

# The economic balance of power and need for alliances

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## Introduction

Unilateral action by the United States has had a limited impact in modifying China's behavior either in the economic or geopolitical sphere. This paper examines the appropriateness of multilateral and plurilateral approaches to geo-economic policy aimed at China's current regime. It is by nature speculative but aims to stimulate thought as to how businesses should position themselves for a bifurcation of the global economy between China and its allies, and liberal democracies. Consideration is also given to China's neighbors as they aim to immunize their economies from China's weaponization of economic linkages. The paper argues that the process of alliance building could deepen economic engagement between like-minded countries and, perhaps counterintuitively, reinvigorate the multilateral trading system in a more sustainable way as a result of China's absence from it.

If the objective is to modify China's behavior through economic policy, success is more likely if policy is broadly applied through alliances.

## Why the need for an alliance?

"[US-China decoupling: How far have we come and how far will we go?](#)" argued that American strategic objectives have either changed or become more apparent since the initiation of tariffs in July 2018<sup>1</sup>. A more expansive use of economic statecraft, beyond just tariffs, will be required to limit China's ability to weaponize the economic interconnections between the two economies. Furthermore, if US aims now revolve more around containment of China's expansionism, rather than being directed towards a renegotiation of the pre-existing economic relationship, buy-in from potential allies is more important. For a geo-economic policy aimed at moderating China's behaviors to be effective, it must have a meaningfully asymmetric impact and for that to be so, cooperation from third countries will be imperative.

Forming a coalition will involve trade-offs between the ambition of the goals and the breadth of support.

There are perhaps two ways in which a coalition can form. The first is through an alliance of like-minded nations with closely aligned geopolitical objectives, forming a bloc of sufficient size that it compels more reluctant "neutrals" to choose sides. The second is to adopt a more moderate set of goals shared by a broader grouping, thus compromising on ambition but requiring less coercion. In addition, there exists an option of encouragement through the prospect of a reaffirmation and deepening of multilateral economic cooperation among the "coalition of the willing." This lends credence to the view that it is not economic multilateralism per se the US is opposing but merely the current version, exemplified by the WTO, which is viewed as dysfunctional due to its inability to accommodate China's economic model. The prospect, for example, of US cooperation in reforming the WTO and restoring the functionality of the appellate body, in the absence of China's membership, would perhaps appeal to potential members of a "coalition of the willing."

Neither the message nor the messenger have had broad appeal, but as US's China policy becomes more bipartisan, it is becoming divorced from the person of Trump.

Alliance building has played little part in US policy making towards China so far, in part because the leadership style of President Trump has alienated public opinion in potential allied countries – as evidenced by the Pew Research center's global attitudes survey<sup>1</sup> – and Trump's China policy has been conflated with his persona. Equally, historic support for a potentially disruptive and costly economic confrontation with China has been lacking. Neither the message nor the messenger has had broad appeal. As the United States' China policy has attracted

more bipartisan support, it is becoming less conflated with the President's personality, something the election process is perhaps underlining.

### China's miscalculation?

The process of garnering international support for a more assertive policy towards China has received a boost from an unlikely source. China, under Xi Jinping's leadership, appears in recent times to have successfully alienated, to some degree, most of its neighbors. The militarization of the South China Sea has provoked anger among those countries impacted. Skirmishes on the Indo-Chinese border have had a significant impact on Indian public opinion as evidenced by the resurgence in economic nationalism there. The Covid-19 pandemic has made China and the current regime a focus of world attention. The imposition of the Hong Kong National Security Law, its wide-ranging potential application, and the ambiguity that it has created, has dented confidence even among the economic elites, both Western and Asian, that have traditionally supported economic engagement with China. Additionally, economic sanctions against Australia and a bellicose attitude towards countries pursuing economic links with Taiwan has added to a sense that China is asserting itself in a hostile manner. Against a more circumspect background, China's human rights record is receiving renewed scrutiny. New light is being shone on its influence campaigns abroad and the consequences of China's economic rise are being debated in forums that hitherto had little interest in the subject. In short, the atmosphere globally has, unfortunately, never been more conducive to economic and military alliance building for concerted action to counter China's revisionism, expansionism and mercantilism.

