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

The fear of an escalation in the trade war between China and the United States continues to be a source of great concern and is especially worrisome for 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 become significant globally over a short horizon.

Following the Papua New Guinea APEC summit in mid-November and more importantly the recent G20 meeting in Buenos Aires, where Trump and Xi met to discuss bilateral trade issues, the dynamics of the conflict are at the forefront of global media and a major preoccupation of both market participants and international organisations.

By putting recent developments into the historical and political context of each country, we try to assess how the trade conflict might evolve and hence influence the global economy in the near future. In a recent article, we covered the American perspective. In this instalment, we present the Chinese point of view.

The Chinese Perspective

Our last paper delved into a deep analysis of the American arguments for threatening a trade war with China, positions we are more often exposed to. Nonetheless, it is crucial to understand both sides of the conflict. This represents a challenge in the case of China due to the cultural and linguistic barriers, as well as the greater difficulty faced by Chinese citizens in openly expressing criticism of their government.

Moreover, until a few months ago, the threat of a trade war with the U.S. was not yet a major concern for the Chinese population. It is possible that the Chinese had not yet felt the impact of the trade war on their daily lives. Concerns may have shifted recently as the effects are starting to be felt, especially as the trade war rhetoric escalates and the conflict threatens to deteriorate further in the near future.

It is also possible that the controlled media apparatus is preventing those affected by the trade war from letting their concerns spread to the general population. However, the recent arrest in Canada of Huawei's CFO, for extradition at the request of the U.S., has certainly garnered attention in China, where a segment of the population is now calling for a ban on Canadian products and three Canadian citizens are currently being detained by the Chinese, possibly in retaliation.

Yet, some criticism of the Chinese strategy is heard within the country. For example, Peking University economist Zhang Wei Ying criticized the promotion of the "Chinese model" pushed forward by Xi. This model recognizes China's exceptional demographic, cultural, and geographic circumstances as an explanation for a unique economic model that would probably fail elsewhere. This model also explains China's remarkable economic growth by the establishment of a centralized single party decision making-process and a planned economy with massive State intervention. It does not, however, recognise the instrumental role played by the U.S. in fostering a peaceful and safe international trade environment. Zhang criticised this model by arguing that the protection of some economic sectors and the promotion of the exceptional character of the Chinese market as excuses for delaying the needed and expected trade reforms, will necessarily lead to a clash with the west, particularly the United States.

The unfolding of the trade clash in the last months provoked a vast array of opinions within the population, from perceived aggressive threat, to opportunity. As Xi acts in reaction to American tariffs, he still enjoys, for the time being, the overwhelming support of the Chinese population. It is interesting to read State-controlled media outlets, which depicts the conflict, initiated by the U.S., as aggressive and ridiculous. In order to fully understand this perspective, a deeper analysis of Chinese culture and politics is needed.

In 1949, the promulgation of the People's Republic of China as we know it today, by Chairman Mao, put an end to what the Chinese called the "Century of Humiliation". The start of the first Opium Wars in 1839, leading to the loss of Hong Kong and the further opening of China to the West, was seen as the pivotal moment where the imperialist Western countries started to "cut the country as a melon" and exploit it. The narrative of humiliation and Western aggression towards China has been instrumental for Chinese leaders to victimize the population in order to foster a greater sense of patriotism and social cohesion.

The trade war, and the way it is unfolding, fits this grand narrative. The trade barriers are not seen as an economically legitimate tool, but rather as an illicit political weapon used to directly hinder Chinese development and global influence. Furthermore, the arrest of Huawei CFO Meng Wanzhou in Canada on December 1st – the same day the truce with the U.S. on trade barriers was decided – is seen as a perfect example of how the U.S. is threatening Chinese influence by attacking Huawei, one of the country's most important companies.

There is a genuine pushback from Western countries against the growing influence of Huawei and the lead it currently has on the development of 5G telecommunication technologies. Case in point: in early December, Germany's Deutsche Telekom announced that it is revaluating its 5G procurement strategy after the government raised the alarm on Chinese technology. The arrest of Ms. Wanzhou, the daughter of influential Chinese entrepreneur and Huawei's founder Ren Zhengei, on charges of illegally dealing with Iran, sparked public outrage in China. Beijing then conveniently channelled its anger against Canada and the United States by raising nationalist sentiment. Incidentally, after her release on bail, Meng Wanzhou stated, "I'm proud of Huawei and my motherland".

