  - Consider whether export control agreements for goods of importance to national security should be more robust and mandatory.
- **Semiconductor restrictions and innovation.**
  - Continue export restrictions on manufacturing materials for advanced semiconductors.
  - Work with allies and partners to ensure a global approach to these restrictions.
  - Foster innovation, including increased R&D in the US, as the best strategy to maintain global leadership in semiconductor technology as well as other critical technologies.
- **Public policy leaders should reinvigorate US trade policy in the Indo-Pacific.**
  - Rejoin the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) to help the US compete in the Indo-Pacific.
  - Establish a private sector advisory council to assist with trade leadership.
  - Lead a coalition with the business community in favor of global trade and the CPTPP, including emphasizing its benefits in every Congressional district.
  - Accelerate the pace on the Indo-Pacific Economic Framework (IPEF) and similar groups for the Pacific island states, Africa, and Latin America by setting clear agendas, goals,

and deadlines, with reciprocal obligations for the US; focus on specific industries as well as thematic pillars; and invite other nations to suggest what they need from the US to make IPEF work.

- **Pursue Areas of Cooperation.**
  - Reinvigorate efforts to work with China on important global issues such as climate, macroeconomics, and geopolitical issues.
  - Work with China on global trade issues.
  - Keep lines of communication open through regular US-China meetings of senior officials.

A Growing Challenge

Attitudes of Americans toward China have become increasingly negative in recent years, and according to a recent Ipsos poll conducted in April 2023 for CED,[4] Americans have a generally hostile view of China, with a plurality (38 percent) viewing China as an adversary and only 18 percent viewing China as an ally or necessary partner. About a third of respondents believe the US has more economic power than China, but 28 percent believe China has more power, and another third (34 percent) believe the countries have equal economic power. Given these figures, it is unsurprising that a large majority of Americans (81 percent) view the current relationship between China and the US as bad.

However, while Americans support almost all trade restrictions with China, including banning Chinese-owned social media companies within the US (57 percent) and restricting the exchange of scientific research between the US and China (52 percent), they do not support barring access to Chinese students to come here. Americans are almost evenly divided on whether the US should focus on building a strong relationship with China (49 percent) or getting tougher with China (47 percent).

The sharp split in Americans' views directly reflects the paradoxical challenges that American business leaders and policymakers are grappling with. Most notably, during the pandemic the growth of US trade with China slowed but did not reverse. The US had a $382.9 billion record trade deficit with China in 2022, even after the pandemic had encouraged some companies to rebalance their supply chains amidst long lockdowns in key Chinese export hubs. US exports to China have risen since the pandemic began, but so have imports, showing our dependence—perhaps our overdependence—on China for many goods.

Even as economic ties have grown, geopolitical tensions—and the potential for conflict—have risen dramatically. This escalation poses the risk of deterring or preventing trade and disrupting trade routes. In the South China Sea, China has continued to assert claims to large portions of the South China Sea, and Chinese coast guard boats and aircraft patrol aggressively, with increasingly close and extremely dangerous encounters;[5] China builds military facilities on reefs in areas claimed by other states,[6] threatening the freedom of navigation on which global trade relies, despite a ruling from the Permanent Court of Arbitration in 2016 that China's claims in the region have no lawful effect beyond what China has under the UN Convention on the Law of the Sea.[7] China is also increasing its efforts at global diplomacy; for instance, it recently helped to broker a very significant reestablishment of diplomatic relations between Saudi Arabia and Iran.

In the economic sphere, China has sought to weaken the US dollar's status as the global reserve currency. The Cross-Border Interbank Payment System, China's alternative to the global SWIFT payments system, processes payments in yuan and has attracted participation from hundreds of banks. Russia is increasingly using the yuan in trade and foreign reserves as a lifeline in the face of Western sanctions.[8] And China and Russia are continuing to promote a new reserve currency based on a basket of BRICS currencies (Brazil, Russia, China, India, and South Africa). As of April 2022, the yuan accounted for only 3 percent of global cross-border trade, but with increasing geopolitical tensions and the US' massive debt and fiscal troubles, the US should not take the dominance of the dollar for granted.[9]

Three "Ts"—tariffs, technology, and the issue of Taiwan—demonstrate the wide-ranging nature of the challenge.

Tariffs

In 2018, the US imposed tariffs on $300 billion of Chinese goods, using Section 301 of the Trade Act of 1974 and separate tariffs on steel and aluminum under Section 232 of the Trade Expansion Act of 1962 as part of a broader effort to impose tariffs on many foreign goods.

While many tariffs on the EU, UK, and Japan have been suspended or removed, those on China remain in place. Aluminum tariffs are a useful example. China subsidizes its state-owned companies, which are then able to sell aluminum at cheaper prices on global markets, crowding out other suppliers. Tariffs help redress this and thus support US jobs that would otherwise be at risk.