### Obstacles to alliance building

There remain, however, considerable challenges to building a consensus for economic action aimed at moderating China's behavior. Assertive US action towards the EU and Canada regarding trade, for example, has chilled relations between core allies. "America First" as a slogan and a policy has cast doubt on US commitment to the global order and to its security umbrella, under which such a large part of the free world has existed. As importantly, American inaction under the Obama administration – which some would argue<sup>3</sup> effectively ceded control of parts of the South China Sea to China without any pushback – calls into question the efficacy of an alliance with the US and its willingness to enforce the rule of international law in the Indo-Pacific. Undoing this damage may require recognition from the US administration that it cannot "right all wrongs" (perceived or real) at the same time if it is to build a global economic alliance to curtail China's ambitions. If China is America's top foreign policy priority, and if it is to be successful in its strategic objectives, other issues may need to be shelved. Past ambivalence and fighting on multiple fronts have reduced confidence and amity among some potential allies.

Among potential American allies there exist both different degrees and types of economic interdependency with China. For example, the UK's key vulnerability is potentially the US\$600 billion<sup>4</sup> in international lending by UK banks in China and Hong Kong, while UK exports to China account for just 1% of UK GDP and

Considerable challenges remain to building a consensus for economic action aimed at moderating China's behavior.

Past ambivalence towards China's assertiveness and internecine conflicts among allies have reduced both confidence and amity.

Differing degrees and types of economic interdependency result in differing vulnerabilities.

The benefits and costs of economic interaction are not necessarily captured in raw statistics; there is a qualitative as well as quantitative dimension to the welfare gains from trade.

are therefore almost negligible. For Australia, on the other hand, 38% of goods exports go to China and they account for 7% of Australia's GDP.

The degree of perceived threat from China does not necessarily correlate with the degree of economic interdependence and therefore the cost of decoupling. Furthermore, the degree of economic interdependency does not necessarily correlate with the level of perceived geopolitical threat from China. This complicates the alliance building since the willingness to absorb economic costs from an escalation of geo-economic action is presumably linked to the degree to which a country perceives its national interests to be threatened by Chinese action. Australia and New Zealand, for example, are more interconnected with China through trade than Japan, but Japan has a territorial dispute with China – a factor absent from the Antipodean-Sino relationship.

In addition, a purely statistical measure of economic interdependence in any specific field, such as trade flows, where one might use bilateral trade as a percentage of GDP, will not tell the whole story in terms of the potential vulnerabilities that interaction has created: the raw trade data does not capture welfare gains from the trade and the opportunity cost of foregoing the trade, which would be determined by factors such as the availability of third party substitutes. Similarly, foreign direct investment (FDI) can be relatively exploitative (investment in mineral extraction for export or acquisition of technology, for example) or beneficial to the host country, in terms of the creation of whole industry clusters that form a lasting industrial complex with significant spill-over effects.

China's apparent recovery from the Covid-induced recession raises the prospect of an even more Sino-centric regional economy in the short-term, raising the cost to policy makers of economic sanctions against China.

A further complication is the time horizon of democratically accountable governments. China's economic rise, coupled with "catch-up" by other developing countries, combined with demographic changes, mean that the dominance of the United States and core allies within the global economy is waning. As global GDP becomes more diffuse, so the potential for effective alliance building to implement geo-economic policies may diminish. China's apparent recovery from the Covid-induced recession holds out the prospect of a more Sino-centric global and regional economy. This may moderate the appetite for any action that would alienate alliance participants from China.

The case of CCCC and the Philippines is illustrative of the issues around multilateral action against China, pointing towards the need for a formal structure to any multilateral action.

The reaction of the Philippines to the recent inclusion of subsidiaries of China Communications Construction Corporation (CCCC) on the US Entity List for their involvement in the construction of artificial islands in the South China Sea is illustrative of these issues. The efficacy of sanctions is in large part determined by the breadth of their application. Initially, it appeared that the Philippines would follow the US lead and prohibit CCCC involvement in infrastructure projects, only for this policy to be apparently overturned by President Duterte. This is indicative of a "free-rider" problem, where a country might share some or all of the strategic objectives of geo-economic policy aimed at containing China, but would rather be a recipient of Chinese largesse while hoping others take the economic cost of action. Addressing the "free-rider" problem may well call for a formalized alliance to coordinate action as opposed to the informal and largely bilateral action that we have seen to date.