This is symptomatic of how the Chinese population can be influenced to take a seemingly isolated incident as a grave insult and aggression against their nation. So far, China retaliated by arresting three Canadian expatriates. The move appears to be politically motivated and aimed at saving face domestically. It shows, on the part of the Chinese authorities, a poor understanding of extradition treaties and international law, as Canada was only acting, legally, on the behalf of the United States in the Huawei matter.

But as the recent Dolce & Gabbana, Lotte and Canada Goose boycotts make clear, public anger and the Chinese people's broad solidarity must not be taken lightly. The subsequent Chinese boycott of Canadian clothing retailer Canada Goose, which was facilitated by anti-Canada sentiment echoed in the Chinese media, illustrates the unintended consequences and pitfalls of engaging in trade wars.

Some Chinese leaders may have interpreted Trump's intentions by seeing him as a rational businessman, while others as a politician craving short-term political wins over the populist issue of trade. Yet, given the opinions held by many of Trump's close advisors, some reasonably consider the conflict as more of a longer term, politically strategic move on the part of the U.S., rather than simply an economic issue. They believe that the rise of China is leading to a clash and understand that it is advantageous for the U.S. to strike as early as possible, before China becomes unstoppable.

Despite this turmoil, another notable trend within the population is the belief that the trade war is good for China in the long run. Paradoxically, some Chinese pundits see benefits and an opportunity in the current situation. Impressive growth of the Chinese economy, and the increase of the population's wealth, may have led China to over-estimate its own power and influence. Being challenged early on by the U.S. could thus allow Chinese leaders to reassess their position, address their weaknesses, and develop better policies as they continue to grow economically and expand their global influence. Yet, some of the concessions the U.S is asking of China are touching upon the core of its long term economic development strategy. Backing down from the Chinese model of economic growth and social cohesion would be seen as weaknesses on the part of the Chinese leadership. In this context, China has little incentive to make any major concessions. Moreover, most Chinese, rather than yield to U.S. demands, would likely support their leaders and accept the short term cost of a trade war, so long as the strategy allows China to reach its longer term objective.

In an attempt to convince critics that it should not have to play by the rules, Chinese leaders often argue that China is still a developing country. China thinks it has the right to protect some sectors of its economy in order to prevent them from being completely overwhelmed on the global stage. Although this argument might have been valid up until a few years ago, today it is seen as self-serving as all countries have emerging sectors worth protecting; however most do not have the means that China does to nurture these sectors to maturity.

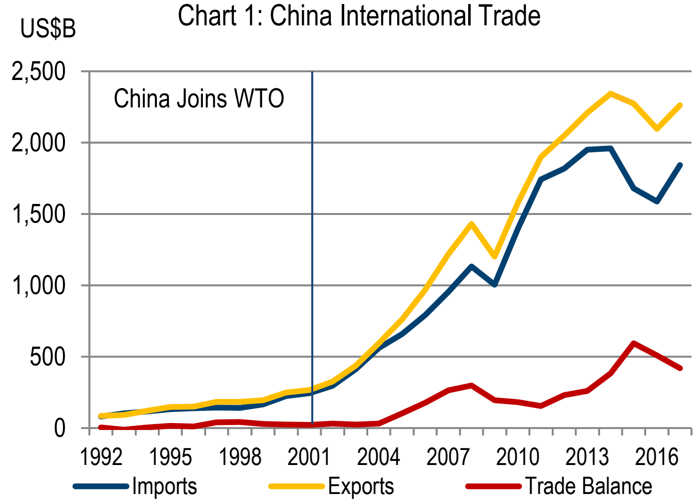
Many other arguments can be made in defense of China's position and trade practices. In fact, it is easy to see the many benefits that China has brought to the global economy. Moreover, as we will see below, China is also in a position to argue that global imbalances - a source of concern to the global economic outlook - are gradually self-correcting. Indeed, most arguments to diffuse the critics of China's trading practices point to the benefits that China's entry in the WTO has had on its trading partners as well as the recent progress that the country has made to address global imbalances.

