

## The Geopolitical Implications of the Trade War: A Theoretical Discussion

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In 2018, the "trade war"—which had previously been limited to a number of declarations by the Trump administration that the US is being treated unfairly in its trade with other countries—escalated to the stage of major policy measures, which have already left their mark on the global economy.

The opening shot of the trade war was fired in March 2018 when the US imposed a tariff of 25 percent on the import of steel and 10 percent on the import of aluminum.<sup>1</sup> At first, the US exempted close allies, such as the EU, Canada and Mexico, from the tariffs. Its decision three months later to cancel those exemptions was a sign that the trade war is not limited to an economic-political struggle between the US and China and other strategic rivals and it is possible that the US administration is indeed determined to change the rules of the game, which had been put in place by the international institutions that it itself created following the Second World War.

During the last few months of 2018, there were indications that some of the tension between the US and a number of its major trading partners had dissipated, such as the joint declaration at the beginning of October of a renewed trade agreement between the US, Canada and Mexico. The tensest front in the trade war was the confrontation between the US and China. As of late 2018, there was as yet no hint that either of the two superpowers intends to deviate from a tit-for-tat strategy, which began to emerge after the US imposed tariffs on Chinese goods worth \$34 billion in July and the immediate response by China, which imposed tariffs on goods with a similar value. A similar phenomenon was observed in August when the US imposed tariffs on Chinese goods worth \$16 billion, which was met by an identical Chinese reaction. In September, a decision to raise the tariffs on Chinese goods worth \$200 billion by a rate of 10 percent went into effect and it is likely to go up to 25 percent by the end of the year. In response, China announced that it would raise the tariffs on American goods worth about \$60 billion.<sup>2</sup> President Trump threatened that China's response would lead to a

1 Even before this, tariffs on the import of washing machines with a value of \$1.8 billion and on solar panels with a value of \$8.5 billion went into effect in January 2018. For a detailed schedule of all of the American tariffs and the responses of the various countries, see: Chad P. Bown and Melina Kolb, "Trump's Trade War Timeline: An Up-to-Date Guide," Peterson Institute for International Economics, September 24, 2018, <https://piee.com/blogs/trade-investment-policy-watch/trump-trade-war-china-date-guide>

2 Ibid.

hike in the tariffs on Chinese goods worth \$267 billion, such that there is the possibility that within a few months almost all of the bilateral trade between the two countries will be subject to tariffs.

The research departments of most of the international economic institutions have, in their annual forecasts for 2019, ranked the increase in international tension surrounding trade issues as being the leading cause of growing uncertainty in the international economic system.<sup>3</sup> Despite the differences in methodology and scenarios used by the various international bodies to estimate the damage to economic growth, almost all of the economic publications agree that this is a negative process which will harm global growth to one extent or another. Since about 80 percent of the volume of international trade is by sea, a major reduction in the volume of world trade will have major implications for commercial fleets all over the world and is liable to intensify the problems of many shipping companies, which in any case have been suffering in recent years from only moderate growth in the demand for ocean transport.<sup>4</sup>

In addition to the attempts to assess the economic damage from the trade war, the exchange of economic blows between the superpowers has been accompanied by a wave of forecasts which predict that a slide into protectionism will undermine the stability of the international system and will even increase the likelihood of violent confrontations worldwide. While the fear that a protectionist policy will harm economic growth is backed up by solid theoretical and empirical research, which enjoys a consensus among the economic establishment, many studies that have attempted to determine whether international trade contributes to peace do not present a clear picture. Thus, it is difficult to present unambiguous empirical evidence in support of the concern that the trade war necessarily constitutes a destabilizing factor which increases the likelihood of violent conflicts worldwide. Nonetheless, research on the subject can certainly help to identify the important variables that should be the focus when analyzing the strategic implications of a major retreat from globalization processes. This brief article

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3 At the end of September, the IMF, the World Trade Organization and the World Bank made a joint announcement that expressed concern regarding the adverse economic implication of the increase in tariffs. A description of the expected damage and the ways to moderate it can be found in the speech given by the Chairman of the IMF, Christian Lagarde. See Christine Lagarde, "Steer, Don't Drift": Managing Rising Risks to Keep the Global Economy on Course," Speech in Washington, DC ahead of the IMF-World Bank Annual Meeting, October 1, 2018, <https://www.imf.org/en/News/Articles/2018/09/27/sp100118-steer-dont-drift>

4 For a description of the implications of the trade war on the commercial fleets and on maritime trade, see United Nation Conference on Trade and Development (UNCTAD), Review of Maritime Transport, October, 2017, <https://unctad.org/en/pages/PublicationWebflyer.aspx?publicationid=2245>

will consider the importance of these variables with respect to the potential geopolitical implications of the trade war escalation.