But China has retaliated with tariffs of its own, particularly on the agriculture sector, hurting US exports. Clearly the tariffs have done little to reduce trade with China—they simply make Chinese products more expensive in the US and US products more expensive in China. For now, the US is offering businesses the chance to seek relief[10] from the tariffs and rejected the World Trade Organization (WTO)'s decision that the steel and aluminum duties broke global trade rules.[11]

In March 2022, the bipartisan US International Trade Commission issued a report on the impact of the tariffs.[12] The review found that most of the costs of the tariffs are borne by US importers, with price increases for goods in industries such as computer equipment, semiconductors, and furniture rising by up to 25 percent, while prices of US goods rose 3–4 percent in response. However, imports on goods subject to tariffs declined from $311 billion in 2017 to about $265 billion in 2021. Overall, the Commission found that the tariffs lowered Chinese imports 13 percent but only raised US output 0.4 percent and increased the prices of US products by 0.2 percent. Many US exporters, however, continue to support imposition of the tariffs as necessary to help them compete.[13] The US Government is continuing its assessment of whether to lift some or all of the tariffs. Further, China and the US should reinvigorate negotiations on phase two of the US-China trade deal.

What would it take to remove the tariffs? Should they be removed? Reforming the WTO is critical so that WTO rules can be enforced for all sides. Further, China and the US should pursue a comprehensive agreement on trade and intellectual property rights, increasing US market access and intellectual property protection. Then, the tariffs can be removed in exchange for a broader resetting of the bilateral trade relationship.

Technology

While the US remains the most advanced and innovative economy globally, from some perspectives, China is gaining advantages over the West in certain areas of technology. The Australian Strategic Policy Institute released a study showing that China has a "sometimes stunning lead" in 37 of 44 critical technologies in areas such as defense, space, robotics, energy, advanced materials, AI, and quantum technologies. The US leads in the other seven (advanced semiconductors, quantum and high-performance computing, vaccines, small satellites, space launch systems, and language processing),[14] concluding that "Western democracies are losing the global technological competition, including the race for scientific and research breakthroughs," raising the risk of "ceding global power and influence" to China. The report attributes this success to "deliberate design and long-term policy planning." The report also noted that while almost 70 percent of the most-cited authors were trained in China, 20 percent of those researchers had postgraduate training in the US, UK, Australia, Canada, or New Zealand—and then moved or returned to China to continue work.

Responding to this threat will require a multifaceted approach. This begins with a greater focus on STEM education in the US, raising both public and private investment, using the $81 billion of science-focused incentives in the CHIPS and Science Act wisely through public-private partnerships,[15] securing technology supply chains, preventing illegal technology transfers, and expanding collaboration among Western countries in advanced research. Implementation of the CHIPS Act, including its multibillion-dollar subsidy program, will require careful attention from the executive branch at all stages of the contracting process and congressional oversight. The ideal use of the funding is to serve as a catalyst for further *private* investment in the semiconductor infrastructure, along with subsidies to build fabrication plants. Also, while it is fundamentally important for US growth and prosperity to continue to be a magnet for scientific and engineering talent from around the world, US universities and companies and the Departments of State and Homeland Security will also need to adhere to oversight guidelines regarding Chinese students and researchers and those from other countries of concern in the fields of science, technology, engineering, and math to ensure that the strongest protections are in place to safeguard US national security and intellectual property.[16]

Last July, in an unusual joint statement, the FBI and MI5 (the UK's domestic intelligence agency) warned that China is ramping up efforts for economic espionage against Western companies, including through both hacking and active agents. The agencies called on the private sector, including technology companies, to exercise increased vigilance in this area.[17] This is an urgent task for US business, particularly in sectors of the economy involving advanced or strategic technologies.

Taiwan

The principal flashpoint in the US-China relationship, however, remains the status of Taiwan, which China claims as "the bedrock of the political foundations of US-China relations and the first red line that must not be crossed in US-China relations."[18] Reunification remains China's primary and longstanding cross-strait policy goal. Taiwan produces about 65 percent of global semiconductors and about 90 percent of advanced semiconductors.[19] The risk of a Chinese invasion is already influencing global investors' decision-making, with some investors already reducing their overall exposure to China for geopolitical reasons.[20] This provides an opportunity for the US to attract some investment that might otherwise have gone to China or for that investment to move to other countries.

The US does not favor Taiwan's independence and has not changed its "One China" policy but opposes changes in the status quo by force; in the event of an "unprecedented attack" on Taiwan, the president has said the US would come to Taiwan's defense.[21] China has reacted strongly to this declaration.

The US should continue support for Taiwan, which is guided by the Taiwan Relations Act, the three US-China Joint Communiques, and the Six Assurances, as a deterrent to Chinese aggression and a means of preventing war. The best way to deter a blockade or invasion is through defense, both strengthening Taiwan's own defenses and the US working with allies in the region to deter an invasion. Beyond this, the US and Taiwan should continue their current efforts to expand trade and investment ties.

Competition for Trade and Investment: China's Belt and Road Initiative

Global economic competition with China is growing. China's Belt and Road Initiative (BRI), announced in 2013, now counts 151 countries around the world as participants, even including NATO allies Italy and Greece. The infrastructure projects the BRI funds are, quite simply, designed to enhance China's prestige and influence in these countries, steer trade towards China, make these countries more dependent on China, help China dominate key global markets, and expand its capacity to project its military power.