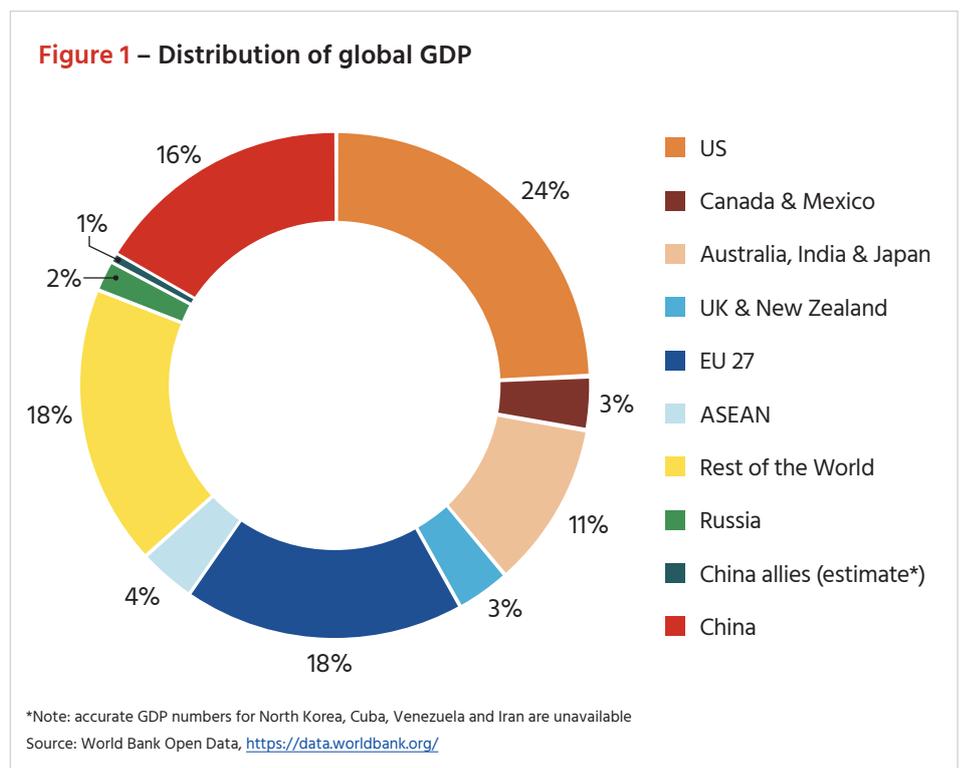
Liberal democracies form a formidable economic bloc – isolation from which would incur considerable and debilitating economic costs.

China accounts for 16% of global GDP, the US 24%, leaving 60% outside the two economies.

### The economic arithmetic of a potential alliance

Liberal democracies form an economic bloc that few others would wish to isolate themselves from if economic prosperity were the only factor in the decision making. It is worth considering the economic arithmetic of alliance building and how the United States, and other countries that share its concerns over China’s growing military power, could put together an alliance that, if forced to choose, would be too compelling to ignore by countries trying to keep a foot in each camp.

As figure 1 below shows, global GDP in 2019 was US\$87 trillion. Of this the United States accounted for 24% of the total at over US\$21 trillion while China accounted for 16% of the total at US\$14 trillion. In a bifurcated world, should the geo-economic confrontation between the two largest economies escalate, that leaves 60% of the world economy to play for. How various countries react will determine the success or failure of American and Chinese strategy and essentially decide which of the two superpowers is isolating which.



If one includes Russia, China’s allies would bring its share of global GDP to around 20%.

In addition to China itself, Iran, Cuba, North Korea and Venezuela are already under US sanction and would therefore, one assumes, not adhere to any US-led demands to retreat from economic engagement with China. Russia is a special case, with regional hegemonic ambitions of its own and conflicting national interests with both China and the US and its allies, but for now we include it in China’s sphere of economic influence. Together these countries account for a further 3% of global GDP, taking a China-aligned bloc to 19% of the total.

The most likely partners for concerted economic pushback against China would be the NAFTA, QUAD and Five Eyes countries.

