



Institute for International Trade

COLD WAR 2.0: IMPLICATIONS FOR MIDDLE POWERS

Executive Summary

The commercial and geopolitical conflict between China and the United States is unlikely to abate in the coming years. This brief discusses the contours of recent geopolitical history in order to contextualize the nature of this new “Cold War” between the two superpowers. Then the brief turns attention to what we can expect from the Biden administration with respect to its policies vis-à-vis China. At the same time, it explores the policy conundrum that the emerging Cold War “version 2.0” poses for United States allies that have close economic ties to China, as is the case for middle powers like Australia and Brazil.

As geopolitical concerns multiply, and the phenomenon of economic coercion becomes more common, middle power leaders are increasingly being guided by security concerns when acting in the economic policy domain. This can lead to unintended consequences and economic damage if geopolitics dominates economic policy thinking during policy formation. Thus, the key policy recommendation of this brief is for governments to create greater institutional dialogue between policy spheres that have typically been operating in a separate fashion after the end of the original Cold War. In short, the importance of better integrating geopolitics and economics¹.

Background

Much has been written about the role of the Trump administration in augmenting bilateral tensions with China. Some have characterized America’s protectionist measures as a tactical move undertaken primarily to address the commercial imbalance between the two countries. In this context, the characterization of the trade conflict as a harbinger of a new cold war might be considered an exaggeration.

The reality, however, is that there has been a significant increase in the rhetoric of both countries in framing developments as a “conflict.” Over the last four years, the USA has announced the reorientation of

its defense strategy with the objective of placing greater priority on responding to a potential great power confrontation (in contrast with the previous focus on international terrorism).

Mike Pompeo, the former United States Secretary of State, explicitly identified the conflict between market economies and socialism with Chinese characteristics as the main determinant of international relations in the 21st century in a speech delivered in July 2020.² On that occasion, he also stated that countries will have to pick a side “between freedom and tyranny.”

China, in turn, has also changed its approach to international relations. Gone are the days when Deng Xiaoping advanced the “keep a low profile” stance as the paradigm for China’s diplomatic policy (sometimes described as a strategy of “hiding your strength, biding your time and never taking the lead”). The Xi Jinping era has been marked by increased diplomatic assertiveness (as illustrated by China’s recent statements and actions with respect to Hong Kong, Taiwan and Australia), a growing military presence in the South China Sea, the ambitious scope of the Belt and Road Initiative – not only as an infrastructure project, but also as a major geopolitical endeavor (despite some recent retrenchment amid concerns about debt sustainability) – and Xi’s proposition that China is ready to “lead the reform of the global governance system with the concepts of fairness and justice.”

There is hope that President Biden will be able to address these issues, restoring the credibility and leadership of the USA among world democracies and diminishing the confrontation with China. The initial appointments of the new government (e.g., the choices of Ronald A. Klain as Chief of Staff, Antony Blinken as Secretary of



State, and Jake Sullivan as National Security Advisor) give credence to the idea that a more conventional approach to United States foreign policy will prevail in the next four years. Some have even characterized Biden's agenda as Obama 2.0 in view of the individuals involved and of recent statements.³ The victories of the Democratic Party in the run-off elections for the Senate in Georgia (January 2021) will facilitate the implementation of this agenda.

Mr. Biden could also use his Executive Powers to address some issues independently of the Congress. The return to the Paris Climate Agreement – which the US handled as an executive agreement, not requiring Senate approval – as well as the decision to retract the US withdrawal notice from the WHO, were among the first decisions of the Biden administration.

Can the United States Become a Credible Partner Under Biden?

Some of the disruptions implemented by the Trump administration, however, will have long-term implications. The credibility of the USA as a trusted partner immediately comes to mind. One should not expect, for example, major changes with respect to trade policy in the short run.

The initial focus of the Biden administration will be the control of the COVID-19 pandemic and its economic externalities. In order to pursue any major new trade agreement, the new government will first have to secure, in the Congress, the renewal of the Trade Promotion Authority, which expires on July 1, 2021.

Future trade agreements are likely to be heavily influenced by the framework of the USMCA (the revised NAFTA driven by Trump's priorities, but also significantly influenced by Democrat members of Congress), maintaining a managed trade bias reflecting restrictive rules of origin and with additional emphasis on labor and environmental standards.