China has also moved aggressively towards a greater role in exploitation of natural resources globally, particularly in Africa, focusing on minerals such as lithium, cobalt, copper, and platinum and controlling mines and ports, with a preference for supplying the Chinese market rather than helping developing countries become global exporters. Often, Chinese projects are built by Chinese workers rather than providing jobs for locals, helping China's unemployment but causing resentment in host countries.

The problem is compounded because lending for BRI projects encourages these countries to become indebted to China. If their economies slow, managing the debt repayments becomes more challenging, leading to a greater risk of default. But to avoid defaults, China, as a principal creditor, effectively has a veto over the country's policies and can stall global debt negotiations, tying the hands of the International Monetary Fund in addressing the crisis, essentially forcing the rest of the world to bail out countries for the benefit of China.

Global Dependence on China

The economic challenge China poses is perhaps nowhere more visible than in supply chains. The Annual Threat Assessment of the Director of National Intelligence[22] addresses the issue of supply chains directly, stating that "China is capable of leveraging its dominant positions in key global supply chains in an attempt to accomplish its goals, although probably not without significant cost to itself," pointing to China's use of leverage to promote forced technology transfers and to President Xi's remarks in April 2020 that China wants control of supply chains so that it could "use those supply chain dependencies to threaten and cut off foreign countries during a crisis." The report also noted that an invasion of Taiwan "would have wide-ranging effects," in particular for global semiconductor supply chains. More basically, pandemic shutdowns illustrated the risk to global supply chains from links that are unavailable to firms that need these inputs[23] and the imperative to avoid the danger of an asymmetrical relationship in which China enjoys market access to the West that is not reciprocated.

Overall, about 40 percent of global trade is "concentrated," meaning that importing economies rely on three or fewer partners for imports of a particular good or commodity.[24] Some of these partners could be substituted relatively easily (for instance, an economy that buys grain principally from one country may be able to switch suppliers fairly easily, even if costs rise); others, for instance, the global market for rare earth minerals—on which China blocked exports to Japan in 2010 and threatened to reduce exports to the US in 2019—are not. Concentrated trade requires that businesses look carefully at their global supply chains for potential vulnerabilities.

China is dominant in a number of markets important to the modern economy. Consider green energy. The International Energy Agency claimed that China manufactures over 80 percent of solar panels and dominates solar photovoltaic global supply chains at all levels and has called for diversification of both raw material and finished products in this area that are important for the green energy transition.[25] China is also the second-largest producer of electric batteries; in conjunction with that, because of its local supply chains, it "controls 92 percent of processed materials, 71 percent of cell assembly, and 65 percent of battery components used in electric vehicles."[26]

The German insurer Allianz found that China "is a critical supplier of 276 types of goods for the US," but the US is a critical supplier of only 22 types of goods for China. Worse, the study found that "as recently as 2018, the US' critical dependence on China was around half of what it is today in GDP terms (now 1.3 percent).[27] In other words, during the period since the US imposed significant tariffs on China, the US' trade dependency on China has increased, not decreased—precisely the opposite of what tariffs normally do. Further, many of the most globalized sectors Allianz analyzed are the ones with greatest exposure to China and thus at potentially greatest risk from trade disruptions.

Strategic sectors for the United States include, at a minimum, semiconductors, strategic and critical minerals, telecom and 5G infrastructure, equipment for the green energy transition, and active pharmaceutical ingredients, as well as the defense industrial base. In these areas, a focus on supply chains is particularly important and in some areas, such as the defense industrial base, domestic production is critical to national security; if necessary, waivers of statutory provisions are justified to ensure robust and resilient supply chains.[28] Increased public-private communication and collaboration on supply chain resilience is essential if the US is to build supply chains involving reshoring, near-shoring, and friend-shoring that do not distort markets but ensure the smooth production of essential goods and functioning of the economy.

Bilateral and regional trade agreements of all types, ranging from industry-specific cooperation, such as the US' semiconductor agreement with Malaysia, to bilateral free trade agreements to regional free trade agreements, such as the US' CAFTA-DR agreement with five Central American nations and the Dominican Republic, will help shift supply chains away from dependence on single sources. And the US, working with industry, should clearly define what sectors have importance for national security, such as during the Cold War with the Soviet Union. A well-thought out and coordinated approach to trade and investment based on national security and national priorities will work far better than ad hoc approaches by Congress, the administration, or private businesses.

Dependence on China for critical minerals

Minerals ranging from lithium for electric vehicle batteries to copper for semiconductors and wind turbines to rare earth minerals used in smartphones are the foundation of an advanced economy. The Interior Department maintains a list of minerals, currently at 50, that are considered "critical" to the US industrial and defense base, developed from criteria in the Mineral Policy Act of 1970 and Section 7002 of the Energy Act of 2020.[29] The list does not include every mineral of importance to the US economy (for instance, copper, important for the green economy and other industries, is not included thanks to its abundance in the US). It does include the "rare earth" minerals, essential components of products ranging from wind turbines and electric vehicle motors to mobile phones, as well as lithium, platinum group metals, and others. Given their importance to production of clean energy technology, global demand for these minerals is expected to grow at very high rates.