Furthermore, from the get-go, China can easily argue that America's large trade deficit is mainly the result of the large and growing fiscal deficit in the United States (soon to reach 5% of U.S. GDP), its lack of private savings, its recent tax reforms (forcing profit repatriation into the U.S.), and its success in attracting foreign investment, as the country's current account deficit is the unavoidable result of its capital account surplus.

Accusations of currency manipulation can also be easily dismissed. When China tried liberalising its capital account in the summer of 2015, its currency fell and China had to spend more than $US 1 trillion defending its currency in order to avoid a global financial crisis; hardly a sign that China's monetary policy was attempting to weaken the yuan in order to gain a competitive edge.

However, probably the most convincing argument that can be made by Chinese negotiators to convince their American counterparts that the situation is not as dire as it might seem is the following: while China's bilateral surplus with the U.S. has grown overtime, it is now substantially smaller in terms of China's GDP then it was in the past. This trend is even more dramatic when looking at China's multilateral trade surplus, where even though exports grew at a rapid pace for almost two decades, imports grew almost as fast. Moreover, imports have recently been growing even faster (see chart 1).

Chart 1: China International Trade



Source: World bank and LBS Econ. Res. and Strategy.

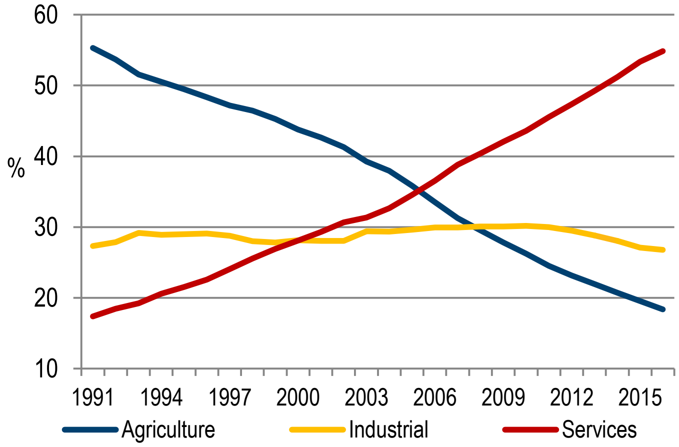
The result is, despite an increasing multilateral surplus until 2016, a falling trade surplus-to-GDP ratio and, for the last two years, a rapidly shrinking multilateral trade surplus. The latter brought the share of China's trade surplus to GDP in 2018 to its lowest level in decades.

The persistent Chinese trade balance surplus can also be viewed as a prudent way of managing a rapidly growing trade environment in order to avoid a balance of payment crisis, like those in the past, that so often sunk Asian and Latin-American emerging economies. Incidentally, many emerging countries later adopted similar prudent policies of building current-account surpluses and foreign exchange reserves as tools to reduce their vulnerability to financial crisis and hence promote economic and political stability.

The strategy also has the added advantage of helping to prevent global recessions. Indeed, the contagion of a balance of payment crisis in one emerging economy rapidly spreading to other emerging countries with weak financial systems and low foreign exchange reserves is often seen as the trigger of such global downturns. Given its size, had China been a country gripping with a balance of payment crisis over the last 20 years, it could have plunged the global economy into a deep recession and made the Asian financial crisis of the nineties look like a small bump on the road.

The Chinese trade data of chart 1 also confirms that the transition of China from an export-oriented economy towards an increasingly consumption-based one is caused by a rapidly growing middle class (see chart 2, 3 and 4). Chart 2 shows that jobs in the service sectors, usually geared towards the domestic economy, are growing at the expense of agricultural, manufacturing and construction jobs.