Biden has signaled his intention to employ domestic preferences in government procurement and tax incentives to strengthen US manufacturing in critical areas (notably, in relation to medical products), combat offshoring by Federal contractors and others, and reinforce national security.⁵

The implementation of Phase 1 of the China-USA agreement signed in January 2020 will continue to be an important point of reference. The appointment of Katherine Tai, an experienced US trade hand (including with respect to US-China trade relations⁶) as USTR suggests that the Biden administration will keep China-USA relations as a top priority in terms of its trade agenda. The mediocre results so far in terms of US export expansion in the context of the agreement, in turn, suggest that additional US action will be required to enforce or renegotiate the accord.

Technological Competition

The focus of the conflict, however, will increasingly shift to the issue of technological competition. The first salvo in this tech-cold war can be traced back to the ban imposed on the sale of American components to ZTE in 2017 after the company was accused of violating American laws that prohibit the sale of American technology to Iran and North Korea. Although this ban was suspended after ZTE settled with the US government and paid significant fines, ZTE and Huawei have now been formally removed from the list of acceptable equipment suppliers for US telecom providers by a decision of the FCC on December 11, 2020.

These decisions were consistent with the efforts of the Trump administration in the context of the Clean Network initiative structured to guide countries as they design, build and manage their 5G infrastructure. One should expect the maintenance of these barriers (e.g., on the use of Huawei's 5G equipment in the US and around the world). US recourse to export controls and extraterritoriality is also expected to continue as means to coerce US and foreign companies to stop selling semiconductors or other sensitive technology products (e.g., with dual military and civilian uses) to targeted Chinese companies.⁷

Pressure continues to build on Huawei. Tom Cotton, a US Republican Senator, Arkansas, for example, argued amid the debate in the UK about 5G provision that: "Allowing Huawei to build the UK's 5G networks today is like allowing the KGB to build its telephone network during the cold war."⁸ And the tech-cold war has been extended to social networks, infrastructure and apps (e.g., TikTok, Tencent and WeChat) under the perception that they pose similar threats to Western values.

Not surprisingly, capital flows are also being impacted by new regulations. In November, the Trump administration identified several companies with presumed ties with the Chinese military, prohibiting

future American investments in the shares of these companies, as well as in investment funds that include these companies. China, in turn, announced in December new rules for reviewing foreign investment proposals based on national security considerations. Although the announcement was made in parallel with assurances that this would not imply a backtracking on liberalizing policies, chances are that this new review process may be used as a mechanism for tit-for-tat measures in the context of US-China and related third-party relations.

The externalities of Cold War 2.0

Cold War 2.0 generates significant externalities for the rest of the world. This is particularly evident in the case of countries like Australia and Brazil that have historical alliances with the USA, but that have become increasingly dependent on the dynamism of the Chinese market. The conventional wisdom that these countries do not need to choose between the USA, the geopolitical ally, and China, their main trade partner, is being increasingly challenged.

The Australian context

In the case of Australia, the alignment with the US with respect to security and privacy concerns is not surprising. After all, Australia is a member of the Five Eyes alliance -- which also includes the USA, the UK, Canada and New Zealand -- that monitors electronic communications. Australia banned the use of Huawei equipment in its 5G network on national security grounds in 2018. Since then Australian comments about the need for an international inquiry into the origins of SARS-Cov2 and criticisms of China's human rights record have led to a series of reactions from Beijing affecting major Australian exports such as coal, wine, and beef.

Ironically, these tensions have been growing as China and Australia joined Japan, New Zealand, South Korea and the ten ASEAN economies in signing the Regional Comprehensive Economic Partnership (RCEP) on November 15, 2020. RCEP provides for gradual trade liberalization eliminating tariffs initially for roughly 65% of the trade in goods among its members, with the share of free trade in goods expected to reach 90% in twenty years. To a certain extent, Australia has become the "canary in the coal mine" for how China will be dealing with countries that confront its new assertiveness, independently of trade agreements.

The Brazilian context

In the case of Brazil, the alignment between the Trump and the Bolsonaro administrations was based more on ideological and personal preferences than on a conventional geopolitical alliance. The Bolsonaro administration abandoned the pragmatic approach (and non-alignment) that characterized the Brazilian diplomacy, pursuing a closer relationship with the USA as of 2018. This approach, according to the government, facilitated the conclusion of the Protocol on Trade Rules and Transparency (October 20, 2020) between Brazil and the USA, as well as American support for Brazil's accession to the OECD.

The change in guard in the White House, however, will pose several challenges for the Bolsonaro administration.⁹ The topic of illegal deforestation in the Amazon region is likely to generate significant tensions. Moreover, discussions on the Brazilian ethanol tariff-rate quota, as well as the tightening of the steel quota adopted by the Trump administration in August, will continue to be topics for negotiations.