On the other hand, the USMCA countries (Canada, Mexico and the US) are so inextricably intertwined that realistically they have no choice but to acquiesce to US policy, if forced to choose, even if they wished for a closer relationship with China. In fact, Mexico probably stands to be one of the biggest beneficiaries of moves to reduce economic interaction with China, while Canada is already a member of Five Eyes<sup>5</sup>. The remaining members of the “five eyes” (Australia, New Zealand and the UK) – America’s closest security allies – account for a further US\$4.4 trillion, or 5% of global GDP. The remaining two QUAD<sup>6</sup> countries, India and Japan, make a further and very meaningful contribution to the balance of economic power. South Korea’s stance may be more nuanced and complicated by North Korea but as a big beneficiary of the US security umbrella, and a treaty ally, would probably fall into line if the economic and political cost were too high to resist.

Collectively this potential bloc has a GDP of US\$38 trillion and accounts for 42% of global GDP.

The bloc of eight countries (US+7) account for 42% of world GDP. Taiwan, with a US\$500 billion economy, is not in the World Bank dataset, but combined with South Korea (both listed under “Rest of the World” in figure 1) would take this to around 44% of global GDP. At US\$38 trillion, this bloc is over two times larger than China and its allies. The major economies by grouping not yet accounted for in this calculus are ASEAN, Latin America, Sub-Saharan Africa and the European Union.

US-EU relations have been strained of late but there is a large, if not complete, coincidence of interests between the EU and US on China policy.

Relations between the United States and the EU have been strained during the Trump administration. Issues such as contributions to NATO, trade disputes, Russian sanctions and Nordstream 2 have all played a part. The EU has demonstrated that it is prepared to pursue its own interests where they differ from those of the United States. With regard to China, however, while there are certainly differences in approach, the overriding interest is in maintaining the territorial status quo in Asia and seeking a more symmetric economic relationship based on reciprocity while pushing back against revisionism, IP theft, and state-sponsored cyber-attacks which dovetails to a large degree with American interests. The elongated and stalled process of negotiating a bilateral investment treaty between the EU and China has been an eye-opener when it comes to dealing with Chinese intransigence and one senses that the EU is moving slowly towards the US stance on China.

Germany has had a relatively successful trading relationship with China.

Germany, for example, has a relatively deep and beneficial trading relationship with China. Bilateral trade in goods was about US\$232 billion in 2019 and was reasonably balanced with German exports at about US\$108 billion and imports at US\$124 billion. Nevertheless, German exports to China only represented about 2.8% of German GDP and bilateral trade represented just 8.5% of Germany’s total trade.

For the rest of the EU however, Chinese trade is small.

Germany, however, dominates the EU’s economic relationship with China. While Germany accounts for 25% of EU GDP, it accounts for 49% of EU goods exports to, and 35% of imports from, China. While exports to China account for 2.8% of German GDP, they account for just 1.4% of the EU’s GDP, and stripping Germany out, the remainder export just 1% of GDP to China.

Germany's economic relationship with China faces significant challenges.

Furthermore, Germany's trade relationship with China has revolved around the export of high-end capital goods and the German car industry (both exports from Germany and China-based manufacturing). "Made in China 2025" specifically and Chinese industrial policy in general is designed to ensure Chinese self-sufficiency in the high-tech arena. Furthermore, China has not been shy about leveling threats against German companies operating in China in an effort to influence German policy. It is becoming evident to German policy makers that China is willing and able to weaponize trade and as such, trade with China comes with a loss of independence when it comes to policy making.

The mood in the EU appears to be hardening against China's mercantilist policies.

There is a healthy ongoing debate in Germany about the nation's relationship with China as there is in the EU generally. While the EU's bilateral trade with China totals US\$650 billion, the Union enjoyed bilateral trade with the United States of US\$740 billion and a further US\$870 billion with the UK in 2019. Realistically one could argue that if the US were to embargo China or cut it off from the US dollar system, with secondary sanctions on third countries that broke the prohibitions, the EU would have little option but to adhere to US policy. One would hope, of course, that a commonality of interests and values would encourage not only EU cooperation in an alliance alternative, but a degree of leadership rather than reluctant participation.

Major ASEAN countries have territorial disputes with China.

ASEAN members enjoy differing degrees of economic engagement with China and perceive both opportunities and threats in this. Vietnam, the Philippines, Malaysia, Indonesia and Brunei all have ongoing disputes with China over territorial waters with significant economic consequences given the hydrocarbon-rich nature of the South China Sea. Yet China is a crucial trading partner for many South East Asian nations and some stand to benefit from the migration of manufacturing from China – a trend that has been accelerated by the geo-economic policies of the Trump administration.

