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advancing sustainable global trade

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China's manufacturing dominance and the potential for the weaponization of trade

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Contents

Introduction

"One of the most important functions of economic history is to alert economists to the fact that the correct model may vary over time." [1]

— *Kevin H. O'Rourke, economic historian*

The world's dependency on China in the economic sphere continues to grow, impacting the conduct and regulation of trade. What are the consequences for the future of trade and globalization?

In recent years, the multilateral approach to trade rulemaking has come under increasing pressure. The rise of a non-market economy to trade prominence has called into question the utility of the current system and the efficacy of the World Trade Organisation (WTO) in overseeing global trade.

China, it seems, has gamed the multilateral system to accrue national power and this influence is now leveraged to reorder global institutions in a fashion more suited to China's interests.

The apparent success of China's mercantilist economic policies – including tight state control over its exchange rate regime, cross-border capital flows and allocation, and large industrial subsidies – is causing a crisis of confidence among market-orientated countries. China, it seems, has gamed the system to accrue national power and this influence is now leveraged to reorder global institutions in a fashion more suited to China's interests.

At the same time, Russia's invasion of Ukraine has shifted the dynamic. The constraints caused by Europe's dependency on Russian hydrocarbons on the

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consequent policy response is a timely reminder of the two-way nature of trade dependency and its role in limiting freedom of policy action. The closer alignment of Russia and China is lending credence to the belief that liberal democracies face a revisionist "arc of authoritarianism" that challenges the liberal world order created under United States hegemony in the post-World War II period.

This Hinrich Foundation series will examine the elements that drive the dynamics of trade dependency with the world's second largest economy.

We explain the series before we outline this first essay. The second essay will examine existing trade dependencies on China at the sector and country level, to establish the degree of influence such monopolistic power might bring to China. The essay will address critical questions. How effectively might China weaponize its economic position, should Beijing deem it necessary? How resilient would the rest of the world economy be in the face of such action?

The third essay will look at the policy response to date in the rest of the world to the threat posed by China's monopolization of various industrial sectors. We will ask: Is China likely to succeed and at what cost in terms of economic efficiency?

Lastly, the fourth essay will examine what kind of institution building and industrial policy is still required to immunize the world economy from the weaponization of trade in a multipolar world. How can the benefits of trade be maximised within a framework that takes account of China's divergence from the trade norms envisaged at the establishment of the post-World War II trade order?

This first introductory essay argues that it is imperative to have a deep and granular understanding of the trade and investment relationship between China and the rest of the world. Organised into four parts, the essay first examines China's economic rise in the past four decades and ascertains the degree of power the country has accrued through its economic success. Secondly, we briefly survey this rise in a historic context, highlighting previous shifts in economic power that have impacted trade and its relationship with great power rivalry.

The third section of the essay looks at the reasons behind the existence of the current multilateral system and asks if those reasons remain valid. Finally, the conclusion asks: What are the chances of the current multilateral system surviving? How can the international community best prepare for its potential breakdown?

How dominant is China in the world economy?

The structure of China’s economy yields more economic influence than its size, measured in GDP terms, might imply.

It might seem odd to talk of China as the world’s economic hegemon when it is not even the largest economy in the world, at least not at market exchange rates. In purchasing power parity (PPP) terms, China overtook the United States in 2016. China’s economy is now 20% larger but the PPP measure has limited relevance when analysing the international dimensions of the economy.[2] Nor is China’s population rich, with per capita GDP in line with global averages.

Due to China’s vast population, however, even a modicum of economic efficiency results in an economy that assumes great global significance. The structure of China’s economy yields more economic influence than its size, measured in GDP terms, might imply. The tight relationship between the party-state and economic actors in China means that economic activity can be co-opted to national purposes more easily than in liberal, market-orientated economies, where private actors pursue profit maximization as the primary objective of economic activity.

Beijing has perpetuated a narrative that China’s economic growth is fundamental to the global economy and that the future prosperity of other nations is intrinsically intertwined with China’s continued success.

According to official data, China has accounted for about 40% of global GDP growth since 2009. This storyline has been helpful to China’s rise. Indeed, Beijing has perpetuated a narrative that China’s economic growth is fundamental to the global economy and that the future prosperity of other nations is intrinsically intertwined with China’s continued success.

