The New Reality of Economic Statecraft

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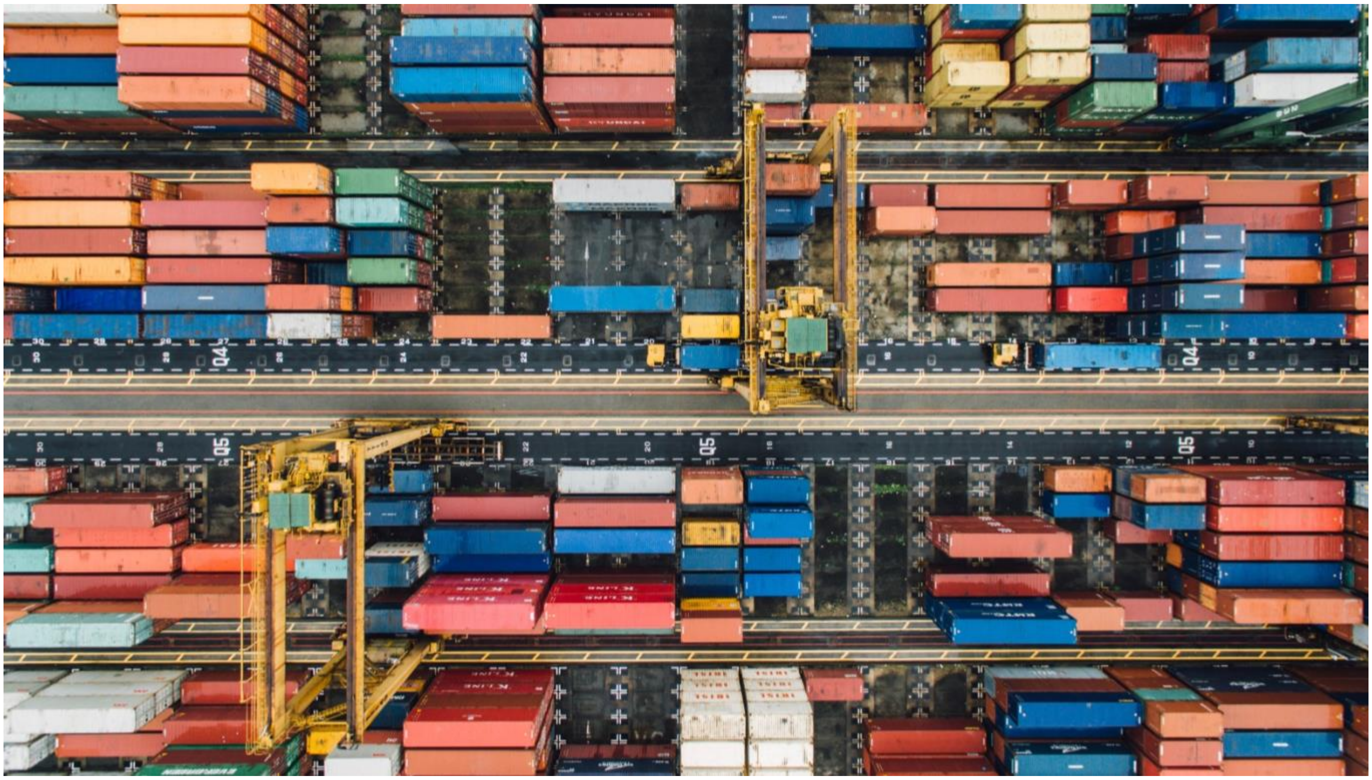

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The August 2022 Taiwan crisis appears to be a classic clash between near peer adversaries. To pressure Taiwan after U.S. Speaker of the House Nancy Pelosi's visit, China launched a series of military exercises from Aug. 4-10, which included deployment of an aircraft carrier, a nuclear submarine, bombers and missile launches. These exercises took place in waters surrounding Taiwan and appear to represent preparation for an eventual invasion of Taiwan. The G7 criticized China's actions, but China appears to be undeterred. Despite direct U.S. criticism, Washington did little to respond to Chinese actions.

What do Beijing's actions portend for what we have dubbed "new economic statecraft" – state intervention to influence trade, investment and industrial policy, rather than the traditional focus on economic statecraft that emphasizes policies related to economic sanctions? [1] Has new economic statecraft already become passé in the face of hardcore military tensions?

In short, no. We argue that although understanding the domestic and international politics leading to an increasingly tense military context is essential, economic statecraft is increasingly relevant – both for China and Taiwan as well as for the global economy more broadly.

