What You Need to Know About the US-China Trade War – The American Perspective

The fear of an escalation in the trade war between China and the United States, via either increased tariffs or other trade barriers, has been a great source of concern recently. The consequences of such a trade conflict are especially worrisome for both American and Chinese consumers and businesses. Moreover, the weight of the U.S. and Chinese economies are such that the spillover from their bilateral trade spat could be significant on global terms. It is therefore not surprising that the trade war is at the forefront of global media and a major preoccupation of market participants and international organisations. Earlier this fall, the IMF revised its global growth forecast from 3.9% to 3.7% for 2019 on the back of concerns about international trade. The OECD blamed the same culprit and made a downward revision of its own forecast to 3.5% a few weeks ago.

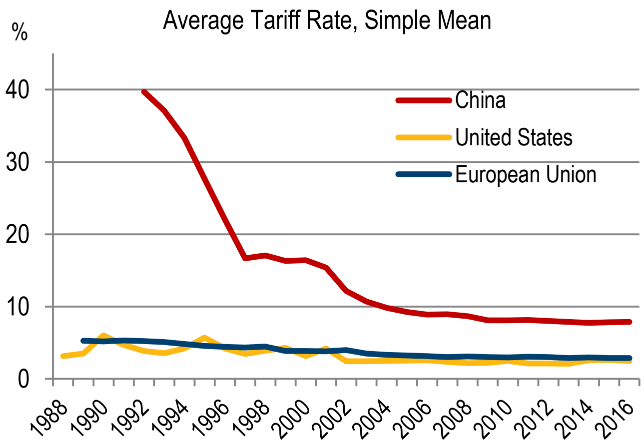
Following the Papua New Guinea APEC summit in mid-November and more importantly the recent G20 meetings in Buenos Aires, where Trump and Xi discussed the de-escalation of the trade war, it is important to understand exactly where each country stands. This article puts recent developments in the trade war into historical and political context, in order to assess the degree to which it might destabilize the global economy in the near future. In this instalment, we will cover the American perspective.[1]

The American Perspective

The U.S. Government is accusing China of unilaterally imposing higher tariffs and adopting non-tariff trade barriers, along with other unfair trading practices. These include intellectual property theft, cyber espionage and forced technology transfer, the existence of which the Chinese leadership refuses to acknowledge. China's economy is structured around massive government investments in State Owned Enterprises (SOEs), including banks. The One Belt One Road initiative is an example of the balance China has stuck between openness to markets and a planned economy. The initiative arguably follows a path of economic neo-colonialism through the financing of massive infrastructure projects in the developing world.

In a recent speech delivered in Singapore, former Treasury Secretary Henry Paulson, who has experience in China restructuring companies, explained how he has gone from optimistically advocating for the development of China-U.S. relations, to predicting the establishment of a new Iron Curtain in the global economy. His disappointment stems mainly from the fact that China has not delivered on its commitments following its entry in the WTO in 2001. While President Trump largely focuses on higher Chinese tariffs (see chart) and the size of the bilateral trade deficit the U.S. has with China, Paulson observes that due to non-tariff barriers, the Chinese market still remains relatively closed to both foreign businesses and investment, despite the impressive economic progress the country has made. One example is the large number of share classes for Chinese equities, all with different investable characteristics. However, as of today, a large segment of the Chinese stock market, known as A-Shares, is closed to foreign ownership and can only be traded by China's mainland investors or "qualified" foreign investors.

[1] The Chinese perspective was also covered and can be consulted at https://www.vmbl.ca/portal/en/economie.



Note: Data for some missing years is interpolated.
Source: Worldbank and LBS Econ. Res. and Strategy.

As the situation stands, following an official dinner between Xi and Trump at the recent G-20 meeting, the 10% tariffs imposed by the U.S. on the US$230 billion of Chinese exports is maintained. The threat of scaling up these tariffs to 25% on January 1st has been postponed. The Americans have agreed to a 90 day truce during which they hope to see concrete actions taken by China in tackling a range of issues.