This narrative has helped ensure both a general enthusiasm for closer economic engagement with China and a reluctance to jeopardize commercial relations should Beijing’s interests come into conflict with those of its trading partners. As a result, considerable influence over other countries has been accorded to China and has enabled the country to advance a Sino-centric trade order in the Indo-Pacific.

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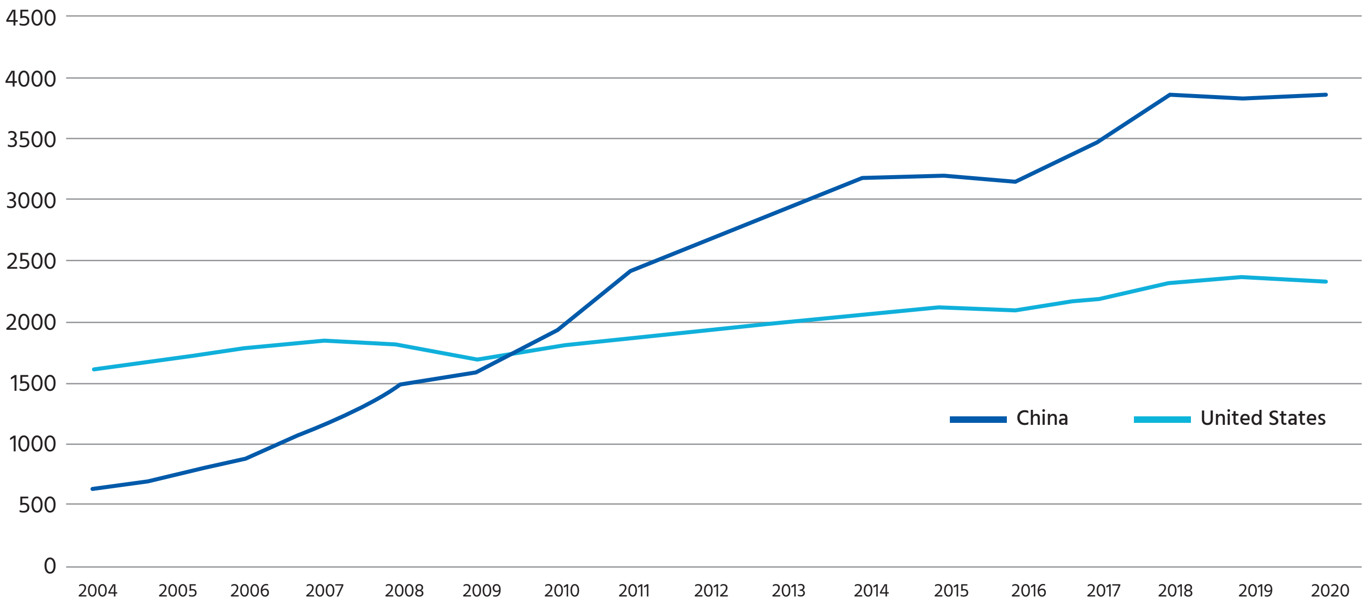
Figure 1 – **The growth of China's and the US's manufacturing (US$ billion)**



Source: World Bank open database

While China accounts for only 17.3% of world GDP, the country accounts for 28.5% of world manufacturing. China's manufactured exports are now 2.5 times as large as the United States'. China's expertise in large-scale manufacturing has placed the country at the center of global value chains.