China is the principal global supplier and processor of rare earths, though other suppliers are rising in importance. From 2018–2021, China was responsible for 74 percent of rare earth mineral imports into the US, with Malaysia accounting for 8 percent and Estonia for 5 percent. Imports of rare earths to the EU from China jumped from under 10 tons to over 30 tons between 2020 and 2022.[30] The US Geological Survey estimates that China has about 44 million tons of reserves of rare earth oxides; Vietnam is second at 22 million tons; other major holders of reserves include Russia and Brazil; the US has only about 2.3 million metric tons of reserves.[31] Currently China accounts for about 61 percent of total mining of rare earths; the US is second at about 15.5 percent, with at least one potential major new deposit in Texas including 16 of the 17 rare earth minerals as well as lithium, gallium (used in semiconductor chips), and other minerals.[32] Other major producers include Myanmar (a country now under US sanctions) and Australia (8.0 percent).[33]

Key to solving the dependency is investment by the private and public sectors in R&D to develop alternative technology that can replace critical minerals, as well as finding alternative sources in the US and its allies and partners. While much more needs to be done, there are several initiatives in the US government designed to promote better access to critical minerals for US needs. The Energy Department's Critical Minerals and Materials Strategy[34] seeks to diversify suppliers, develop alternatives to critical minerals and materials, and invest in the circular economy as well as promote domestic supply chains for rare earths. More broadly, the president signed an executive order to examine the supply chains for critical minerals and promote a "Made in America" policy where possible.[35] The administration is also using $675 million funded by the Infrastructure Investment and Jobs Act to address vulnerabilities in the domestic supply chain for critical minerals and materials, expand development and commercialization of new technologies, and fund research on critical materials, particularly for manufacturing of clean energy technology.[36] Working in cooperation with the private sector, the administration should continue to develop its critical minerals strategy, better understand US deposits of rare earths, and promote both domestic and global critical minerals supply chains for resilience.

Diversification

Diversification is a natural solution to supply chain dependence. To some degree, this is happening already, as customers demand access to the inputs they need, and this may require sourcing from multiple sources or countries rather than just one, where possible. China, for its part, wants to keep supply chains domestically focused, both to meet China's own demand and to exercise greater control over global commerce.

There are three basic options for a US firm considering supply chain redesign: reshoring (moving production to the US), near-shoring (moving production to Canada, Mexico, or a nearby country with which the US has a free trade agreement), or "friend-shoring."[37] Friend-shoring involves shifting supply chains to "trusted" allies in the hopes of avoiding geopolitical conflict and building supply chains for resilience—"free but secure trade."

Whether from pandemic-induced shortages or broader geopolitical concerns, US businesses are reacting. A report in November 2022 from consulting firm Deloitte found that 62 percent of large manufacturers it surveyed had begun reshoring or near-shoring production capacity, with a potential impact in 2022 alone of adding 350,000 US jobs.[38] Globally, a study from HSBC bank and the Toluna consulting firm showed that 42.2 percent of [global] firms said supply chain transformation was a priority for 2023; another 46.7 percent called it a priority for the future, and only 11.1 percent said it was not a priority.[39] Similarly, in The Conference Board's 2023 C-Suite Outlook, US CEOs ranked supply chain disruptions fifth on their list of high-impact issues, dropping from third in 2022.[40]

Is diversification possible, in the near term?

Most assessments of the time it would take to diversify from China give very long lead times. As companies determine whether to onshore and shift R&D efforts to develop alternative products, there may be more viable near-term options for diversification. To measure the extent to which the US could realistically shift supply chains more quickly in areas where it is dependent on China, The Conference Board looked at categories of imports from China in 2022 for which China's share is very large, plus the strategic categories of semiconductors and other electronic equipment and rare earth minerals. It determined the second and third contributors to US imports of these goods and then estimated the degree to which diversification is possible.

Table 1 shows the relevant sectors and possible alternative sources of goods. The results are mixed but show positive signs. In every category except textile mill products and semiconductors and other electronic equipment, Mexico or Canada was either the second or third largest exporter to the US (and in some cases both second and third), offering the potential to increase these exports. For the category of basic chemicals, Ireland was second and Canada third. For some categories where China's share is particularly large, including textile mill products, boilers and shipping containers, computer and communications equipment, household appliances, and electric lighting equipment, diversification will likely be more difficult. The US will have to continue to depend on China for these supplies or explore options of either making them in the US at higher cost or beginning the process of seeking other sources for these goods, which could require those countries developing supply chain infrastructures of their own to supply them. The process will likely be easier depending on the level of sophistication of the product and the degree to which it requires many inputs and large supply chains. For instance, diversification of textile products and electric lighting equipment will likely be easier than for computer equipment.