China on the other hand has made significant investments in smaller ASEAN states.

Trade and investment linkages with China have grown and China's chequebook diplomacy carries some weight in ASEAN. This is particularly true in Laos and Cambodia where Chinese FDI associated with the Belt and Road Initiative (BRI) is seen as a major driver of economic growth.

The EU has been the largest outside investor in ASEAN over the past decade and collectively the EU, Japan and the United States account for nearly ten times the amount invested by China. In fact, Australia, Taiwan and Korea have invested as much in ASEAN as have China and Hong Kong<sup>7</sup>.

Should the EU and ASEAN be persuaded to align themselves with US allies, such a bloc would account for 65% of global GDP and 80% of GDP ex-China and its allies.

Should the EU and ASEAN come onboard, such an alliance would cover 65% of world GDP. Non-EU European countries such as Norway and Switzerland, close US allies in the Gulf and Middle East such as Israel and Saudi Arabia, coupled with American allies in South America, would cement an all-powerful economic bloc arraigned against China. The rest of the world would be rolled-up because the economic costs of being cut out of engagement with such a bloc would simply be too high.

### Burden sharing, purpose, structure and a road map to normalization

There are perhaps four points for consideration concerning the prospect of such an economic alliance to resist China's geopolitical ambitions.

1. The costs of disentanglement would not be spread evenly. Australia and South Korea, for example, have outsized exports to China relative to the size of their economies. Would a mechanism for redistributing costs be required?
2. Unity of purpose requires a clear strategic and achievable goal to be agreed upon, together with a yardstick by which to measure its achievement.
3. Does a multilateral grouping of countries already exist that could provide a framework for achieving the goals of such a policy, if it were expanded (or contracted) appropriately to include the broadest possible number of willing participants?
4. If success is measured as a re-engagement of China in the multilateral trading system on more mutually beneficial and enforceable terms, what changes would that require within China?

Other multilateral organization have burden-sharing mechanisms.

Collective security organizations, such as NATO, have cost sharing mechanisms and an equivalent for geo-economic policies is surely a possibility. It is worth bearing in mind that defense expenditure as a percent of world GDP has fallen from more than 6% at the height of the Cold War to about 2% now. The four-percentage point saving is worth US\$3.5 trillion to the global economy given its current size. Avoiding the need for a return to these levels by the judicious use of economic leverage to induce compliance is surely a prize worth having.

There appears to be a growing consensus around some defensive economic goals.

In terms of strategic goals, defensive objectives could be identified as: ensuring, through the realignment of supply chains, the inability of China to disrupt economic activity; the limitation of technology transfer with dual use potential; and preventing China from gaining a position to weaponize economic interdependence in other areas such as payment systems and capital markets. There appears to be a growing consensus around achieving some of these aims, although the dominance of the US dollar as a reserve currency is contentious among some potential allies.

Conditioning negotiations for a normalization of economic relations upon the settlement of geo-political issues would bring pressure to bear for a multilateral approach to a solution.

More expansive goals would be to prevent China from gaining sufficient economic might to support its ongoing pace of military expansion, settling China's lengthy list of territorial disputes and agreeing to enforceable mechanisms to prevent military technology diffusion and nuclear proliferation to rogue states. If such goals were achievable, then a normalization of economic relations could be conditioned on the reciprocity and market economy principles that were the intended conditionality of WTO membership.

One issue with conflating economic engagement with geopolitical issues is that multilateral groupings tend to revolve around one or the other, but not both. China is the leading member, in terms of economic size, of the Regional Comprehensive Economic Partnership (RCEP), for example, but all the non-US members of the US-led QUAD – Australia, India and Japan – are also members of

A new structure for Indo-Pacific economic and security co-operation is needed.

RCEP. The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) would appear to be the most likely existing structure that could be expanded to incorporate countries seeking to maintain stability in the Indo-Pacific. Indeed, China has previously criticized the grouping as designed to contain China and the decision by the Trump administration to abandon the agreement is widely seen as a geo-strategic misstep. Yet furnishing the agreement with a harder geo-strategic mission would likely be resisted by some members and give pause for some of those countries in the region who have expressed an interest in accession. Hence, it is perhaps more likely that a new structure for Indo-Pacific economic and security co-operation is needed.

