



# The Economics of Strategic Stability in US-China relations

*Nicola Leveringhaus*

## KEY POINTS

- Re-start high level economic talks like the Bush-Hu era US-China Strategic Economic Dialogue.
- Both states can inflict punishing economic measures on one another and are developing resilience to become ‘sanctions-proof’. Yet Mutual Assured Destruction already exists since US-China relations are key to the health of the global economy. A war between both would likely have greater economic consequences than the War in Ukraine. A study of the global consequences of US-China conflicts is urgently needed.
- Develop Confidence Building Measures. This extends to US allies, to reassure them they are under an ‘economic umbrella’ should sanctions be enforced upon them by Beijing.

The economic aspects of strategic stability tend to come second place in the study of US-China relations. For good reason, scholars have focussed on the military aspects of strategic stability, including the role of emerging technology and cyber capabilities, in this most important geopolitical relationship. Yet, considering the ongoing War on Ukraine, as well as tensions over Taiwan, it is worthwhile considering the effect coercive economic tools such as tariffs, sanctions and embargoes, can have on wider strategic stability.

Afterall, the United States and China are not simply great powers in military terms, but economic ones too. Even in the era of COVID, the United States, with the world’s largest GDP, has the largest growth per capita in 2022, and holds the world’s dominant reserve currency, the US dollar. China’s economy,

the second largest in the world, has developed at a staggering pace from the era of Reform and Opening Up under Chinese CCP leader Deng Xiaoping. Since then, Chinese leaders, and especially current leader Xi Jinping, have sought to maintain and build on Deng's legacy. This has mostly worked, albeit with some slowing in growth in the COVID era. Overall, since 2000, China's GDP has soared from \$1.2 trillion to \$17.7 trillion. China has become the leading trading partner for many countries and a critical part of global supply and manufacturing. Since 2012, Xi's flagship Belt and Road Initiative has resulted in a vast global network of financial assets and investments – admittedly some profitable, some not - for China.

Yet wider US-China relations have been on a significant downward trend since the Obama administration. Today, both sides rarely talk to the other, with few channels of communication at strategic levels. In 2007, US President Bush and Chinese leader Hu Jintao established the US-China Strategic Economic Dialogue. This was then replaced in 2009 with the U.S.-China Strategic and Economic Dialogue, which combined both economic and military matters and was last held in 2016. Since then, there have been no similar arrangements. Instead, Trump publicly launched a 'trade war' with China, and fear over trade competition and unfair economic practices continue to unite the political sphere in the United States even in the current Biden administration. This is worrying as bilateral relations between China and the United States are important for strategic stability, and the wider health of the global economy.

Ideally, economic forms of strategic stability exist when the actions of one side do not spark an action-reaction cycle that alters the basic global economic situation (either because both sides understand the action is limited or because the other side reacts in ways that restore the status quo). Past Chinese analysis of strategic stability (*zhanlue wendingxing* 战略稳定性), as offered by prominent scholars such as Li Bin and Nie Rongyi, highlight two main goals. The first is crisis stability, in particular confidence building measures and improved communication to minimize misconceptions and build trust between states. The second goal relates to arms control and, should war breakout, war limitation to prevent escalation to nuclear war. This brief is not suggesting that economic coercion can lead to nuclear escalation or first use, but it may have disruptive effects. Taking these interpretations into account, what impact do economic issues have in shaping the prospects of arms control stability between the United States and China? Would they make bringing China to a negotiating table harder or easier? What about crisis stability, do economic tools always exacerbate pre-existing hostile relations, making knee-jerk

reactions more likely in times of crisis? How can both states make themselves economically resilient (or 'sanctions proof') in a responsible manner in peacetime, without raising tensions in their bilateral relationship, or with their allies and partners?

