



*The Marathon Initiative*

# Economic Interdependence Will Not Deter U.S.-China War

**Bottom Line:** Economic ties linking the U.S. with China are insufficient to prevent a war. American financial muscle alone will not tame China's ambitions for Taiwan. Moreover, interdependence compromises the ability to use coercive economic statecraft, increasing the likelihood of military confrontation. In short, interdependence does not prevent states from going to war; it does, paradoxically, compromise the ability to use economic statecraft.

To restore the viability of economic statecraft, American policymakers must focus on making China more dependent on us than we on them by selectively restricting outbound investment in some sectors and building Chinese dependence in others, such as agriculture and energy.

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## **Strategy that counts on economic statecraft to deter China rests on two questionable assumptions.**

Assumption 1. Interdependence will deter war. Sovereign debt and corporate stocks and bonds form a “balance of financial terror” that amounts to deterrence by mutual dependence.<sup>1</sup>

- China holds \$1.1 trillion of U.S. sovereign debt while U.S. investors hold \$1.1 trillion in Chinese stocks and bonds. Any coercive power is compromised by symmetrical vulnerability.<sup>2</sup>

Assumption 2. If tensions did escalate, Washington would use the threat of sanctions to blunt a Chinese attack on Taiwan. A program of Russia-like sanctions, capital restrictions, export controls, and asset seizures can provide a swift and bloodless defense.

- Robert Blackwill and Philip Zelikow propose crushing economic sanctions in the event of an invasion of Taiwan. “First, the United States would freeze all assets owned by China, or its citizens, in the United States.” Then, “the United States would cut off, and strictly control, any business transactions or dollar transactions with China.”<sup>3</sup>
- Representative Mike Gallagher, a leader on China policy in Congress, has said: “If you doubt the willingness of a future President to go to war over Taiwan, you can guarantee that...a future president will fire every economic and financial weapon in his arsenal at China.”<sup>4</sup>

## **Continued U.S.-China escalation over Taiwan will stress-test these assumptions.**

For the first time in the People’s Republic of China’s history, Beijing’s capabilities match its long-standing intentions to “reunify” Taiwan.<sup>5</sup>

- *Intentions...*: Xi Jinping has demonstrated lower tolerance for the ambiguous cross-strait status quo. He sees Taiwan as a “hidden danger” that threatens “national rejuvenation” and has not shied from staking the legitimacy of the Chinese Communist Party on the Taiwan question.<sup>6</sup>
- *...Match capabilities*: Civilian passenger ships, fitted for dual use, augment the PLA’s amphibious lift capacity, solving the “most immediate limitation in executing a Taiwan campaign.”<sup>7</sup>

## **History suggests that economic sanctions will not forestall a Taiwan crisis.**

In the years prior to World War I, Great Britain and Germany were close trading partners, and their economic relationship expanded even as their political one faltered.

- *Economic linkage...*: Between 1890 and 1913, Britain’s exports to Germany doubled while their imports from Germany tripled.<sup>8</sup>

- *...Proves insufficient:* British-German economic interdependence failed to ballast the wider geopolitical forces. After interdependence failed to deter, British strategists tried to repurpose interdependence as a tool for warfighting.<sup>9</sup>

In the lead-up to war, British leaders believed they could rely on economic coercion to cripple their German rival. Great Britain devised plans for economic warfare that would have precluded a “continental commitment” of British troops. But economic warfare was called off.

- *Situation:* Economic warfare of “unprecedented” scale was “the cornerstone of British strategic preparations against Germany.” The objective was to smother the German economy the moment war arrived. The Cabinet even pre-delegated the Admiralty authority to implement the strategy.<sup>10</sup>
- *Result:* When war came in August 1914, the strategy failed. Policymakers feared economic coercion would exacerbate an acute financial crisis. Ingrained economic interests chafed at Whitehall’s oversight of the financial sector and flexed their political influence. Chastened, Whitehall scrapped plans for economic warfare and almost abandoned even the most basic trade restrictions like a blockade.<sup>11</sup>

**Pressure from economic interests, fear of blowback, lack of follow-through, and poor implementation neutered Britain’s efforts at economic coercion. These forces have returned.**

Today, Chinese economic planners are exploiting interdependence by devising countermeasures specifically designed to nullify the effect of economic weapons.