Table 1

Dependence on China:
Top three importers' shares for key commodities, December 2022

NAICS 314	TEXTILE MILL PRODUCTS
China	49.0%
India	17.2%
Pakistan	6.5%

NAICS 323	PRINTED MATTER
China	43.4%
Canada	12.5%
Mexico	7.8%

NAICS 3251	BASIC CHEMICALS
China	18.0%
Ireland	12.6%
Canada	11.6%

NAICS 3261	PLASTICS PRODUCTS
China	37.9%
Canada	15.0%
Mexico	10.9%

NAICS 3324	BOILERS, SHIPPING CONTAINERS
China	43.0%
Mexico	13.5%
Canada	7.8%

NAICS 3341	COMPUTER EQUIPMENT
China	46.1%
Mexico	27.1%
Taiwan	8.4%

NAICS 3342	COMMUNICATIONS EQUIPMENT
China	49.3%
Vietnam	18.8%
Mexico	8.2%

NAICS 3344	SEMICONDUCTORS/OTHER ELECTRONIC EQUIPMENT
Taiwan	17.1%
Malaysia	16.6%
China	13.0%

NAICS 3351	ELECTRIC LIGHTING EQUIPMENT
China	55.1%
Mexico	14.1%
Canada	5.3%

NAICS 3352	HOUSEHOLD APPLIANCES
China	46.1%
Mexico	22.5%
South Korea	8.3%

NAICS 3369	TRANSPORTATION EQUIPMENT
China	28.8%
Taiwan	16.6%
Mexico	14.8%

	RARE EARTH MINERALS
China	74%
Malaysia	8%
Estonia	5%

*2018-2021 figures. Rare Earth Minerals does not have a separate NAICS category.

Sources: US Census Bureau, 2022; US Geological Survey, 2023

Of course, any US business must make its own supply chain decisions based on a number of factors, including cost, quality, reliability of supply, and the length of its supply chains. These decisions are often not easy. But the prevalence of Canada and Mexico among major suppliers in important industrial sectors shows that diversification is possible, in the nearer term.

However, the difficulties of shifting supply chains rapidly should not be underestimated. While many countries wish to obtain investment moving from China, and while many Western businesses have adopted "China+1" or "China+2" strategies to build resilience in supply chains by moving some operations to countries such as Vietnam or Indonesia, it is not always easy,[41] and it involves increased cost, particularly with regards to labor, which adversely affects inflation. If manufacturing supply chains still depend on precursor materials that are only obtained from China, by definition the supply chain still depends on China. China still maintains a production cost advantage compared to many of its competitors for investment (and to the US). One estimate suggests it costs 44 percent more to produce semiconductors in the US than in Taiwan (which itself has a higher cost base than China).[42]

There is one particularly bright spot in this picture: Mexico. Mexico has benefitted in recent years from a strong near-shoring trend, with global exports in September 2022 reaching a record $52.3 billion and $578 billion for the year—about what China exports to the US. China, too, has invested heavily in Mexico, partly for its own push into Latin America and partly as a way to reach the US market without tariffs under the United States-Mexico-Canada Agreement (USMCA), with investment levels reaching almost $500 million in 2022. The US takes 80 percent of Mexico's exports, including computers, cars and parts, commercial vehicles, and oil.[43] This is good news for the US, as Mexico is moving up the value chain making ever-more sophisticated products and becoming far more integrated into North American supply chains than ever before. This demonstrates that near-shoring works. Now, both US and Mexican businesses should find more ways to collaborate, build continental supply chains, and help grow Mexico's industrial base. The US also remains the largest investor in Canada, at over $500 billion.

US investment in India exceeded its prepandemic peak at over $45 billion in 2021. But for India to succeed as a major destination for international foreign investment, it will need to improve its own domestic supply chains, an area where China has a clear advantage. One estimate, from Bloomberg Intelligence, suggests that it could take eight years to move just 10 percent of Apple's production of iPhones outside China, given the extensive local supply chain that has sprung up around Apple's facilities.[44] Replicating this supply chain would be challenging—a testament to China's dominance in certain global markets. India will also need to improve its often confusing and restrictive policies toward foreign investment to make India more welcoming and friendly to foreign businesses.

Foreign Investment: Follow and Enforce Guidelines from the Committee on Foreign Investment in the United States (CFIUS)

In most circumstances, the US should welcome foreign investment, which leads to jobs and greater trade. That said, Chinese investment in the US is controversial, and can present risks to national security. Consequently, investment in high technology sectors, both by China in the US and the US in China, is increasingly under close scrutiny. For example, earlier this year an assistant secretary of the Air Force wrote that a proposed corn mill near Grand Forks Air Force Base in North Dakota "presents a significant threat to national security"[45] because of the potential for surveillance of a military site housing, among other missions, the US' High Frequency Global Communications System and a major defense laboratory. In response, North Dakota's Senators are seeking an American company to undertake the project.[46]

Even cranes used at ports—cranes that help import Chinese goods—could be used for spying through sensors tracking the movement of containers that could potentially be controlled remotely. "Cranes can be the new Huawei," according to one former US counterintelligence official, "the perfect combination of legitimate business that can also masquerade as clandestine intelligence collection."[47]

Another controversial issue in recent years has been the popular app TikTok, owned by ByteDance, a Chinese company, the use of which is prohibited on mobile devices owned by the US Government, over 25 US states, Canada, and the European Commission. The main reason for the prohibition is concern about security,[48] including the possible transmission to China of geolocation data and all other personal data. The central issue is the main one that stalks all Chinese companies—the issue of the control of the Chinese government. Questions surround the security of data of the over 100 million TikTok users in the US. Other concerns about data security include how data can be accessed and by whom, whether and how data storage should be limited to the US, and whether the company should be sold. Whatever the facts (currently under investigation) are regarding TikTok's use of data, the risks of sale or misuse of personal data are real, as numerous cyber incidents have shown.