Reaching an agreement in a firm and definite 90 day timeframe, however, does not seem realistic. President Trump tweeted on December 4th that the negotiations would end in 90 days "unless extended", and Larry Kudlow, Trump's Director of the National Economic Council, has suggested some "wiggle room". Trade Representative Robert Lighthizer, however, denies that such flexibility exists. A Chinese delegation led by Vice Premier Liu He is thus scheduled to arrive very soon to the U.S. in order to jump start the negotiations process.

Yet, the recent arrest of Huawei CFO Meng Wangzhou in Canada at the request of the U.S., on charges of avoiding U.S. imposed sanctions on Iran, has the potential to drastically add to the already complex situation and postpone any agreement, given the massive uproar it provoked in China. The issue at hand ties the current negotiations into a larger context of American defense of national security, as the Western world has pushed against Huawei and its efforts to develop internationally and implement 5G technologies on a global scale.

This technology would put different systems such as driverless cars into a networked system, and thus, in the American's eyes, increases the risks of foreign surveillance and cyber-attacks. American officials claim that the timing of the arrest is purely coincidental. However, it is a testament to the profound cleavages within Trump's inner circle on the question of the trade negotiations with China and lack of a definitive and cohesive strategy.

U.S. Strategy: Trump and His Advisors

With the Republicans losing control of the House in the midterm elections, Trump's strategy has been to put pressure on China in order to force an improvement in trade practices, a strategy that is enjoying bi-partisan support. The strategy is also popular among the American public, business community and the media. Criticisms of the tariffs have been expressed by advocates of free-trade and, more specifically, by U.S. businesses negatively impacted by the trade war. These include importers of steel as well as soybean exporters (see the WSJ account of the conflict's adverse consequences on S&P 500 companies). At least for now, critics remain limited and the negative macroeconomic impacts of the current tariffs look tame. However, the negative factors could rapidly degrade if the trade war was to intensify in early 2019, and last indefinitely.

There is a significant division in strategy within Trump's team. He has hawkish advisors like Wilbur Ross, Robert Lighthizer and Peter Navarro, advocating for a hardline approach, as well as councillors like Larry Kudlow and Treasury Secretary Steven Mnuchin, who are pushing for a quick deal. This division fosters a lack of consistency and predictability in U.S. strategy. The latest stunts from the Trump Administration include Trump labelling himself "A Tariff Man" on Twitter as well as John Bolton, another hardliner, calling for a ban on the imports of goods and services produced from the theft of American intellectual property.

Impact of the Trade War

So far, the impact of the tariffs imposed by the U.S. has been partly absorbed by the recent roughly 10% depreciation of the Yuan relative to the U.S. dollar. This allows Chinese producers to remain competitive without an increase in prices for U.S consumers. However, the IMF forecasts that the U.S. tariffs, and the retaliation by China, will shave 0.3% off China's GDP. If the U.S. were to impose the higher 25% tariffs on March 1st, the IMF estimates that it would take an additional 0.3% off Chinese GDP.

Chinese tariffs on U.S. soybean, coupled with the recent depreciation of the Yuan, have severely affected American soybean producers. These farmers risk losing their Chinese market share now that Brazil and Argentina have become viable alternative sources of soybean. However, although estimates vary, the economic cost of the trade war appears smaller for the U.S. economy, as American exports to China amounted to less than US$200 billion in 2017. President Trump likely sees this asymmetry as a bargaining chip and a short-term negotiation tactic. The costs are nevertheless not insignificant, and based on the impact seen for U.S. soybean farmers, it's clear that targeted retaliatory measures by China can have substantial consequences on certain segments of the American economy.

The Ambiguity of Chinese Signals

At the end of the recent APEC summit, China refused to endorse a statement condemning protectionism and unfair trade practices (the fairly mild "We agree to fight protectionism including all unfair trade practices"), indirectly acknowledging that it is indeed guilty of unfair trade practices. Yet, President Xi recently claimed in several international events that China is very much an advocate of business and desires to promote open borders and international trade. Xi even invoked the "lessons of World War II" to warn against unilateralism.