Concerning 5G, the Brazilian Ministry of Foreign Affairs has issued a declaration supporting the concept of the Clean Network initiative. Such a statement, however, has not been validated by the relevant regulatory agency (ANATEL), nor has it been formally discussed by the Congress. The telecommunications companies in Brazil have alerted the government to the potential economic costs that prohibiting Huawei equipment may entail. Their concerns arise not only due to consequences of limiting competition, but also potential problems in the operation of the telecom infrastructure. Huawei is currently a major player in 4G networks in the country. The auction for the use of 5G spectrum is expected to be held in the first semester of 2021. There are no available legal instruments to veto *ex ante* the participation of a specific company. But there was speculation that the government would pursue some creative language in the auction rules to accomplish this in an indirect manner. More recently, however, Brazil's dependence on Chinese inputs for a Covid-19 vaccine seems to have influenced the government's position, paving the way for Huawei's participation in the Brazilian 5G auction.

China is the largest trading partner of Brazil since 2008, when it overtook the USA. Brazil traditionally achieves a significant bilateral trade surplus vis-à-vis China (with an anticipated surplus of more

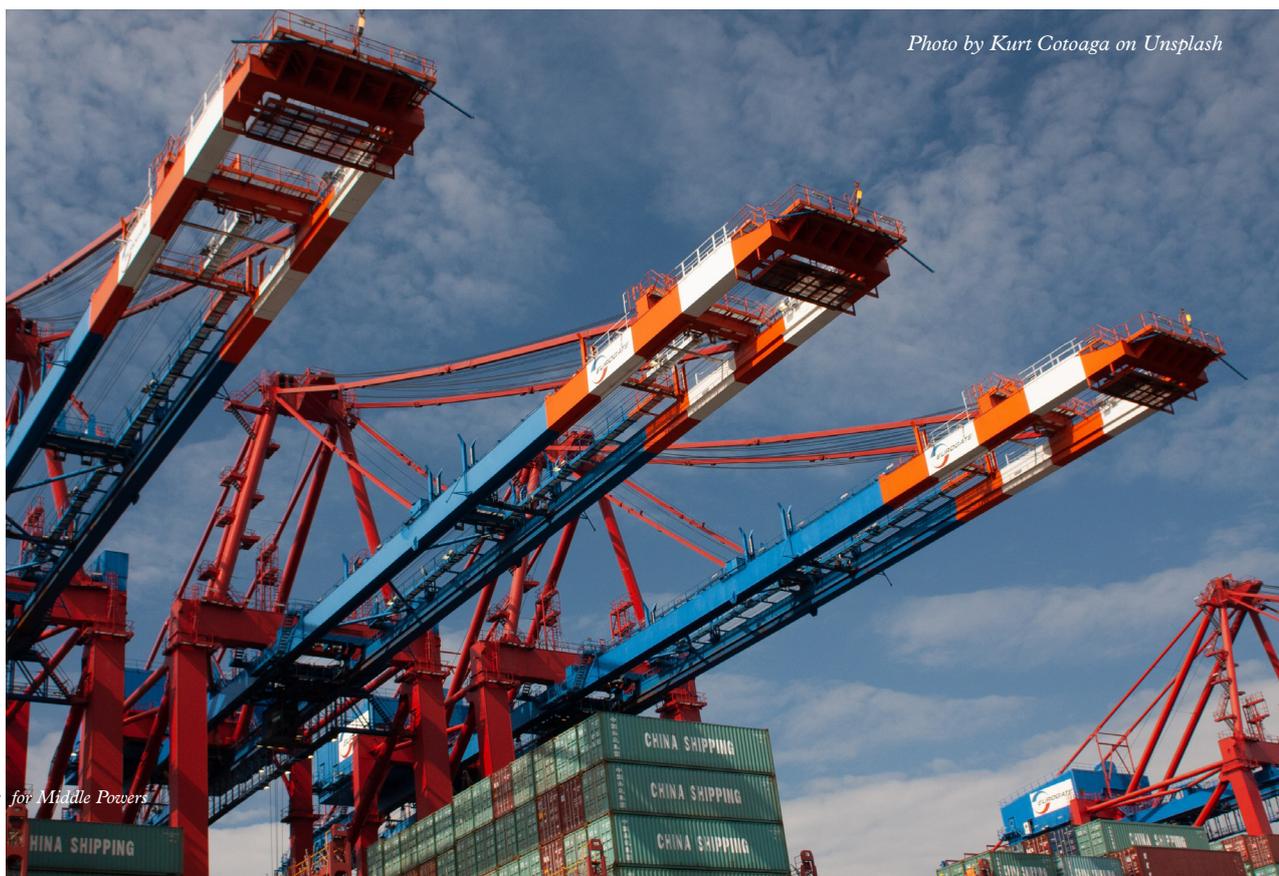


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than US\$34 billion in 2020). In the first eleven months of 2020, Brazilian exports to China increased by 9.4%, while they contracted in double-digits with respect to other major trading partners (USA, EU and Argentina). Primary products (e.g., soybeans, meat, iron ore, oil) are the main items exported by Brazil to China while industrialized products (e.g., telephones, broadcasting accessories, integrated circuits) dominate Chinese exports to Brazil.

The bilateral relations, however, have been affected by ill-advised comments of some government officials and politicians (including one of the sons of the President who chairs the International Affairs Committee in the Congress). The decision on the 5G infrastructure will play an important role in framing the dialogue between Brazil and China in the coming years.

Cold War 2.0 will remain as a major source of tensions at international level in the years to come. The best hope is that, as in the original Cold War, the contest between the two super-powers does not evolve into a dramatic economic decoupling or even a “hot” war. The interdependence of the Chinese and American economies, as well as the recognition that multilateral solutions in areas such as climate change and global trade governance, creates significant incentives for cooperation. These are the main arguments in favor of a new version of superpower détente. At the same time, as the recent “political” agreement on the EU-China investment treaty suggests, automatic alignment by democracies with the USA is not guaranteed.

Recommendation: Integrating economics, foreign policy and security policy making domains