In response, Congress passed the "No TikTok on Government Devices Act" in December; at the time, CIA Director William Burns said that China could "insist upon extracting the private data of a lot of TikTok users in this country and also to shape the content of what goes on to TikTok as well to suit the interests of the Chinese leadership." Commerce Secretary Gina Raimondo recently said that it is dangerous to ban a particular company; instead, the better approach is to identify and assess risks, taking action where necessary."[49]

Should the US impose sanctions on particular companies? Yes, if the issue provoking sanctions can be isolated to the behavior of one company, rather than assuming that an entire industry or a particular technology itself poses a danger. An approach giving discretion to the executive branch to evaluate the risks, consistent with the current approach of the interagency Committee on Foreign Investment in the United States (CFIUS) giving the private sector an opportunity to make its case, rather than legislation targeted at a particular company, seems the best approach in dealing with threats regarding foreign investment in the US.

More broadly, in September the president issued an executive order on evaluating national security risks in foreign investment.[50] The order notes that the US "commitment to open investment is a cornerstone of our economic policy" when that investment is "consistent with the protection of national security." It orders CFIUS to consider transactions that might put the data of US citizens and businesses at risk and risks arising from cybersecurity. This is a tightening of rules on foreign investment but one that reflects clear concerns about US national security, including economic security. And the US is considering restrictions in other key technology sectors.

The same national security focus should apply with respect to exports. During the Cold War, 17 Western countries, including the US, operated a Coordinating Committee for Multilateral Export Controls (CoCom), which implemented an embargo on products for countries in the Soviet Union and countries in the Soviet bloc. Both exports to and investment from these countries were subject to strict regulation. Following the end of the Cold War, CoCom was replaced in 1996 by the Wassenaar Agreement[51] which includes 42 countries and focuses on "dual use" technologies capable of military application. However, the Agreement is not legally binding, as CoCom was, with veto power over certain technology transfers.

Even more broadly, therefore, Western nations will likely have to consider whether both restrictions on foreign investment and export control agreements for goods of importance to national security, such as semiconductors and items capable of military use, should once again be made more robust and mandatory, along the lines of the CoCom agreement.

National Security Restrictions on Semiconductor Exports

In October 2022, in one of the largest shifts of US technology policy in decades, the administration announced new US export controls on semiconductors and AI technology. These controls included export restrictions on some supercomputing chips and tighter sales restrictions on some semiconductor equipment but primarily focused on China's abilities to produce advanced military systems including weapons of mass destruction; improve the speed and accuracy of its military decision making, planning, and logistics, as well as of its autonomous military systems. They also addressed China's continued human rights abuses.

The new policy includes the application of the Foreign Direct Product Rule, under which the US must approve the re-export of foreign produced items located outside the US "when they are a 'direct product' of specified 'technology' or 'software,' or are produced by a plant or 'major component' of a plant that itself is a 'direct product'" of that specified technology or software.[52] The US has used this Rule in 2020 against Huawei Technologies,[53] including non-US Huawei affiliates and broadly against Russia in response to the invasion of Ukraine; it has also threatened its use against China again if China provides arms or other military equipment to Russia.

Recognizing the risks of acting alone, the administration reached agreement with Japan and the Netherlands to restrict exports of advanced semiconductor equipment as well, covering the major producers in those countries.[54] The "Chip-4" group (US, Japan, South

Korea, Taiwan) should develop greater coordination on export controls and an early warning system for chip shortages.[55]