## US and Chinese practices of economic statecraft

The United States is a prolific and seasoned practitioner of economic statecraft, extending carrots like the Nunn-Lugar initiative in the 1990s and applying sticks such as sanctions against Iran or North Korea for their respective nuclear programmes. In contrast, China's own view and practice of economic carrots and sticks has undergone much bigger change and evolution. The Belt and Road Initiative is the clearest example of an explosion of economic carrots China employs in its foreign policy today. In terms of sticks, in the past, China has condemned use of economic coercion – it was itself the recipient of various sanctions especially in the wake of Tiananmen in 1989. Yet today China is actively counter-sanctioning others (such as MERICS, a Berlin based think tank) and developing domestic laws to regulate and restrict economic affairs so they conform to national security goals. China is also becoming more resilient to external economic coercion, potentially reducing the impact of this type of statecraft in a crisis.

In bolstering its economic resilience and becoming 'sanctions proof', China has two distinct advantages over the United States. The first is psychological. Unlike the United States, China can draw deeply on its own historical experience of economic wilderness following the break in relations with the Soviet Union in 1959/60. From 1960 to 1963, China faced unprecedented international isolation in economic, technology and diplomatic terms. This has not faded from the memory of China's top Party leaders, despite China's massive economic growth since Deng Xiaoping. Should China be cast into international economic wilderness again, it has a clear historical narrative already in place from which it can draw. Crucially, this narrative will be politically useful for the CCP, serving as a key mobiliser for hyper nationalism during a crisis against the United States in ways Washington is unlikely to replicate.

A second advantage is that China is learning from Russia's mistakes today and the challenges the European Union and United States face in applying economic measures during the ongoing War on Ukraine. Beijing is closely studying how (and for how long) Western states can use economic tools to counter or disrupt Russian actions in Ukraine. The slow pace of institutions like the EU for organizing action (and the ability to disrupt collective action) will be key areas of interest in Beijing. So too will be

the support for said sanctions among extra-regional players: countries like Singapore, for instance. The key message is this: these types of economic measures could be applied against China in a potential conflict over Taiwan. Indeed, the US Treasury is currently studying various economic options it could use in a potential war with China over Taiwan. Yet, the strategic element of surprise has been lost in economic terms. In China, high-level political meetings have been taking place since February 2022 to identify and plug any economic gaps that could be vulnerable to outside pressure. The Chinese have focussed on vulnerabilities in supply chains and ring-fencing banks like the Import/Exxon bank, a key bank for the BRI. China has already started to adapt its business abroad to avoid secondary sanctions and is advising wealthy Chinese business figures how best to safeguard and secure their assets abroad.

As China's economic resilience has grown, so has its sanctioning of others. The clearest example of this is in 2016 against South Korea. In response to Korea's installation of a US missile defence system, THAAD, Beijing put in place several unannounced, informal sanctions and embargoes on select businesses in Korea, such as the supermarket Lotte and the tourism sector. The goal was to disrupt, rather than derail, bilateral economic relations. This proved to be punishing for the Korean economy and has significantly soured bilateral relations between Seoul and Beijing. While China did not experience much damage to its economy during the THAAD incident, the considerable diplomatic blowback to China's economic coercion was likely unexpected in Beijing. As such, even informal sanctions can be costly politically. That said, on a more sensitive matter, such as Taiwan, China might be willing to bear these higher costs of diplomatic blowback.

### China-Taiwan-US relations and economic coercion

Current tensions over Taiwan have resulted in China applying sanctions on the island but there has so far not been much escalation or response from the United States beyond an increase in higher profile US government visits to Taipei. Yet this may not always be the case in the future.

Historically, China has applied, with mixed success, both economic carrots and sticks in its relationship with Taiwan. Beijing's core goal across the Straits remains, despite growing military capabilities, peaceful reunification. In its economic statecraft towards Taiwan, China generally uses business to pressure politics, with the goal of influencing the Taiwanese government through the public. In practice, this means not directly or formally sanctioning political parties in Taiwan, like the

Democratic Progressive Party. Instead, Taiwanese businesses like Acer could be targeted, or specific sectors like tourism. The methods used could be quite informal, disrupting trading with over-excessive tax auditing, rather than ceasing all trading or imposing direct sanctions. China largely practises informal rather than formal sanctions. These types of sanctions are unannounced and selective to the extent they do not destabilise the entire economic relationship, with the intention of shaking politics in Taiwan, and demonstrating action to audiences back in the mainland.