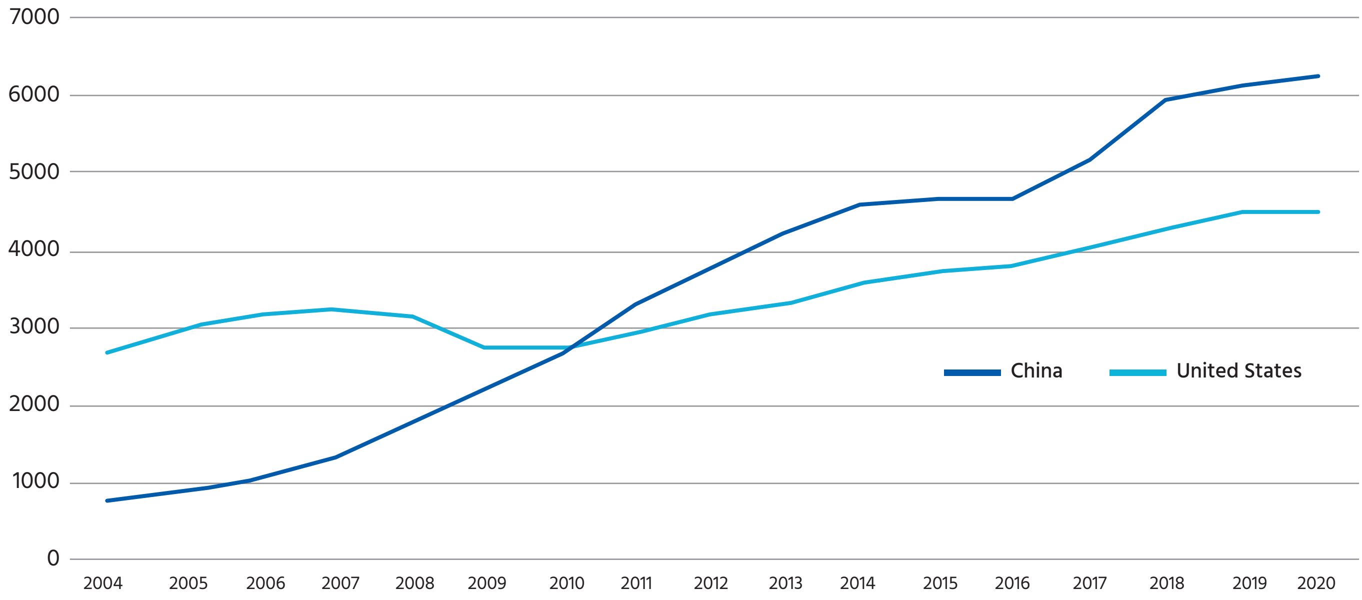
In addition to its size, contribution to growth, and perceived future dynamism, China's economy remains firmly rooted in manufacturing. While China accounts for only 17.3% of world GDP, the country accounts for 28.5% of world manufacturing.[3] China's expertise in large-scale manufacturing has placed the country at the center of global value chains. Consequently, 14.5% of world merchandise exports are from China and 11.5.% of world merchandise imports go to China. More than one in four dollars of world trade involves China in one way or another.[4]

If one focuses purely on manufacturing trade, China's dominance is even more extreme. In 2020, 69% of US merchandise exports were manufactured goods or US$987 billion, while 94% of China's merchandise exports were manufactured goods or US$2,434 billion. In other words, China's manufactured exports are now 2.5 times as large as the United States'. They are also twice as large as Germany's manufactured exports.[5]

Furthermore, since 2008 China has saved more on an annual basis than the United States. Today, the country saves more than the US, Japan, and Germany combined.[6] As a result, China accounts for 29% of world investment.

Despite running an investment to GDP ratio of 43% in recent years, China has been a net exporter of capital every year since 1994. Indeed, China's gross overseas assets have multiplied, from just US$936 billion in 2004 to US$9,324 billion at end of 2021 – a ten-fold rise.[7] As China deemphasized foreign exchange reserves and diversified its international assets towards infrastructure and other productive investments, the geopolitical impact of China's accumulated capital exports has sharpened.

Figure 2 – The growth of China's and the US's investment (US$ bn)



Source: World Bank open database

China is now the largest trading partner to over 120 countries and ASEAN countries import more from China than they do from each other.

Hence, although in a global context China's economic size remains proportionate to its population share, the national power that China has accrued and the impact of the country's economic rise has become disproportionate. Its ability to weaponize its economic linkages both through the capital account flows and trade has risen dramatically and is now arguably greater than that of the United States.