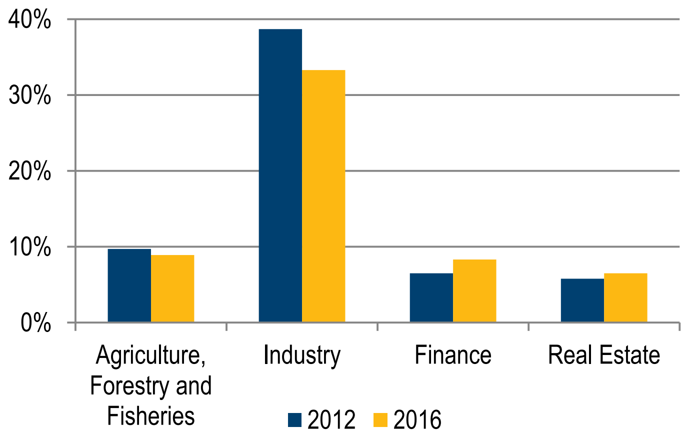
Chart 2: Employment by Industry (% of Total)



Source: World bank and LBS Econ. Res. and Strategy.

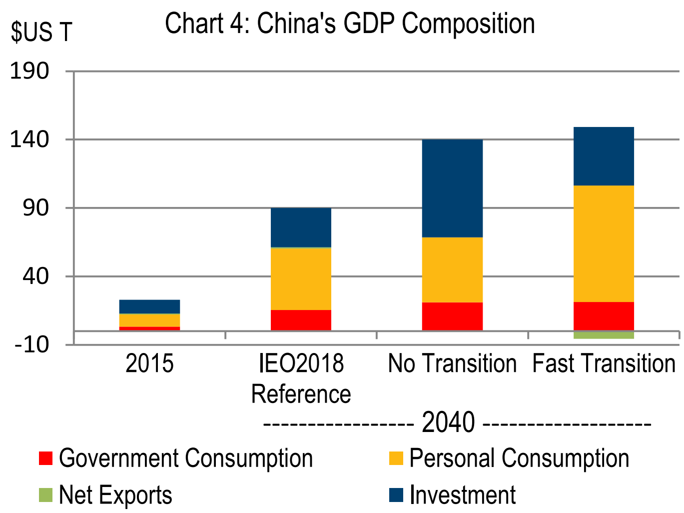
Chart 3 illustrates that many fast growing domestic sectors contribute a larger share to China's GDP growth as the country's development unfolds.

Chart 3: China Share of GDP



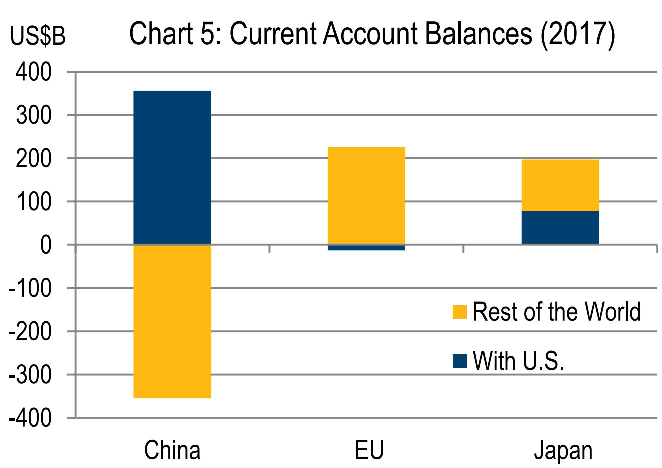
Source: China Statistical Yearbook (2012/2017).

And chart 4 illustrates that the transition is expected to continue.



