Resolution of the trade war between China and the United States during the summer

The Trump administration remains divided on how to conduct its trade war with China. There are those, above all President Trump, who are particularly concerned about the trade deficit the United States has with China. Others would like to see China start playing by the rules of international trade. Negotiations are aimed at making China stop intellectual property theft, forced technology transfers and manipulation of the yuan, reduce tariffs and non-tariff barriers, and the multiple obstacles and restrictions to foreign investment.

Finally, the most radical elements in the White House would like to disrupt two core projects in China's long-term social and economic development strategy: 1. China's plan for structural transformation and modernization into a high value-added manufacturing economy (Made in China 2025 or China 2025) and 2. The deployment of an extensive physical and technological infrastructure network outside China (One Belt, One Road, or Belt & Road - B&R) with completion planned for 2049, 100 years after the Chinese Revolution. The avowed goal of American opponents to these Chinese initiatives is to contain China's hegemonic ambitions.

Obviously, investors are nervously asking themselves what direction this trade war will take following the announcement of recent American restrictions on Huawei, seen by the Chinese as an unfair and dishonest attempt by the Americans to undermine China's economic development. Besides, a number of observers say that criticisms aimed at Huawei are simply a pretext to camouflage the relative technological lag of American companies and an attempt to gain time.

However, despite the uncertainty that these restrictions leave hanging over the progress of the China-United States trade war, we believe that the Chinese are prepared to make the necessary compromises and concessions to reduce their trade surplus with the United States and play by international trade rules so that the two countries can reach an agreement quickly.

In the short term, therefore, we anticipate an improvement in the U.S. deficit with China. The Chinese authorities seem inclined to meet President Trump's demands, as this concession will not have major consequences for China's economic development and the achievement of its longer-term goals.

Since the U.S. trade deficit can be attributed to a considerable fiscal deficit and the undeniable success that the United States is having in attracting foreign investment in recent years, President Trump's desire to improve the United States trade deficit with China through administrative measures is more like wishful thinking.

It should not be forgotten that a capital account surplus always implies a current account deficit. The Chinese can always promise to buy more goods and services in the United States, but the American current account deficit is likely to persist. If there is an improvement in the U.S. trade balance with China, it will very likely be to the detriment of other United States trading partners.

As for compliance with international trade and foreign investment rules, the Chinese very likely agree with the validity of American criticisms, even if they do not acknowledge it publicly. However, because China has benefited from its delinquent behaviour since joining the WTO in 2001, Chinese authorities are doubtless in no hurry to correct the situation.

Since negotiations began, the Trump administration has sought assurance from the Chinese that they would commit to making the necessary reforms. The Chinese leaders have promised on several past occasions to change, but they have not delivered the goods. This time, the Americans are insisting that the Chinese adopt restrictive legislative changes immediately before lifting the 25% tariffs imposed by the United States on more than $200 billion of Chinese imports.

To keep up the pressure, the White House is threatening to extend these tariffs to all Chinese imports to the United States, which amount to nearly $550 billion. For its part, Beijing replies that the legislative changes demanded by the Americans would infringe on Chinese sovereignty. In addition, since the Chinese always seem reluctant to give in to U.S. demands, various restrictions were placed on Huawei by the United States in recent weeks.

We believe nonetheless that the two sides will very probably reach an agreement in June. The Americans will need to agree to give China time to implement the desired legislative changes, so that the Chinese authorities can convince their citizens (very nationalist by nature) that this is a domestic initiative in the national interest, and not a concession made to the United States in response to political pressure.

Nor should it be forgotten that the day is coming when China will dominate the international stage. It will then be in the Middle Kingdom's interest that its trading partners comply with the international trade rules and laws that protect intellectual property. For the time being, it seems that the Chinese are pulling out all the stops to put off the inevitable as long as possible. So we can understand why the Americans appear to have lost patience with the Chinese authorities and are ramping up the pressure.

Furthermore, in our opinion, there is a very low probability that China will yield to American demands aimed at restricting the implementation of China 2025 and B&R. If the U.S. wishes to continue on this path, trade negotiations could deteriorate, or even drag on and possibly lead to a global recession.

The inflexible Chinese position on the challenge to their long-term development strategy is also well illustrated by their strong negative reaction to restrictions announced on Huawei more than two weeks ago by the United States. This company ranks among the national companies designated as technology leaders that are supposed to lead China towards achieving its long-term economic and social development goals.

We therefore expect the Americans not to insist on this third issue in June if they want to convince the Chinese to commit on the first two points being negotiated. This additional pressure on Huawei must instead be seen as one more negotiation tactic by the Trump administration aimed at forcing China to agree to principles that it has long acknowledged, but is still not following in the absence of credible pressure from the United States.