China's willingness to use its trading clout to attempt to exert influence over other countries will continue to rise, and engagement with China will create key trade vulnerabilities. We have recently seen China attempt to alter Australian attitudes through restrictions on trade in wine and barley. However, this is just the latest episode in a long history of geo-economic policy. In 2010, China used an unofficial rare earth embargo to influence Japan's response to the arrest of a Chinese fishing crew. There is a strong suspicion that Philippine exports of bananas were impacted by Philippine resistance to China's presence on Scarborough shoal.

To maintain autonomy of decision making, it's crucial that countries be informed of these fissures and immunize against them. For example, China is now the largest trading partner to over 120 countries and ASEAN countries import more from China than they do from each other.[8] A growing number of countries are dependent on China for more than a third of their imports, making policymaking autonomy difficult.

Lessons from history

While China's rapid accumulation of market share in manufacturing and trade has caused considerable economic displacement, is it unprecedented?

From 1800 to 1880, the United Kingdom's share of global manufacturing increased from 4.3% to 22.9%.[9] Similarly, from 1830 to 1900, the United States' share of world manufacturing rose from 2.4% to 23.6%. The US continued to expand its presence; by 1928, the country commanded a global market share of nearly 40%. In the aftermath of World War II, Japan and Germany were in ruins and much of the industrialized world was exhausted. In this environment, US manufacturing grew even more imposing and subsequently accounted for about half of global manufacturing output. In this context, China's accumulation and level of economic power is far from unprecedented.

However, it is important to note three critical observations that may distinguish the current situation.

The first observation relates to the previous contexts of globalization. The groundwork and initial flourishing of each of the two great waves of globalization took place in a unipolar world. In this setting, a global hegemonic power was able and willing to oversee and nurture a free and open trade order, albeit perhaps one slanted in its favour.

From the end of the Napoleonic wars in 1815 to the 1870s, the United Kingdom's unchallenged supremacy helped facilitate the integration of global commodity markets and a process of country specialization. Rapidly falling transportation costs and lower tariffs, at least in Europe, propelled developments. Even as trade policy became more protectionist in the 1880s, the gains from trade and technological innovations continued the globalization process until World War I.

China's economic rise has ended the period of unipolar US hegemony. The multilateralism that we have grown used to in the post-war and post-Cold War period is now under threat.

The second wave of globalization began in earnest during the 1970s with the collapse of fixed exchange rates that took place against a backdrop of American economic hegemony. This wave, which lasted until perhaps 2009, had its roots in Pax Americana (a period of relative peace and security under the American influence following the end of World War II) and the Bretton Woods institutions (multilateral institutions built to help rebuild the post-war economy and promote international cooperation). What was largely a North Atlantic orientated trading system transformed and achieved a wider participation with the collapse of the Soviet Union in the late 1980s and the subsequent unchallenged hegemony of the United States.

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The second observation relates to the orientation towards a market economy. In each of the two waves of globalization, the leading global power adopted a free trade stance. The UK has functioned under a free trade orientation since 1846 and the United States has advocated for trade liberalisation since 1945.

China has followed the lead of previous aspirant hegemons by deploying mercantilist commercial policies for national advantage.

In contrast, challenger powers tended heavily towards mercantilist traditions. Consider the erosion of the UK's unrivaled economic position, first by the United States and its deployment of "the American system", and then Germany, acting under the heavy influence of Frederick List and his protectionist philosophy. The American system entailed a variety of protectionist policies designed to promote domestic industry.

Former Axis powers Japan and Germany deployed heavily interventionist economic policies as they rebuilt their economies after World War II but neither was large enough to challenge the supremacy of the United States nor did they see it in their interests to do so. Furthermore, both countries were operating under the US security umbrella; therefore their economic rise posed no threat to US geopolitical interests.

China has followed the lead of previous aspirant hegemons by deploying mercantilist commercial policies for national advantage. Within the open trading order that the US and its allies established, China has done so with great success.

As demonstrated by the history of trade since the industrial revolution, great power rivalry has usually been associated with the disruption of trade patterns and a reversion to mercantilism by at least some protagonists.

The third observation is perhaps the key takeaway for the issues facing the global trading system today. As demonstrated by the history of trade since the industrial revolution, great power rivalry has usually been associated with the disruption of trade patterns and a reversion to mercantilism by at least some protagonists. Progress and the deepening of trade have tended to take place in a unipolar world where a global power has policed the commons largely unchallenged.