The clash between China and Taiwan has far reaching consequences for the pursuit of economic statecraft. Here, we focus on the potential disruption of global supply chains, continued trade conflict and accelerating efforts to regulate cross-border flows of investment in the context of a renewed emphasis on industrial policy, primarily in the context of U.S.-China relations. From our perspective, the view that the shift from the Trump administration to the Biden administration would herald a return to a globalized world after a protectionist interlude has proven false. Rather, we see much greater continuity in American policy as it pertains to economic statecraft and the likely continued fragmentation of the global economy.

Threat to global supply chains

Although the most immediate concerns in the aftermath of the recent Taiwan crisis have dissipated, analysts argue that tensions between Taipei and Beijing have been escalating more generally, and that the recent crisis is a manifestation of growing conflict, which will likely result in a significant disruption to global supply chains in the future.

Taiwan is a crucial link in global technology supply chains. Indeed, the Taiwan Semiconductor Manufacturing Co. (TSMC) accounts for 90 percent of the world's cutting-edge chip capacity, while downstream electronic contract manufacturers such as Foxconn produce components and assemble products for some of the world's biggest companies. Specifically, Interos's global relationship-mapping platform reveals that hundreds of thousands of U.S., European and East Asian firms rely on Taiwanese suppliers for parts including semiconductors, software, chemicals and other electronic equipment.[2]

Second, the Taiwan Strait represents a chokepoint for global shipping – particularly when the Luzon Strait is impacted by bad weather.[3] Best estimates suggest that nearly 50 percent of global container ships transited through the strait this year.[4] If the Taiwan crisis translates into a hot war, global supply chains will undoubtedly be disrupted,

Unsurprisingly, a great deal of commentary has focused on the effect of a potential conflict on the global supply chain for semiconductors, and the central role of TSMC – particularly for advanced processors with 5-nanometer and 7-nanometer transistors. Drawing insights from a wargame scenario, global consulting firm IHS concluded that "any significant disruption to semiconductors production or transportation logistics to key markets would create significant shockwaves to various industries, such as electronics and auto manufacturing."[5] With the global semiconductor industry "already facing significant backlogs in its new orders pipeline," these production shortages are expected to continue in the foreseeable future.[6]

And while many countries have been promoting their own domestic chip industries while TSMC itself has expanded its operations beyond Taiwan, this is unlikely to lead to an immediate resolution of industry concentration and reliance on Taiwan.

Continuing trade tensions

Beyond the prospects of a proximate Taiwan crisis, broader trade disputes between Washington and Beijing have continued.

First, the Phase One trade accord is failing to live up to its promise – with the Covid-19 pandemic coupled with looming economic challenges in China contributing to the agreement failing to deliver on its promise.[7]

Moreover, tensions appear to once again be escalating. Over the past 12 months, multiple Chinese companies including Huawei have been blacklisted by U.S. regulators over national security concerns. Washington also continues to make clear its concern surrounding intellectual property theft. The U.S. and Japan also pledged to work closely in areas "such as 5G, A.I., quantum computing, and semiconductor supply chains."[8]

In response, China passed the Anti-Foreign Sanctions Law to counter U.S. trade sanctions in June 2021. According to the law, "individuals or entities involved in making or implementing discriminatory measures against Chinese citizens or entities could be put on an anti-sanctions list… their assets within China may be seized, detained, or frozen."[9]

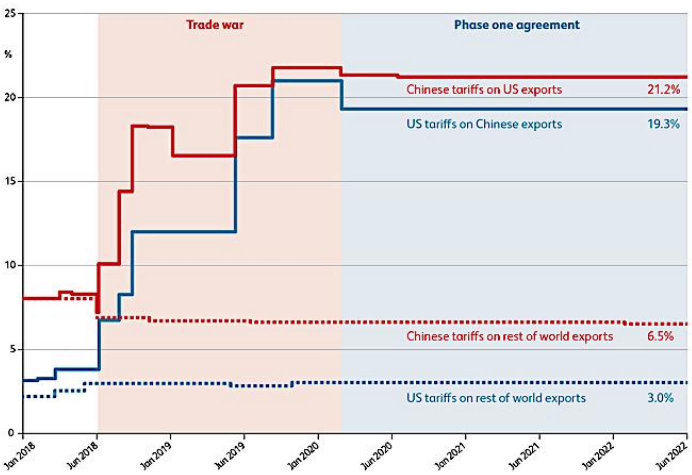
During the first half of 2022, the office of U.S. Trade Representative Katherine Tai doubled down on competition with China in its 2022 Trade Policy Agenda and 2021 Annual Report. Tai emphasized that the U.S. "must recognize that China … has uniquely distorted global trade through its economic policies and practices, causing harm to U.S. production, investment, and even consumption" and that there is an "urgent need for reform."[10] So far, more than 110

Chinese firms have been added to the list since the start of the Biden administration.[11]