By catching China in this contradictory position, the American administration is hoping to bring the country towards freer trade and market reforms which would allow more foreign goods and investment into China. Speeches recently delivered at the Boao International Forum for Asia and at the Shanghai International Import Expo explicitly engaged with increased openness, even though many observers underlined the fact that Xi remained vague.

Although promising to expand the Shanghai free trade zone, among other measures, if Xi wishes to see a significant shift in American positioning on the issue, he will have to move past rhetoric. At the same time, what we have observed so far is the Chinese reacting mostly verbally to U.S. measures rather than strongly retaliating by proactively imposing tariffs on American goods. The political failure on the part of the Chinese to reconcile their official positions on trade with their own trade policies is interpreted in the West as a clear double standard on China's part. The American administration is thus calling for the Chinese leadership to genuinely reduce trade barriers.

The popular support at home and genuine grievances towards Chinese trade policy on the part of the international trade community could motivate Trump to keep to his hard-line style of negotiation, despite the negative economic impacts. Moderate advisors within the Trump administration and the need for Trump to show concrete personal successes will prove essential in reaching a favourable agreement in the near future.

The Trade War in a Broader Power Struggle

It is essential to recognize that the trade war is rooted in a broader geopolitical context. Many observers recognize that some Chinese trade practices are irreconcilable with multilateral trade liberalisation, and are simply an attempt to tilt trading terms to China's advantage. China's behaviour is consistent with its strategic long term objective of implementing the One Belt One Road initiative, which would significantly increase its economic power and international political influence. Many in Trump's administration are perhaps more worried that this will challenge the U.S.' hegemony than they are concerned about the economic consequences of China's unfair trading practices.

China's reaction to the current stand-off is a testament to how Trump's strategy has forced the Chinese leadership to address the issue head-on, rather than ignore it like it has often done in the past. At the recent G20 meeting, China accepted to buy more American goods, notably soybean and natural-gas, roll back tariffs on American made cars and agricultural goods, as well as address the flood of Chinese fentanyl into the United States. Larry Kudlow also claimed that the U.S. and China were "pretty close to some agreements" to protect intellectual property and halt illegitimate technology transfers.

It's uncertain how the arrest of Ms. Meng (recently released on a CAN$10 million bail) will affect the upcoming trade negotiations in Washington D.C., as Vice Premier Liu He and his delegation of 30 officials prepare for their visit. Recently, however, things have been looking more positive. China has just agreed to reduce their 40% retaliatory tariffs on U.S. cars back down to 15%. Also, as we write these lines, China just announced, in another apparent concession, that they will replace their Made in China 2025 plan, a blueprint to dominate high-tech manufacturing, with a revised strategy that would be more open to foreign competition.

Conclusion

Whether Trump is a credible negotiator in this trade conflict remains unclear. Will Trump, who simultaneously appears to be promoting free-trade on the international front and protectionism at home – ironically, a position similar to Xi's - accept the outcome of free-trade if the Chinese come around to the demands of his own administration? Alternatively, will he fall prey to the hardliners of his Cabinet, who seem bent on obtaining unreasonable concessions on the part of the Chinese in the name of preserving U.S. hegemony, even at the cost of a damaging trade war?

Trump's relative success in this trade conflict, given the asymmetric costs of the trade war, does not give him much incentive to pre-emptively alter his course. The question might be: what does Trump want? The tariffs are only the tip of the iceberg. What the Americans are asking for from the Chinese is a deep restructuring of their economy in order to make it more compatible with their own.

Now that the inconsistencies in China's trade policies have been fully exposed, Trump has gained some bargaining power, which he's leveraging against China. China, however, given its long-term economic objectives, is unlikely to yield to American demands on many of the significant issues.

The 90-day truce will be critical in assessing how far China is willing to go to please the United States. What is certain is that the trade war has the potential to escalate to a level that would make the current spat look inconsequential in comparison to what could happen if we can't reach an agreement

Luc Vallée | Chief Strategist
514 350-3000 | valleel@vmbl.ca

Charles Lepage | Analyst

Charles, who speaks mandarin, lived in China for 12 months over the course of the last three years, studies political science at McGill University and works part time at Laurentian Bank Securities. His opinions are his own and do not reflect those of Laurentian Bank and its affiliates.