The concentration of economic power has been a perennial source of national rivalry. Some form of mercantilism has been the usual response from aspirant nations. Indeed, the UK's transition towards a laissez-faire approach to international commercial relations occurred only after it had established itself

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It is revealing to look at the examples of the United States' rise in economic importance relative to the UK and the rise of Germany relative to other European powers in the second half of the 19th century. There were severe implications for the global trading system. Neither the United States nor Germany adopted market-orientated international commercial policies. Both countries were heavily influenced by the writings of List and the neo-mercantilist policies he prescribed for economic development, particularly the protection of infant industries.

Furthermore, as rivalry intensifies, economic durability and resilience become the key determinants of success. The industrial might of the United States and the UK combined made Germany's defeat in World War I inevitable once it failed to keep the US out of the war and yield a quick victory. Equally, the economic failure of the Soviet Union ensured its ultimate defeat in the Cold War. As US President John F. Kennedy remarked, "Wealth is usually needed to underpin military power and military power is usually needed to acquire and protect wealth".[10]

Whether China's economic rise would have happened without the multilateral trading system is a moot point. The ascent took place within the system and the system is seen as enabling its perpetuation.

Thus, one could argue that any system of trade governance that facilitates a large transfer of relative economic power in one direction is always likely to have a shelf-life. Quite simply, the relative losers will regard it in their interests to dismantle such an architecture. Whether China's economic rise would have happened without the multilateral trading system is a moot point. The ascent took place within the system and the system is seen as enabling its perpetuation.

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Multilateralism's fragile existence

Trade liberalization in the early multilateral system was largely limited to the North Atlantic economies of Europe and North America. The debt crisis engulfing emerging markets in the 1980s fuelled a raft of economic reforms in developing economies.

It is worth briefly considering the circumstances that gave rise to the current multilateral trade regime that originated with the General Agreement on Tariffs and Trade (GATT) and evolved into the World Trade Organization.

With the world divided between American and Soviet spheres of influence at the end of World War II, a considerable policy divergence emerged. The Soviets tended towards autarchy. Recently decolonized countries tended to head down the protectionist route. Meanwhile, elites in countries whose industrialists had benefited from the war had a strong interest in protecting their newfound industries. Almost by definition, the major participants in the early multilateral system had a tendency towards an open economy and a desire and need to trade. Hence, trade liberalization was largely limited to the North Atlantic economies of Europe and North America.

The debt crisis engulfing emerging markets in the 1980s fuelled a raft of economic reforms in developing economies. Large parts of the developing world began to adopt the "Washington consensus" – policies aimed at low inflation, budget balance, export-orientated growth, and open capital accounts. The culmination of this broadening of free trade was the accession of China to the WTO in 2001.

This period of multilateralism, spanning nearly five decades from 1950 to 2009, is distinguished by three elements.

The establishment of a rules-based order for international commerce across continents was unprecedented. t is anomalous in history for countries to set aside issues of national sovereignty and security in favour of economic efficiency.

Firstly, the period is unique in history. Although the negotiations involved in lowering tariffs and trade barriers were long protracted, the establishment of a rules-based order for international commerce across continents was unprecedented. It is truly anomalous in history for countries to set aside issues of national sovereignty and security in favour of economic efficiency. The twin drivers were the horror and destruction of World War II and the threat posed to the free world by the Soviet Union.

Secondly, the United States, whose political leadership and financial largess played such a dominant role in post-war economic recovery outside of the Soviet bloc, made multilateralism possible. Arguably, the "de-politicisation" of trade required a relatively benign world hegemon, given the highly weaponizable nature of economic interlinkages.

Lastly, multilateralism produced an unprecedented growth in trade. Global trade grew faster in the second half of the 20th century than in any other period of history. Indeed, its annual growth rate of 5.93% was significantly faster than the pace prior to 1913.[11] Trade ties deepened as the ratio of trade to GDP rose, despite the increasing importance of services and non-tradable goods in the overall GDP aggregate.