The Biden administration has also maintained Trump-era tariffs on Chinese goods – and when the U.S. government opened the window for comments on the tariffs in May 2022, it received "hundreds of requests for them to remain." It is widely expected that the Biden administration will "allow Trump-era tariffs on hundreds of billions of dollars of Chinese merchandise imports to continue while it continues its review."[12]

China also maintains much higher tariffs (21.2 percent) on U.S. goods than on the rest of the world (6.5 percent).[13]

FIGURE 1 **COMPARISON OF US AND CHINESE TRADE TARIFFS, 2018-2022**
Source: Peterson Institute for International Economics, updated June 2022



Alongside the challenges posed by the continuing trade disputes and rounds of sanctions, the U.S. and China have diverging perspectives concerning the direction of institutions to govern global trade. *The China-led Regional Comprehensive Economic Partnership (RCEP) came into effect on Jan. 1, 2022, with the most recent data showing that China's trade with member countries expanded 6.9 percent year-on-year to 2.86 trillion yuan (approximately $449 billion).*[14] *RCEP allows China to leverage its trade potential further to secure greater market access in the region – coupled with its broader Belt and Road Initiative. RCEP also reinforces economic interdependence between China and other participating countries, further pushing the region into China's political orbit.*[15] *Ironically,* China also requested to join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), a regional trade agreement with higher standards than the RCEP and a successor to the Trans-Pacific Partnership from which the U.S. withdrew in the early days of the Trump administration.[16]

In response to China's actions on trade agreements, on May 23, President Biden launched the Indo-Pacific Economic Framework for Prosperity (IPEF) with a dozen initial partners. On the economic front, the Biden administration aims to deepen economic engagement with its Indo-Pacific partners on a wide range of issues such as digital trade, cross-border data management, supply chain resilience, decarbonization and anti-corruption.[17] Geopolitically, the IPEF is a response by the U.S. to efforts by Beijing to bolster a China-led regional economic order.

While analysts have rightfully focused on the high-politics nature of a possible Taiwan conflict, we are likely to see continued tension on trade issues and strategic maneuvering in this arena.

National security regulation of investment and industrial policy

In the U.S., there remains an increasing concern surrounding Chinese investment, particularly in sensitive sectors tied to national security.[18] Investment regulation and industrial policy now increasingly go hand in hand. In Biden's first year in office, Washington implemented an industrial strategy to revitalize U.S. manufacturing, create more domestic jobs and strengthen American supply chains. As these efforts mature, they will almost certainly have downstream consequences for global supply chains, and for Chinese companies, in particular.

Under the Trump administration, the long-standing administrative process to review investments known as the Committee on Foreign Investment in the United States (CFIUS) was enhanced with Congressional passage of the Foreign Investment Risk Review Modernization Act (FIRRMA) in 2018. This new legislation calls for the review of even minority stakes in U.S. companies. The definition of "critical technologies" will also continue to be refined on a rolling basis by the Department of Commerce.[19]

The U.S. Senate has also passed the CHIPS and Science Act with the goal of reducing U.S. reliance on overseas supply chains. It also aims to boost the nation's science and technology research base and address China's anti-competitive trade practices amid broader concerns surrounding intellectual property theft.[20]

The direct link between industrial policy and investment regulation is explicit in the CHIPS Act. It prohibits funded recipients from "expanding semiconductor manufacturing in China and other countries defined by U.S. law as posing a national security threat to the United States."[21] In addition, companies doing business in China over the next 10 years will not be able to produce highly advanced chips that are smaller than 28–nm.[22]

Troublingly for Beijing, similar moves appear to be headed to Europe. For example, the European Union is investing more to boost chip production and mitigate losses from supply chain disruptions.[23]

Unsurprisingly considering these developments, China is already taking steps to insulate its economy from external vulnerabilities. Technological and material self-sufficiency are primary goals of China's 14th Five-year Plan (2021-2025).[24] It appears the Taiwan crisis might further strengthen China's determination to reduce its dependence on foreign suppliers – though China's domestic semiconductor industry lags behind the industry standard.

Conclusion

So, what should we make of these developments? Current events are notoriously difficult for academics to deal with in terms of broaching theoretical trends. However, supply chain concerns made salient by the Taiwan crisis, the trade war that continues unabated, and efforts to limit foreign direct investment and bolster national economies via industrial policy does appear, in our view, to serve as an indication that how states engage their economic levers of power in the service of national security appears to be changing – both qualitatively and by degree.

This is a critical area of competition that is not likely to abate anytime soon. Understanding how different states make "strategic bets" on R&D projects as well as the types of tools they use to bolster national industries is needed now more than ever. We might also consider how institutions developed over the past 70 years to enable global trade and development might have to be re-tooled to cope with the contemporary reality that we find ourselves in. Despite wishful thinking about a return to peaceful economic globalization, new economic statecraft looks like it is here to stay.

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