In this context, restrictions imposed on Huawei can be interpreted as an aggressive strategy aimed at putting a spoke in the wheel of China 2025 and B&R if the Chinese still refuse to make the necessary concessions to reduce their trade surplus with the United States and at last scrupulously follow international trade rules. Putting China's development strategy at risk by attacking China 2025 and B&R, starting with Huawei, is the credible threat that the Americans are using to make the Chinese bend.

We believe that President Trump, in his June meeting with President Xi in Japan, will offer to temporarily drop all tariffs and all demands that would hinder China 2025 and B&R if the Chinese agree, within a reasonable timeframe, to buy more American goods and, above all, to implement the necessary legislative changes with respect to international trade and foreign investment in China.

However, to prevent the Chinese from dragging out the implementation of these changes indefinitely, the Trump administration will want to impose an irrevocable deadline on China beyond which the tariffs and the restrictions targeting Huawei will come back into effect. In June, there will also doubtless be agreement to put off negotiations on irritants related to the deployment of Chinese technology and the widening of China's spheres of influence. These subjects will nevertheless resurface in the medium term (after the U.S. presidential election of 2020) and will be the subject of more intense debate in the not-so-distant future.

This compromise will ensure that both powers emerge with a short-term political victory even though the issues of technology and growing Chinese influence on world affairs remain unresolved. The Americans will have found a way to avoid a recession, restore fair play in international trade, and further open China to foreign investment while maintaining a credible threat in place if the Chinese continue to drag their feet.

The Chinese will have preserved their two long-term development initiatives (China 2025 and B&R) by allowing Huawei, ZTE and other technology giants to continue to operate without hindrance--at least in the short term--while getting rid of the tariffs on their exports to the United States.

In our opinion, it would be too costly for both countries to not resolve the two primary issues underlying this trade war (American deficit with China and Chinese non-compliance with international trade rules). For President Trump and the Republicans, provoking a recession would be political suicide given the quickly approaching presidential election.

For China, it is a question of seizing an opportunity to stimulate growth and moving its long-term development plan forward, while making concessions only on points deemed fundamental and essential to the proper functioning of an integrated global economy by members of the WTO (which China joined in 2001).

In addition, despite Chinese rhetoric in recent weeks, the risks of not finding common ground with the United States in June are considerable for China. Chinese economic growth is already slowing, and it is difficult to evaluate the magnitude of the punitive effect of American tariffs, if they are extended to all China's exports to the United States.

The Chinese will also fear the reaction of the United States and their other trading partners if they once again refuse to play by the rules that most countries follow. The restrictions put on Huawei could also eventually be extended to other Chinese companies, and very quickly hinder plans to implement China 2025 and B&R.

Finally, there is also a strong consensus in the United States and abroad on the importance of continuing to put pressure on China. The Chinese authorities are very aware that this consensus could incite the Trump administration to extend the conflict until China agrees to what are widely perceived as reasonable demands from the United States.

If the parties judge an eventual agreement to be essential to achieving their economic, political and social goals, delaying its signing only creates additional risk and results in pointless costs. In our opinion, any delay would only poison the negotiating atmosphere and make comprise more difficult. In this situation, all parties should wish for the announcement of a credible agreement as soon as possible.

In conclusion, we think that Presidents Xi and Trump will certainly hold a G20 meeting in Japan at the end of June, and that there will be hope once again that an agreement in principle will be signed in the short term. Once this agreement is worked out, we anticipate a lifting of bilateral tariffs and restrictions on Huawei.

The threat by the U.S. administration to restore 25% tariffs on all Chinese exports, if the Chinese fail to honour their commitments in an acceptable timeframe (which must be before the Presidential election of November 3, 2020) should be sufficient to lead the Chinese from words to action within the prescribed time.

A final agreement should therefore be in place no later than the beginning of autumn 2019, with autumn 2020 as the deadline for Chinese implementation of a legislative framework more conducive to trade and foreign investment in China. This must include an obligation to grant greater protection to technology and intellectual property developed by foreign companies.

Finally, with this kind of agreement, the probability of a U.S. recession in 2020 is likely to decline. With a growing economy, President Trump will stand for election having brought rival China to heel, a need for which there is consensus among the American electorate. Unlike most of President Trump's other political initiatives, over which the Democrats and Republicans are firmly divided, this goal is sought by both parties. Its achievement will strongly favour the re-election of the President and his party in November 2020, in our opinion.

If the Chinese are slow in implementing the agreed measures over the next year, hoping that Trump will be replaced by a Democrat in November 2020, the U.S. president, would, true to his word, once again implement tariffs on imports from China and probably add other restrictions on large Chinese companies. Even if this may be negative for stock markets, the economic impact of these measures would probably not be felt until after the 2020 elections. Such an outcome would contribute to American solidarity towards the President, whose instincts concerning the hostile intentions of China towards the United States would be confirmed.

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