When viewed through this prism, the stress facing the global trade order is hardly surprising. The world is becoming more multipolar as US domination of the global economy shrinks. Great power rivalry is mounting. The rise of Japan, Germany, and the European economies posed challenges. But the challenge they posed to

The uneven distribution of the gains from trade has also produced a backlash from interest groups who have been marginalized while economic progress expanded.

the United States is neither geopolitical nor ideological. The same cannot be said of China, whose system is antithetical to liberal values, with a tendency towards revisionism that poses a real challenge to the existing order.

As was the case in the 1880s, the uneven distribution of the gains from trade has also produced a backlash from interest groups who have been marginalized while economic progress expanded.

At the national level, the costs of maintaining an open world order have fallen disproportionately on the United States, the world's largest debtor nation. Given America's relative autarchy and its heavy trade dependency on its two large neighbours (Mexico and Canada), the United States has questioned the cost-benefit of the current system.

The use of economic sanctions has risen as policymakers recognize the potential to influence the behaviour of countries through economic coercion in such an interconnected world.

Thus, the set of circumstances that gave rise to this unique deviation from the history of trade governance seems to have faded, if not reversed. The use of economic sanctions has risen as policymakers recognize the potential to influence the behaviour of countries through economic coercion in such an interconnected world.

The establishment of a rules-based order for international commerce across continents was unprecedented.

Conclusion

China has accumulated a significant amount of economic power in a relatively short period. This achievement is not without precedent, but it has had the impact of moving the world from a unipolar to a multipolar economic order.

China has accumulated a significant amount of economic power in a relatively short period. This achievement is not without precedent. However, it has had the impact of moving the world from a unipolar to a multipolar economic order. In a geopolitical sense, the fallout from the recovery of European economies and Japan after World War II was limited, because western Europe and Japan were under the US security umbrella. In China, the liberal democracies face a multi-dimensional challenge: economic, ideological, military, and political.

History suggests that such sudden redistributions of economic power induce a reaction from trading partners and rivals. These tend to result in a reordering of the global trading system. By representing a distinct departure from bilateral and unilateral trade regulation, the period of multilateral trade regulation that began with the GATT in 1954 and oversaw an unprecedented growth in trade through to 2009 is anomalous. Given its reliance on the de-politicisation of trade, it is perhaps miraculous that multilateralism has lasted this long.

Adam Smith, the doyen of market-driven economics, was quick to recognize that it was utopian to expect free trade among rivals. Instead, he supported the Navigation Acts[12] on grounds of national security. He also saw that when one country adopts an interventionist approach to trade, other countries need to adapt to the challenge. Smith remarked that, "The very bad policy of one country may thus render it in some measure dangerous and imprudent to establish what would otherwise be the best policy in another."[13]

The world is grappling with a fragmenting global economy and the geopolitical challenges posed by revisionism. Understanding the likely evolution of trade patterns in a period of great power rivalry could be the key to future growth.

The rise of China is an example of Smith's prediction. The world is grappling with a fragmenting global economy and the geopolitical challenges posed by revisionism. Hence, we require a deep and granular understanding of our trade dependencies with China to ensure that societies that wish to immunize themselves from China's influence can do so. For global economic actors, understanding the likely evolution of trade patterns in a period of great power rivalry could be the key to future growth and survival as the economic landscape is remade.

Researcher bio: Stewart Paterson

Stewart Paterson spent 25 years in capital markets as an equity researcher, strategist and fund manager. He has worked in London, Mumbai, Hong Kong and Singapore in senior roles with Credit Suisse, Credit Suisse First Boston, CLSA and more recently, as a Partner and Portfolio Manager of Tiburon Partners LLP.

Having started his career with Hill Samuel in London in 1991, Stewart has covered the full spectrum of global markets equity strategy, developed market equities and emerging market equities. In 2007, he co-founded Riley Paterson Investment Management in Singapore, where he ran a macro-driven hedge fund. He returned to the UK in 2012.

Stewart is the author of *China, Trade and Power: Why the West's economic engagement has failed*, a highly acclaimed book supported by the Hinrich Foundation. He is also the Founder of Capital Dialectics, a monthly publication aimed at financial institutions.

Stewart holds an MA degree in Economics from the University of Aberdeen.

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Endnotes

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