### **Is the trade war necessarily a destabilizing factor?**

The direct and most important question that arises from the aforementioned processes is whether the raising of tariffs and the reduction in the volume of trade are increasing the likelihood of violent conflicts between countries worldwide and are leading to the creation of a “cold war” between China and the US which might even escalate into a violent confrontation. Many of the op-ed articles that have commented on the trade war mention the fact that the protectionism which prevailed during the Great Depression in the 1930s contributed to the various processes that in turn led to the international tension prior the Second World War. Considering the historic context can indeed assist in the analysis, but must be carried out carefully and while controlling for variables that differentiate between the different circumstances and periods. Indeed, most of the contemporary research does not rely only on the investigation of historic processes, but also on quantitative analysis that utilizes sophisticated statistical techniques whose goal is to examine how trade affects the likelihood of conflicts between nations.

Starting from the 1990s, dozens of studies have reported a negative and statistically significant relationship between bilateral trade and the probability that two countries will go to war. This finding supports the well-established liberal logic according to which countries do not go to war against their main trading partners in order not to sacrifice the fruits of trade. In other words, the greater the volume of trade between a pair of countries, the higher will be the cost of war and therefore the likelihood of war will diminish. In recent years, the research on this topic has presented empirical findings showing that the more open countries are to trade in general and to additional globalization processes, the more restrained their behavior will be in the international arena. This is because they concern that war will harm their trade and investments with third parties which are not directly involved in the war.<sup>5</sup>

According to the logic underlying this research, one of the major dangers of a trade war is that the retreat from globalization will indeed lead to a significant drop in the volume of trade between countries and therefore to a drop in the opportunity cost of a conflict between potential adversaries. Although this logic is likely to be relevant for various pairs of countries, it apparently does not hold in the case of China and the US in the short term. Even after all the planned tariffs have gone into effect, the mutual economic

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5 There is a vast literature on the topic and it is difficult to review it all in an article of this type. For a good review of the articles which show that trade reduces the likelihood of conflicts, see: Gerald Schneider, “Peace through Globalization and Capitalism? Prospect of Two Liberal Propositions,” *Journal of Peace Research*, Vol. 51, no.2 (2014), pp. 173–183.

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dependence between the superpowers will remain and the potential decoupling will have disastrous effects on the economy of the two superpowers and on the entire global economy. In other words, if the fear of economic damage is indeed a factor that can prevent conflict, then the trade war—at its current level—will not reduce the superpowers' fear of the economic consequences of a violent conflict between them.

The research which supports the theory that trade contributes to peace will claim that despite the recent increase in tension on the surface, the acceptance of China into the World Trade Organization in 2001 and its opening up to additional globalization processes have contributed to international stability, since they have created a mechanism of "mutually assured economic destruction" between China and the US, which reduces the likelihood of a violent confrontation between them. The US is the largest export destination for Chinese goods and China is the largest source of goods imported into the US and is the third largest destination for US exports. The trade relationship is, however, characterized by a chronic US trade deficit that stood at more than \$375 billion in 2017.<sup>6</sup> The American claim that the trade deficit does not only reflect fundamental economic factors and is primarily the result of unfair Chinese policy (such as a fixed exchange rate between the dollar and yuan) was voiced by the economic establishment in the US long before the Trump administration declared the deficit to be the main factor behind the change in trade policy. Even bodies that totally oppose the Trump administration's recent moves justify some of its main claims against China's trade and investment policy. However, and despite US complaints against unfair Chinese policy and notwithstanding the determination to change China's policy, it does not appear that the sides can allow themselves to make moves that will lead to a cutoff of economic relations between them.

China's trade surplus with the US is one of the main factors that has led to the return of capital to the US by way of the purchase of US bonds. China holds a total of \$1.18 trillion in US treasury bonds,<sup>7</sup> which makes it the largest creditor of the US government. The escalation of the trade war raised the possibility that China would respond to the American tariffs by selling off US bonds, with the goal of lowering their value. Although China may gradually reduce its holdings of American assets, it is clear that a rapid selloff of US bonds would hurt China's asset portfolio. Thus, a situation exists that prevents the sides from suddenly cutting off economic relations.<sup>8</sup>

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6 United State Census Bureau, <https://www.census.gov/foreign-trade/balance/c5700.html>

7 US Department of the Treasury, <http://ticdata.treasury.gov/Publish/mfh.txt>

8 For a theoretical analysis of the difficulty China faces in using its US bonds as geopolitical leverage, see: Dan Drezner, "Bad debts: Assessing China's financial influence in great power politics," *International Security*, Vol .34, No.2 (2009), pp. 7–45.