- *Market access:* A flurry of new laws, including a data security legal regime, are meant to put foreign companies operating in China in a “legal bind” – giving them a stark choice between complying with American sanctions and maintaining access to China’s domestic market.<sup>12</sup>
- *Asset seizure:* The costs of noncompliance with these laws are so severe that they include “expropriation of the foreign firm’s Chinese assets.”<sup>13</sup>
- *Firm behavior:* Some multinational companies may opt to defy American sanctions and remain in the Chinese market. After Trump’s trade war, “U.S. and allied firms were not more likely to exit China, suggesting that foreign direct investment outflows do not ‘follow the flag.’” At the very least, the U.S. government will find American corporations lobbying Washington on China’s behalf against harsher restrictions.<sup>14</sup>

**The absence of an effective economic option may force an American president to choose between a shooting war and humiliating capitulation. Counterintuitively, the immense scale of American and Chinese interdependence may increase the odds that a confrontation ends in a limited war.**

The military option may be the path of least resistance in a Taiwan contingency.

- *Best strategized:* While a defense strategy is codified in key American strategic documents, policymakers still debate whether economics can serve grand strategic objectives.<sup>15</sup>
- *Best rehearsed:* The president's richest department has war-gamed and drilled a military defense of Taiwan.<sup>16</sup>
- *Choice of history:* The United States turned to its military to help resolve the first three crises in the Taiwan Strait.
- *Appeal for China:* The surest way to nullify the coercive power of American economic statecraft may be to initiate a limited war that disrupts an unfavorable macroeconomic equilibrium. This equilibrium finds Chinese surpluses dependent on America's consumer market, providing incentive to "jump the tracks."<sup>17</sup>

**The United States needs an economic strategy focused on restoring the feasibility of American coercive economic measures.**

Single-minded focus on decoupling is misguided. Policymakers should not count on simply aiming to reduce the overall volume of trade in a few selected sectors on the principle of "trade less, raid less" via government interventions and incentives.

- China can backfill the loss of American capital from domestic sources and more pliant third-party countries. Only five percent of China's FDI is from the United States.
- Decoupling may work in China's favor. Large capital inflows threaten the viability of Chinese capital controls, vital to core Chinese economic objectives. Stemming the flow would remedy a financial problem vexing Chinese central bankers.<sup>18</sup>

**American policymakers must develop more effective – which is to say, more usable – tools of economic statecraft by counterintuitively but ruthlessly deepening interdependence in certain sectors, so that China is more dependent on us than we on them.**

Being more deliberate about the flow of capital and goods can help shape the character of U.S.-China interdependence and maximize the potency of economic tools in the event of conflict. Recommendations:

- *Investment screening to scrutinize the types of capital flows:* Implement an outbound investment screening mechanism ("reverse-CFIUS") with the authority to unwind transactions that provide substantial technological or management knowhow or that contribute to supply chain bottlenecks in critical areas.
- *Deepened economic integration between U.S. and allies:* Cooperate on outbound investment screening as well as "in house" production of key items among Western partners can align priorities and minimize the blowback of American economic statecraft in the event of a Taiwan rupture.
- *Leveraged capital:* Deepen U.S.-China connectivity in a few specific sectors with the objective of, first, building Chinese dependencies on U.S. surpluses, including energy and agricultural commodities, and, second, growing the stock of Chinese nationals' holdings of dollar-denominated financial assets that are subject to Treasury's sanctions authority.