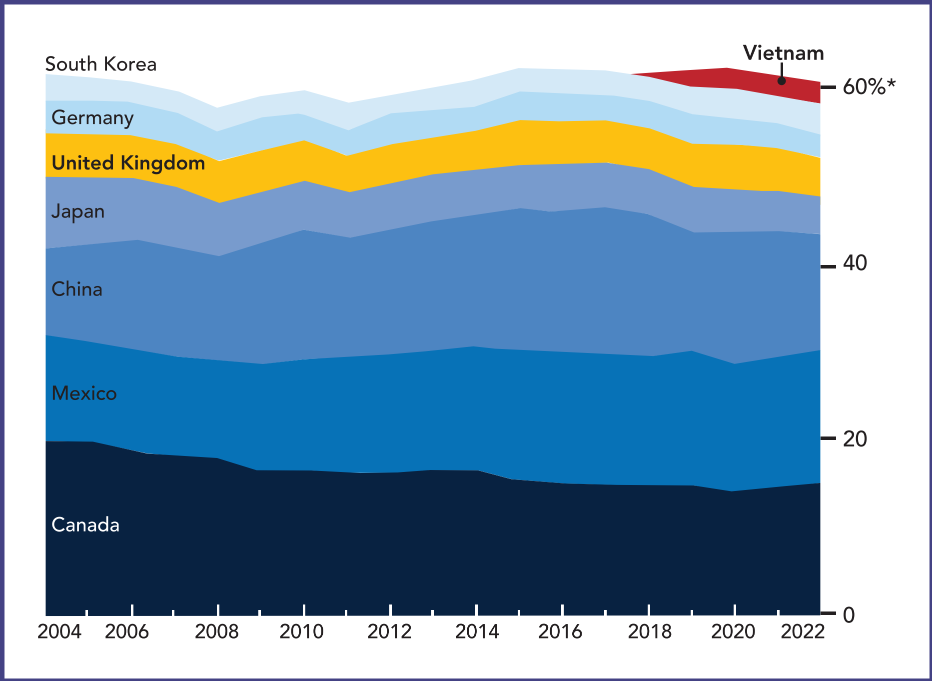
The restrictions are significant, and some analysts believe that it will take considerable time (and vast expense) for China to catch up. In 2018, one Chinese company built a machine that could make 90 nanometer semiconductors, many generations behind that of global leaders. China has recently embarked on a $140 billion effort to spur and subsidize greater domestic semiconductor manufacturing.

The sanctions are a powerful tool to slow China's advanced chipmaking capability. Ultimately, though, fostering greater innovation here is the most important part of a strategy to maintain global leadership in this and other critical technologies.

US Trade Policy in the Indo-Pacific

"The Big Seven"

Vietnam is now among the US' seven largest good trading partners



*Share of total goods trade; 2022 is through October

Sources: Bloomberg News, 2022; US Census Bureau; The Conference Board, 2023

A global economy built on the foundation of open trade remains essential to US national and economic security interests and requires renewed US leadership in trade. Nowhere is this truer than in the Indo-Pacific. The single most important task for US trade leadership in the region is to launch discussions to join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).[56] The CPTPP was formed, on a Japanese initiative, among countries committed to open trade in the region once the US withdrew from the Trans-Pacific Partnership (TPP)[57] in early 2017. Many chapters of the CPTPP have essentially the same text as the TPP—but *without* concessions that had been made to the US in key areas such as intellectual property, agriculture, and film. Its chapter on small and medium enterprises was designed to help smaller exporters take advantage of new opportunities in the region. Common rules of origin and verification were designed to help build resilient supply chains.

CPTPP includes some Latin American countries such as Mexico and Chile with which the US has free trade agreements and other countries such as Vietnam, which is now on par with the UK in its share of US merchandise trade.[58] The United Kingdom has recently completed negotiations to join CPTPP as well.[59]

CPTPP members are reducing trade barriers among themselves, but they face a rival: the Chinese-led Regional Comprehensive Economic Partnership (RCEP),[60] which brings together the countries of East and Southeast Asia, including US allies Japan, Korea, and Australia, in a tariff-reducing bloc, even as they also belong to CPTPP and the US-led Indo-Pacific Economic Framework (IPEF). In this situation, now the challenge will be to avoid distorting trade in China's favor or away from the US.

Notably, in 2016, the Peterson Institute for International Economics estimated that TPP would raise real US national income $131 billion annually by 2030 and increase US exports $357 billion per year, while raising wages for US workers on average. Importantly, the economists also found that the US would receive the most benefit of any TPP country and that the impact of delay of TPP entry cost the US an estimated $94 billion per year.[61]

As such, it is time to negotiate our reentry into the process and resume our leadership in trade in the region. Doing so will benefit many sectors of the US economy and help US businesses develop robust and resilient supply chains with products that meet high standards. The business community has a clear and strong responsibility to lead a coalition in favor of global trade and the CPTPP, including emphasizing its benefits in every congressional district.

Without the benefit of a traditional market access free trade agreement, the US is forced to adopt other methods of seeking to increase US trade in the region, promote high standards, and compete with China.

IPEF was formally launched in May 2022.[62] It includes 13 countries (Australia, Brunei, Fiji, India, Indonesia, Japan, South Korea, Malaysia, New Zealand, the Philippines, Singapore, Thailand, and Vietnam) that account for about 40 percent of global gross domestic product and allows for other "Indo-Pacific partners that share our goals, interests, and ambitions for the region" to be invited to join.

Unlike traditional trade agreements such as the CPTPP, the IPEF will not negotiate tariff reductions or market access issues (although it has now adopted a trade pillar). Instead, a summit of IPEF trade ministers in Los Angeles in September 2022 identified four pillars for work: sustainable trade, stable supply chains, decarbonization and infrastructure, and taxes and anticorruption. However, India decided not to participate for now in the trade aspects of the framework. While the US declared that IPEF members are "really comfortable and excited about the model" and that operating through an executive agreement, rather than a trade treaty that would face Senate ratification, "will be durable and lasting,"[63] it is hard to escape the conclusion that the US remains behind in the region and is still on a slower track than China to increase regional trade.