Another important point raised in the literature relates to the complexity of the trade networks in the global era, which reduces the possibility of one large economy being able to harm another, without it also harming the supply and production chains that benefit other members of the network.<sup>9</sup> A major share of Chinese exports to the US is composed of electronic products that include components imported by China from US allies, such as Japan and South Korea. A rapid drop in US imports from China would have far-reaching implications for the global production and supply chains and would likely cause economic damage to strategic US allies and other countries, who account for a significant portion of the demand for imports and investment from the US.

In conclusion, and according to the logic of the literature which holds that globalization is a stabilizing factor, the depth of the mutual dependency that currently exists in the global economy has significantly raised the cost of cutting off economic relations between China and the US, and therefore the possibility has been reduced that an exchange of economic blows between them will soon escalate into a violent conflict or other moves that will lead to a rapid drop in trade between them. The fear expressed in the research relates to the possibility that the trade war will gradually undermine the stabilizing mechanisms that have led the globalization of the entire world economy.

It is believed that the lion's share of trade between China and the US, as well as between the US and its allies, is not expected to be adversely affected in the near future. However, the recognition that the trade war is providing indications of a possible shift in global trade and the weakening of US commitment to existing institutions could lead various countries to look for ways of formalizing their trade in bilateral and multilateral agreements that do not include the US.

The expectation of barriers to free trade may motivate countries to consider the development of commercial and even military solutions that will ensure their access to future trade. It is worth mentioning in this context studies which claim that the expectations among European countries of the continuation of the trend toward protectionism in the early 20<sup>th</sup> century and their desire to ensure access to economic resources contributed to the maritime arms race that preceded the First World War.<sup>10</sup> Clearly there are huge differences between that period and the current international situation; nonetheless, the possibility of a slide toward protectionism that may cause countries to increase their efforts to ensure their trade cannot be ruled out. Paradoxically, the trade war—which may in the short run harm the demand for ocean transport—may lead countries to

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9 Han Dorussen and Hugh Ward, "Trade networks and the Kantian peace," *Journal of Peace Research*, Vol 47, No.1 (2010), pp. 29–42.

10 Dale C. Copeland, "Economic Interdependence and War: A Theory of Trade Expectations," *International Security*, Vol. 20, No. 4 (1996), pp. 5–41.

reinforce their economic security through greater dependence on their own commercial fleets. Thus, an escalation in the trade war may actually increase the size of national commercial fleets and encourage acquisitions for their navies.

### The trade war as strategic competition

Although the aforementioned studies are the ones that have attracted the attention of the economic establishment, which has promoted the globalization process in recent decades, there are many other studies that challenge this logic and the empirical findings presented in the surveyed studies. These studies have claimed that the empirical findings which allegedly show that trade promotes peace do not take into consideration the fact that it is friendly nations that trade with one another in the first place, such that the finding is the result of a methodological problem. And indeed, a number of studies have shown that the relationship between trade and peace becomes statistically insignificant if the order of events is correctly controlled for.<sup>11</sup>

Other studies have demonstrated that the inclusion of countries within globalization processes increases the likelihood that they will be attacked by strategic rivals who fear that their inclusion in the global economy will strengthen them.<sup>12</sup> According to this logic, the trade war is essentially an American attempt to prevent China from growing too strong and the US will be willing to risk economic harm if its actions cause even greater harm to China, which will prevent it from achieving strategic advantages. Specifically, the US is willing to absorb price increases and to risk a certain reduction in its exports in order to impede the economic and political expansion that China is trying to promote by means of its "One belt, one road" initiative and in order to prevent the potential growth that the vision of "Made in China 2025" can provide it. Made in China 2025 is an ambitious program that is aimed at changing the economic model and transforming China into a competitive industrial superpower that stands at the forefront of technological knowledge in various domains, such as aerospace, robotics and maritime technology. It is clear that apart from the fear of economic competition from China, Chinese dominance in the aforementioned sectors will have far-reaching implications for security.<sup>13</sup> The US tariffs are liable to harm sectors that were meant to advance the plan, but it is in fact possible that increased pressure on Chinese exports

11 Omar M. G. Keshk, Rafael Reuveny and Brian M. Pollins, "Trade and Conflict: Proximity, Country Size, and Measures," *Conflict Management and Peace Science*, Vol. 27, No.1 (2010), pp. 3–27.

12 Timothy M. Peterson, "Third-party Trade, Political Similarity, and Dyadic Conflict," *Journal of Peace Research*, Vol. 48, no.2 (2011), PP. 185–200.