Source: EIA and LBS Econ. Research and Strategy

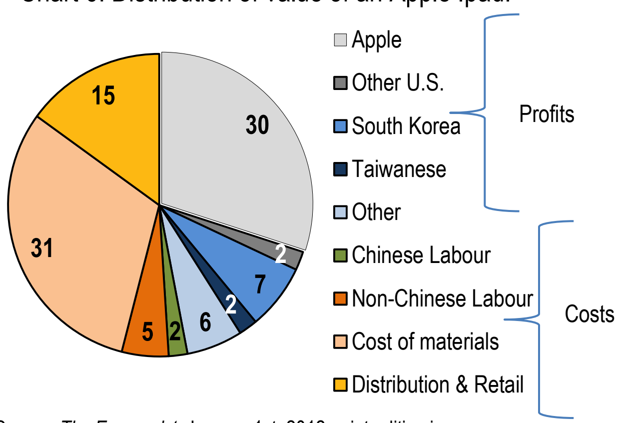
Even though the bilateral trade deficit with the U.S. is still growing, the evolution of multilateral trade balances is more relevant than that of bilateral trade deficits in assessing the origins of global imbalances. China might have a large trade surplus with the United States, however, when including what it imports from its Asian neighbours; the country's multilateral trade surplus becomes much smaller. Moreover, both Japan and the Eurozone enjoy large multilateral trade surplus with the rest of world (see chart 5). In fact, a case could be made that Europe and Japan, both individually smaller than China, play a larger role in maintaining global imbalances. A solution to address this issue could call for these countries to increase domestic spending on imported goods and services, rather than pressuring China to do so.



Sources: Thomson Reuters / BEA, Oxford Economics, State Administration of Foreign Exchange of China and LBS Econ. Res. and Strategy calculations.

Chart 5 also illustrates that national accounting rules are distorting the size of China's surplus with the United States. China imports parts from Asia and intellectual property from tax haven countries, and assembles manufacturing goods domestically. When China exports their final products, only a marginal value has been added through the manufacturing process. By attributing to Chinese exports the whole value of the final good assembled in China, we vastly overestimate China's real exports. For instance, if the U.S. import statistics took into account that the parts of an iPad assembled in China and sold into the United States come from many other countries, the Chinese trade surplus with the U.S. would be much smaller (see chart 6); that of Korea and other Asian countries would likely be higher on the other hand.

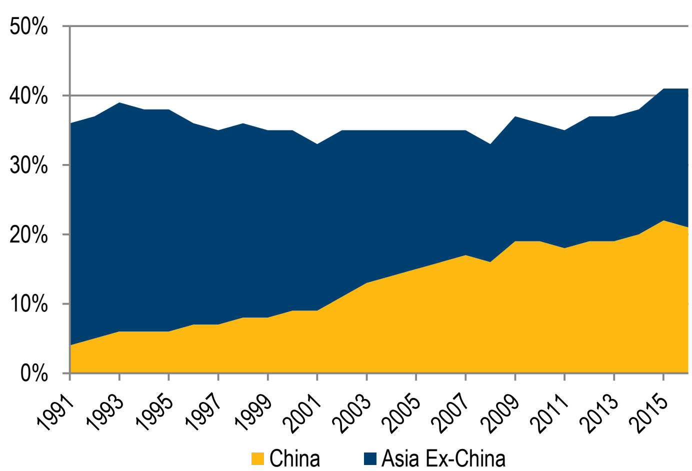
Chart 6: Distribution of value of an Apple Ipad.



Source: *The Economist*, January 1st, 2012. print edition issue.
https://www.economist.com/finance-and-economics/2012/01/21/ipadded

This point is illustrated by the evolution of American and European imports from Asia, which have not grown over time in terms of GDP. They simply transit through China today while national accounting rules, rather inappropriately, impute the total value of exports from China to other countries when they should not. Whereas in reality, Asia ex-China has essentially lost its "assembly" market shares to China (see chart 7) where cheap labour led to a reallocation of low-value added manufacturing: The "Made in Taiwan" of the nineties has become "Made in China".

Chart 7: Chinese Market Share of U.S. Imports

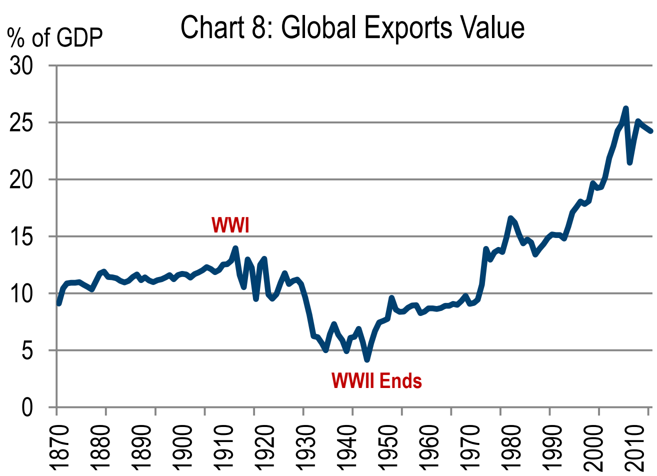


Source: World Bank and LBS Econ. Research and Strategy.