IPEF (and similar efforts for Pacific island states, Africa, and Latin America) suffer from several principal weaknesses. First, they do not open markets as traditional trade agreements do and thus cannot really compete with those trade agreements such as the RCEP which lower tariffs. Second, they are vague and do not necessarily commit the US to further action, leading to potential drift. Third, they need to be accompanied by other efforts, including funding to raise standards of all types and help other countries integrate more deeply with US supply chains. The focus on supply chains, in particular, should include common standards on rules of origin and verification.

To revitalize IPEF and similar efforts, several steps should be taken. First, set clear agendas, goals, and deadlines, perhaps starting with efforts at trade facilitation such as work on customs clearance and tax matters, with reciprocal obligations for the US. Second, focus on particular industries as well as thematic pillars, for instance, health infrastructure or telecommunications in addition to clean energy. Third, invite other participants to make specific suggestions as to what they need from the US within the IPEF context, either on a bilateral or multilateral basis—and then act on those recommendations.

The US is behind China in the global race for infrastructure development, broadening trade ties in the Indo-Pacific and elsewhere, and emerging standards. It is time to reengage and show leadership in all aspects of global trade, including traditional market access agreements.

Areas of Cooperation

It is vital both to our national interest and to the world that the US and China collaborate with China in areas of mutual interest. Climate is a prominent example. China is the world's largest emitter of carbon dioxide and other greenhouse gases, accounting for 31 percent of global emissions (more than all developed countries combined) in 2021,[64] and China is continuing to build coal-fired plants even as it pledges to be net-zero by 2060, ten years later than the Paris Agreement global goal.

China suspended collaboration with the US on climate last summer in retaliation for Speaker Pelosi's visit to Taiwan, although the two issues were unrelated. There are some signs that cooperation is being renewed; China's climate envoy Xie Zhenhua held an informal meeting with US climate envoy John Kerry on the margins of the COP-27 climate summit. But Xie noted China's position that the US had to take "responsibility" to "clear the barriers" to the resumption of formal climate talks between the countries. Treasury Secretary Janet Yellen and former Chinese Vice Premier Liu He agreed in January 2023 that the countries should discuss global climate finance. These are positive steps, but more should be done. China's leadership in clean energy technology carries a responsibility to help reduce global—and Chinese—emissions quickly.

More broadly, the world's two largest economies should work together, including greater and more regular communication on global macroeconomic and financial issues. These talks may be candid, but they must be held. As Secretary Yellen said in meeting former Vice

Premier Liu in January, "[w]hile we have areas of disagreement, and we will convey them directly, we should not allow misunderstandings, particularly those stemming from a lack of communication, to unnecessarily worsen our bilateral economic and financial relationship." Liu responded positively that "[w]e do believe that we have to always bear in mind the bigger picture, try to manage our differences appropriately and seek common ground... hopefully we can work together to maintain the overall stability of Chinese-US relations."[65] The IMF has estimated that dividing the world into economic blocs would cost the global economy $1.4 trillion annually, with larger impacts in some poorer countries.[66]

Continued dialogue with China is also important, however difficult, on geopolitical issues. North Korea is a prime example. Regular meetings between the US and China on the subject are important, even if little progress is apparent.[67] Given the ever-growing risk of confrontation in the South China Sea, reasserting US policy in the region and reaffirming the fundamental right of freedom of navigation, is essential. Strong ties in the Indo-Pacific will reinforce the US position.

Other global issues on which US-China cooperation are possible include strengthening global institutions, for instance actively promoting reform of the WTO, in particular its dispute resolution mechanisms. This will help both US and Chinese exporters and reaffirm the importance of global trade. Despite current tensions, it should also be possible for the US and China to cooperate on steps to prevent future global pandemics. Regular meetings between US and Chinese officials, in particular the Departments of State, Treasury, Defense, and Commerce, are essential to maintain lines of clear communication and increase understanding that will help deter conflict and promote cooperation for mutual benefit where possible. Despite the challenges, stabilizing relations with China is in the interest of both the US and the world.[68]

Meeting with President Xi last November, President Biden said "[t]he world expects, I believe, the US and China to play a key role in global challenges, from climate change to food insecurity, and for us to be able to work together. The United States stands ready to do just that. In response, President Xi said that "China-US relations currently face a situation that is not in the interests of the two countries, their peoples, or the expectations of the international community. As the leaders of China and the United States, we must take the helm and steer the bilateral relationship in the right direction."[69] At the same time, another US official noted that "[t]he only thing worse than having contentious conversation is having no conversation at all." Recognizing the full dimension of the challenges in the relationship is in fact the best reason to hold regular talks and keep lines of communication open to prevent misunderstandings that make relations worse and conflict more likely.

Conclusion

Neither US policymakers nor US businesses should underestimate the multifaceted challenge the US faces in our economic and strategic competition with China. But that is no excuse for inaction or drift. The US-China relationship will influence the course of the 21st century. How we respond will affect our own prosperity and the lives of billions of people around the world. Robust US engagement both with China and around the world, including strong American leadership, offers the best plan to avoid the "new Cold War" or at a minimum, temper its impact on economic growth.

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