Underlying the whole argument for a more assertive response to China's militarization and mercantilism is of course the assumption that, under President Xi, China will not modify its behavior unless it must. Furthermore, the most likely driver of change would be a substantial challenge to the prosperity of the country. There is, though, a plurality of opinion in China and there is a danger that much of the rest of the world, by moving from a position of indulgent engagement with China to an assertive defensiveness in such a short space of time, is seen to be closing down options for those in China who want to see the country converge on global norms. The mistake of the late 1990s was to assume that prosperity would drive reform, whereas it has in fact cemented the Communist Party in power. Perhaps the mistake now would be to isolate China for what it is rather than what its current policies under this leadership are.

### Conclusions

Whether because of the Trump administration's actions, despite them, or completely unconnected to them, there is a growing consensus that a return to the pre-trade war ex-ante status quo regarding economic engagement with China is undesirable. China's growing economic might has been transformed into increased military power and that has been accompanied by a more assertive and expansionist geopolitical agenda which is the driving force behind a growing desire for collective action to maintain stability in the Indo-Pacific region.

China's past and ongoing willingness to weaponize the economic interdependencies that have grown with its economic power is driving the need on the part of the US and China's neighbors to immunize their economies from such action. While the adoption of geo-economic policies aimed at moderating China's behavior will entail costs, so too would acquiescence to China or the alternative – military expansion to maintain an ability to deter China.

A multilateral approach is more likely to achieve strategic goals.

For economic policies to have the desired impact they must have a significantly more debilitating impact on China than on the countries implementing them. It is debatable whether the unilateral action from the United States so far has had such an asymmetric impact. A multilateral approach is more likely to achieve strategic goals and that requires an alliance building process.

Furthermore, a diminished role for China in the international economy could well facilitate a deepening of economic engagement between like-minded states, based on market economy principles with reciprocity, transparency and

The task for like-minded nations going forward is to refocus on the benefits of sustainable trade.

the rule of law at the core of such a system. If it has been the case that China's inclusion in organizations such as the WTO has had a debilitating impact on their effectiveness – that China's brand of nationalistic state capitalism is incompatible with a sustainable and equitable trading system – is it possible that a diminished role for China would reinvigorate the system in a more sustainable way? Equally, if economic engagement has failed to induce reform and compliance with global norms of international behavior, could a challenge to China's newfound prosperity increase the probability of a liberal resurgence in China?

The task for like-minded nations going forward is to refocus on the benefits of sustainable trade, ensuring that the governing structure is robust enough to ensure compliance. In this context, the economic relationship between China and the rest of the world from 2001 to 2019 should perhaps serve as a reminder of the dangers of asymmetric engagement lacking in reciprocity and underlines the importance of a commonality of purpose – the maximization of economic welfare – in economic interaction.

### Footnotes

- <sup>1</sup> July 2018, the US imposed tariffs on imports from China beginning what has become known as the US-China Trade war.
- <sup>2</sup> <https://www.pewresearch.org/global/2020/09/15/us-image-plummets-internationally-as-most-say-country-has-handled-coronavirus-badly/>
- <sup>3</sup> A number of incidents occurred during the Obama administration, perhaps most notably the stand-off between the Philippines and the PRC over Scarborough Shoal where it could be argued more assertive action from the United States could have helped establish de facto what the Permanent Court of Arbitration has established de jure.
- <sup>4</sup> BIS cross-border lending statistics available at: <https://www.bis.org/statistics/rppb1907.htm>
- <sup>5</sup> The intelligence sharing alliance comprising Australia, Canada, New Zealand, the United Kingdom and the United States.
- <sup>6</sup> The Quadrilateral Security Dialogue (also known as the QUAD) is an informal strategic forum between Australia, India, Japan and the United States.
- <sup>7</sup> ASEAN produce their own FDI figures with a lag available here [https://asean.org/?static\\_post=foreign-direct-investment-statistics](https://asean.org/?static_post=foreign-direct-investment-statistics). See also the UNCTAD ASEAN trade report available here. [https://unctad.org/en/PublicationsLibrary/unctad\\_asean\\_air2019d1.pdf](https://unctad.org/en/PublicationsLibrary/unctad_asean_air2019d1.pdf)

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