Many other convincing arguments can also be made to defend the Chinese position. One such argument being that U.S. tax rules have, for a long time, favoured profit offshoring and have contributed to artificially inflate the size of the U.S. trade deficit. Not only were U.S corporate tax rates higher than in the rest of the world until last year, but the requirement that U.S corporations be taxed on their world income encouraged profit offshoring: corporate inversions, location of intellectual property in tax havens and other such strategies. The result is that, for instance, Apple's intellectual property is considered an import from China (by way of tax haven Ireland) while we all know that its true origin is American.

The Chinese can also argue that "cheap labour" can no longer be used as frequently to complain about China stealing American jobs: Not only has the wages of Chinese workers increased faster than those of American workers in recent years, but robotic and A.I. technologies are so advanced today that labour is often not the main cost in manufacturing and thus not the main determining factor when businesses decide where to locate their production facilities (see, for example, the price of making a plastic bottle).

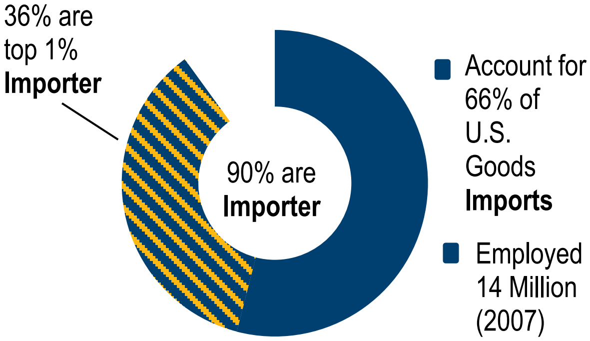
China could also convincingly argue that American consumers benefited enormously from free-trade with China, as the cost of many goods are much cheaper than they would otherwise be. Yet, the benefits of trade should not only be commercially motivated. There are also political, as well as geopolitical dimensions to consider. For instance, the relationship between China and the U.S., at least until recently, has been improving over the 16 years since China entered the WTO. Moreover, on a global level, extreme poverty has also been dramatically reduced by free-trade, which has certainly contributed to peace and prosperity of the last several decades. Case in point, the closing of borders after WWI led to the great Depression and then to WWII (see chart 8), while the reviving of globalisation in 1945 is likely the main contributor to the longest lasting global peace period on record.



Source: Fouquin and Hugot; CEPI, Ourworldindata.org.

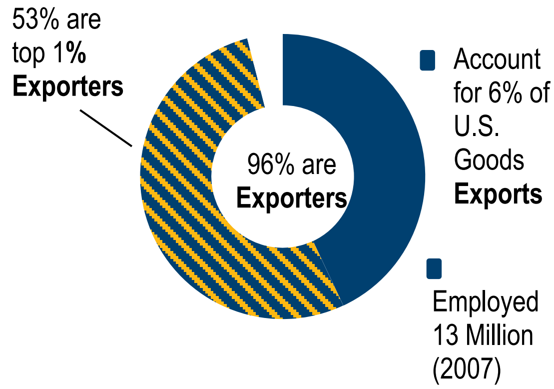
Finally, a final word of caution, as the world economy has become highly integrated since the end of WWII (see, for example, the Tesla Model X and chart 9). It appears that, regardless of the validity of the arguments made by the American administration to justify entering the trade conflict with China, undoing the value-chains that have been responsible for monumental improvements in the efficiency of global manufacturing and service delivery, would come at an enormous cost to the global economy. It is an undeniable fact worth remembering during the current negotiations.

Chart 9A: Top 1% of U.S. **Exporters** (2,000 Firms)



Source: PIIE and LBS Economic Research and Strategy.

Chart 9B: Top 1% of U.S. **Importers** (2,000 Firms)



Source: PIIE and LBS Economic Research and Strategy.

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