13 Paul Mozur and Jane Perlez, "China Tech Investment Flying Under the Radar, Pentagon Warns," *The New York Times*, April 7, 2017, <https://www.nytimes.com/2017/04/07/business/china-defense-start-ups-pentagon-technology.html>

will increase China's motivation to more rapidly reduce its dependence on the export of labor-intensive goods and to increase the budgets allocated to the 2025 vision.



נשיא ארה"ב דונלד טראמפ ונשיא סין שי זינפינג בפגישתם יולי 2017,  
מקור: אתר משרד החוץ הסיני

It would appear that the same asymmetry in trade between the two countries, which is presented in the US as the reason for changing the rules of the game, provides the US with more tools in the trade war relative to China, since the quantity of Chinese goods that are sold in the US and on which tariffs can be placed is much larger than the quantity of American goods sold in China, as well as being due to the difference in dependence on exports and imports between the US and China.

Total Chinese exports stand at \$2.27 trillion and constitute 20 percent of Chinese GDP. Of this, 19 percent goes to the US. China's imports total \$1.23 trillion and 9.9 percent of that originates in the US.

Total American exports total \$1.32 trillion and constitute 7.1 percent of US GDP. Of that, 9.2 percent goes to China. Total American imports total \$2.12 trillion and 21 percent of that comes from China.<sup>14</sup>

14 The Observatory of Economic Complexity; MIT Media Lab.

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In addition, the increasing difficulty in exporting from China to the US may even reduce the attractiveness of investment in China for multinational companies and thus reduce total investment in China. However, the trade war does not have to be limited only to tariffs and China can respond to American moves by impeding the operations of American companies in China in various ways or by reducing the value of the currency, which will offset the effect of the tariffs on trade relations between the countries. These potential measures, like the sale of US bonds mentioned above, will impose significant costs on both sides.

### **The effect on the system of alliances**

As can be seen, it is difficult to find unambiguous assessments of the expected contraction in trade and it is even more difficult to find unambiguous findings which conclude that the trade war and the possible drop in the volume of trade will indeed raise the likelihood of violent confrontations. However, and notwithstanding the disagreements between the studies, research on this issue has produced a consistent finding that can help in understanding one of the most important expected implications of increased tension in trade relations. Almost all statistical studies of the issue report a positive and statistically significant connection between trade on the one hand and the existence and strength of alliances on the other.<sup>15</sup> This is apparently a two-way connection, whereby allies trade a lot with each other and trade is a way for countries to express their commitment to an alliance.

These consistent findings can provide an indication that the escalation of the trade war and a major contraction of US trade with its friends in Europe, Asia and the Americas will be added to other factors that increase the concern that the US is not fully committed to its allies. The fear of losing faith in US commitments to its allies has various results, such as attempts by some of the countries to improve relations with China and greater willingness to take part in the new international institutions that it is trying to promote, including the Asiatic Infrastructure Investment Bank (AIIB) and others. It would be premature therefore to conclude that the American steps herald the fragmentation of the trade system and constitute a threat to world peace. However, an escalation of the trade war will likely lead to a slow disintegration of the global trade system that is also likely to herald changes in the network of US alliances, which it nurtured during the years when it was the leader and initiator in international trade.

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15 Nizan Feldman and Tal Sadeh, "War and Third-party Trade," *Journal of Conflict Resolution*, Vol. 62, no.1 (2018), pp. 119–142.



Table 1:

China	US\$	USA	US\$
China GDP	12,014,610	US GDP	19,390,600
GDP per capita	8,309	GDP per capita	57,831
Trade of GDP	19.10%	Trade of GDP	13.40%
Trade per capita	1,586	Trade per capita	7,756
China Export	2,263,329	US Export	1,546,725
China Export out of GDP	18.84%	US export out of GDP	7.98%
China Export to US (*)	430,033	US Export to China	182,347
China Export to US out of GDP	3.58%	US Export to China out of GDP	0.94%
China Export to US out of all export	19%	US Export to China out of all export	11.79%
China Import	1,841,889	US Import	2,409,495
China Import out of GDP	15.33%	US Import out of GDP	12.43%
China Import from US	182,347	US Import from China	430,033
China Import from US out of GDP	1.52%	US Import from China out of GDP	2.22%
China Import to US out of all import	9.90%	US import from China out of all import	17.85%

(\*) direct export

[https://www.wto.org/english/res\\_e/statis\\_e/statis\\_e.htm](https://www.wto.org/english/res_e/statis_e/statis_e.htm)

<https://atlas.media.mit.edu>

Israel is not currently involved in the trade war, but of course a reduction in the volume of international trade and a change in the institutional arrangements can be expected to affect the Israeli economy, which is export-biased. Increased tension between the superpowers on economic issues is likely to increase the interest of the US in the amount and character of China's investments in Israel and may even lead to pressure on Israel to refrain from accepting Chinese investments in strategic domains.