For middle powers like Australia and Brazil, the greater the influence of the security and intelligence establishments in defining foreign policy, the bigger the chances of economic harm, particularly, if these influences are expressed in an “amateurish” or ideological fashion. Thus, it is increasingly important to strike a proper balance between economic and security interests.

Ideally, policy decision-making should advance national interests in an environment characterized by pragmatism and a realistic perception of the rapidly changing face of international relations. This requires closer coordination between economic, foreign affairs and national security institutions.

Leadership from the top is fundamental to coordinate these efforts and to minimize the inevitable clash of the cultures that dominate these institutions.

Different countries, with different institutional arrangements, will have to adjust their decision-making processes with a view to effectively pursue their national interests. But unless a country develops an effective mechanism to better integrate different perspectives, the danger of policy incoherence increases in this new era of great power confrontation.

It is often mentioned that the ideogram for crisis in Chinese is a combination of the characters that signify danger and opportunity. Such an interpretation was popularized by John F. Kennedy and Al Gore, even though it is disputed by Chinese linguists. An alternative interpretation is that the ideogram in question combines characters associated with the concepts of danger and of “a critical juncture” or a “crossroads.” No doubt we are now facing the proverbial “fork in the road.” Decisions taken in Washington, Brussels and Beijing, as well as in Canberra and Brasília, may determine the future of international economic relations for years to come.

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- ² See “Communist China and the Free World’s Future,” Speech at The Richard Nixon Presidential Library and Museum (July 23, 2020).
- ³ See, for example, Joseph R. Biden, Jr., 2020, “Why America Must Lead Again: Rescuing U.S. Foreign Policy After Trump,” Foreign Affairs (March/April).
- ⁴ Vox, “Democrats – and Trump – declare victory on USMCA”, 10 December 2019; <https://www.vox.com/2019/12/10/21004584/usmca-democrats-trump-nafta-trade-deal>.
- ⁵ Joe Biden, “The Biden Plan to Rebuild US Supply Chains”, 2020; <https://joebiden.com/supplychains/>.
- ⁶ New York Times, “Biden Picks Katherine Tai as Trade Representative, 9 December 2020; <https://www.nytimes.com/2020/12/09/business/economy/katherine-tai-us-trade-representative.html>
- ⁷ For further details see Chad P. Bown, 2020, “How the United States marched the semiconductor industry into its trade war with China,” PIIE Working Paper, 20-16 (December). Also see, US Export Regulations, US Department of Commerce; <https://www.trade.gov/us-export-regulations>, including the Commerce Control List and the Entity List.
- ⁸ As quoted in J. Kynge and N. Fildes, 2020, “Huawei: the indispensable telecoms company,” Financial Times (January 31st).
- ⁹ It is worth mentioning that Jair Bolsonaro became known as a “Tropical Trump.” Brazil was the last G20 country to formally congratulate president-elected Joe Biden on his victory, as some advisers to the President kept alive the narrative that the results of the US election could be reversed by the courts.

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