In the future, if a military crisis were to break out across the Taiwan Straits, and sanctions applied to China, Beijing would need to reassure its BRI partners that its investments and loans would not be adversely affected, that it would be 'business as usual'. Beijing would also be looking towards its near and greater periphery: how states from Singapore to Fiji might respond to new economic measures introduced during a conflict. While China does not have allies in name, it does have important partners, such as Russia and South Africa. China may draw on these economies in times of crisis. Indeed, a recent book on economic statecraft, *The Economic Weapon* by Nicholas Mulder, suggests that, historically, state coalitions to resist or dilute powerful economic sanctions tend to form at times of crisis. For the United States, then, the concern might be to avoid a deepening of Sino-Russian relations because of harsh economic sanctions. Domestically, within China, sanctions could threaten internal circulation – the cycle of production, distribution, and consumption-, and mobilise anti-US sentiment among the Chinese public: a toxic combination in escalation and crisis stability terms. China might see any formal external sanctions as an economic weapon deliberately wielded by the United States to undermine its sovereignty. The United States has sanctioned China before, over Tiananmen in 1989, and for export control violations in the 1990s. Yet none of these sanctions related to Taiwan, at a time when a Chinese leader is actively calling for national rejuvenation. So, in any future scenario formal and announced sanctions may be seen from an American and European perspective as a milder first option in a crisis with China. But Beijing might view things differently. For China, sanctions could be considered a military option in and of itself. In essence, economic sanctions could be more escalatory for Beijing than Washington when it comes to Taiwan.

What then are the economic options for the United States? Is it impossible to expect the same types of sanctions against China that we are seeing today against Russia over Ukraine? Is the cost too high, economically? Should the United States and Europe

consider less formal, unannounced and selective forms of economic coercion? Considering the Taiwan Relations Act, what are the political and reputational costs of inaction for the United States? A few early observations can be made here. First, a lot will depend on the circumstances under which a Taiwan invasion scenario could occur. If it is protracted and messy, involving not simply the United States, but allies and partners like Japan and Australia, then the resilience of economic systems comes more into play. The United States would also need to consider its own domestic resilience to Chinese economic coercion, such as the impact on specific national supply lines, or the business cost of applying tariffs and sanctions on technology goods. US allies would also need to assess their own economic resilience to sanctions in a region-wide conflict. Second, the United States could consider fewer formal sanctions and opt instead to disrupt BRI business and undermine China's reputation among BRI partners, showcasing China as an unreliable economic partner. It could do this actively, or passively by encouraging alternatives to China in BRI global hotspots, such as supporting Indian technology and infrastructure development in Latin America and the Caribbean.

A war between the United States and China over Taiwan would likely have greater economic consequences than the War in Ukraine. In a war over

Taiwan, the consequences for global and regional economies will likely be wider and deeper, for example leading to a paralysis in trade in key sectors such as rare earth minerals, disruption to sectors such as fisheries, or the deliberate tampering of telecommunications, either established networks of under-water cables or emerging space-based systems. A wide-spread study of the potential effects of a US-China conflict on the economies in Northeast Asia, South Asia, Southeast Asia and the Pacific Islands is urgently needed.

Ultimately, the economic-security nexus – a burgeoning area of study in International Relations – is crucial to understanding the prospects for strategic stability between the United States and China. The ongoing Taiwan tensions speak to the timeliness of this issue. Yet, at present, there are few if any platforms where the United States and China can meet neutrally to speak privately, in peacetime, about how to avoid economic behaviours that are misleading and escalatory. The time is now to engage in strategic talk on economic matters between Washington and Beijing.

**Dr Nicola Leveringhaus** is Senior Lecturer in East Asian Security and International Relations in the Department of War Studies, King's College London, UK.

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NUPI  
Norwegian Institute of International Affairs  
C.J. Hambros plass 2D  
PO Box 8159 Dep. NO-0033 Oslo, Norway  
[www.nupi.no](http://www.nupi.no) | [info@nupi.no](mailto:info@nupi.no)

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