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## ENDNOTES

<sup>1</sup> For Larry Summers' notion of a "balance of financial terror," see Brad Setser, "The balance of financial terror, circa August 9, 2007" *Council on Foreign Relations*, August 9, 2007

<sup>2</sup> For the latest figures, see Amanda Lee, "US debt to China: how big is it and why is it important?" *South China Morning Post*, December 3, 2020 and "Securities (C): Annual Cross-U.S. Border Portfolio Holdings," *U.S. Department of the Treasury*, Annual Statistics, 2021. For more on the concept of "Mutually Assured Economic Destruction," see Graham Allison, *Destined for War* (New York: Houghton Mifflin, 2017), 210

<sup>3</sup> Robert Blackwill and Philip Zelikow, "The United States, China, and Taiwan: A Strategy to Prevent War," *Council on Foreign Relations*, February 2021. See also Richard Haass: "Washington and its European partners should devise a sanctions regime to put in place in the event of a Chinese attack—and should reveal the scope of those potential sanctions to China" in "The Growing Danger of U.S. Ambiguity on Taiwan," *Foreign Affairs*, December 13, 2021

<sup>4</sup> Representative Mike Gallagher, "Chairman Randall G. Schriver and Congressman Mike Gallagher: Next Steps in Competition with China," Project 2049 Institute, October 26, 2021

<sup>5</sup> Elbridge Colby and Jim Mitre, "Why the Pentagon Should Focus on Taiwan," *War on the Rocks*, October 7, 2020

<sup>6</sup> Xi Jinping, "Speech at the Commemoration of the 110th Anniversary of the 1911 Revolution," *Xinhua News Agency*, October 9, 2021. Carlos Garcia and Yew Lun Tian, "China's Xi Vows Reunification with Taiwan," *Reuters*, October 9, 2021

<sup>7</sup> Thomas Shugart, "Mind the Gap: How China's Civilian Shipping Could Enable a Taiwan Invasion," *War on the Rocks*, August 16, 2021

<sup>8</sup> Allison, 64

<sup>9</sup> Richard Cooper, "Economic Interdependence and War" in Richard Rosencrance and Stephen Miller eds., *The Next Great War? The Roots of World War I and the Risk of U.S.-China Conflict* (Cambridge: MIT Press, 2014)

<sup>10</sup> Nicholas A. Lambert, *Planned Armageddon: British Economic Warfare and the First World War* (Cambridge: Harvard University Press, 2012), 502. Also see, Christopher Vassallo, "Defending Taiwan Requires Defusing the Financial 'Doomsday Machine,'" *The National Interest*, January 8, 2022

<sup>11</sup> Lambert, 498-501. As Jakub Grygiel memorably put it, "Economic pain alone is unlikely to deter powers that want to occupy territories they deem part of their civilizational core" in "How to Deter Russia and China," *Hoover Institution Strategika* 77, February 17, 2021

<sup>12</sup> Matt Pottinger and David Feith, "The Most Powerful Data Broker in the World is Winning the War Against the U.S." *New York Times*, November 30, 2021

<sup>13</sup> Mary Lovely and Jeffrey Schott, "Can China Blunt the Impact of New US Economic Sanctions," *Peterson Institute for International Economics*, June 2021

<sup>14</sup> Samantha Vortherms and Jiakun Jack Zhang, "Political Risk and Firm Exit: Evidence from the US-China Trade War" *21st Century China Center Research Paper No. 2021-09*, September 2, 2021

<sup>15</sup> For more, see Elbridge Colby, *The Strategy of Denial: American Defense in an Age of Great Power Conflict* (New Haven: Yale University Press, 2021)

<sup>16</sup> Tara Copp, "'It Failed Miserably': After Wargaming Loss, Joint Chiefs Are Overhauling How the US Military Will Fight" *DefenseOne*, July 26, 2021

<sup>17</sup> Political theorists have found that interdependent states go to war when nations' expectations of future trade diminish. See Dale Copeland, "Economic Interdependence and War: A Theory of Trade Expectations," *International Security* Vol. 20, No. 4 (Spring, 1996), pp. 5-41

<sup>18</sup> According to the central bank trilemma, "If China wants open capital markets, it must give up control either of the currency or of the domestic money supply" in Michael Pettis, "Why it might be good for China if foreign investors are wary," *Financial Times*, August 2, 2021