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U.S.—CHINA TRADE UPDATE

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KEY TAKEAWAYS

Trade tensions between the U.S. and China have escalated in the last month, but negotiation still remains the main path forward.

Despite threats of additional tariffs, the tariffs in place remain manageable, and there's plenty of time before any new tariffs under discussion would kick in.

The main U.S. advantages in the trade dispute are broad recognition of the need for Chinese trade reforms and a large goods trade deficit.

Trade tensions between the U.S. and China have been building over the course of 2018. These tensions have escalated over the last month, but while risks are rising, economic disruptions have remained minimal. We continue to believe the final economic impact of current trade tensions won't be insignificant, but will be small relative to the short- to intermediate-term positive impact of deficit-financed fiscal stimulus, business-friendly changes in the tax code, and deregulation. We do remain concerned with Trump administration efforts to simultaneously shift terms of trade with all major trading partners: China, the European Union, Canada, Mexico, and, to a lesser extent, Japan, who together accounted for over two-thirds of total U.S. trade. While all of these negotiations are important, trade relations between the U.S. and China—the world's two largest economies—remain the focus. Despite trade tensions, both countries remain highly motivated to avoid an all-out trade war and, despite ongoing debates about the most efficient means to achieve U.S. trade goals, some shift in trade relations with China was necessary and general movement toward fair trade, if achieved, could benefit both the U.S. and the global economy.

WHERE THINGS STAND

When reviewing the current status of trade negotiations with China, it's important to keep in mind what has actually been put into place and what still can be negotiated. The tit-for-tat threats and counterthreats we've seen over the past few months may be more aptly viewed as the two countries feeling each other out to better understand the other's pain points as they (hopefully) progress toward a more mutually beneficial relationship as major trading partners. To date we have seen key tariffs put into place on only washing machines, solar panels, steel, and aluminum. The next stage of tariffs—25% tariffs on $34 billion (out of $50 billion) of Chinese imports—goes into effect July 6. While there may be more, we typically see about 60 days from announcement to imposition of the tariffs to give businesses and trade authorities time to react, which also leaves time for further negotiation. The Trump administration's recent request to draw up a list of an additional $200 billion of Chinese goods for 10% tariffs remains in its early stages and currently can be considered a legitimate threat, but one that's still far from implementation.

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PAIN POINTS

Whether a trade war or just a trade dispute, all sides take some damage. A trade disagreement is "won" when new concessions compensate for the damage, with the side that can take the most pain typically getting more concessions. Of course, if the same ends or something close could have been achieved by less-painful means, the losses were simply wasteful. Also, if both sides have the political will to absorb a lot of pain, the eventual gains must be greater to make up for the losses. Here's what we see as the major advantages and disadvantages for the U.S. and China in current negotiations.

ADVANTAGE U.S.

- Goods Surplus—With far fewer goods exported to China than imported from China [Figure 1], the U.S. retains a structural advantage in its trade disputes with China. Last year the U.S. exported $130 billion in goods to China, while China exported $505 billion in goods to the U.S. Consequently, China is going to run out of direct reprisals quickly should it look to match U.S. tariffs, a point brought home sharply by the Trump administration's announcement that it is looking at potential tariffs on an additional $200 billion in goods, an amount that China cannot directly match.

1 POTENTIAL TARIFFS ON U.S. GOODS ARE LIMITED

	U.S. to China	China to U.S.	U.S. Goods Deficit
2013	122	440	**318**
2014	124	468	**344**
2015	116	483	**367**
2016	116	463	**347**
2017	130	505	**375**

Source: U.S. Census Bureau 06/25/18

- Moral High Ground—The U.S. has plenty of legitimate moral high ground when it comes to complaints about China's unfair trade practices, including weak protection of intellectual property (IP) rights, excessively restrictive rules for foreign investment, and inadequate protection against industrial espionage. According to the Organisation for Economic Co-operation and Development's measure of investment restrictiveness, China is the most restrictive of any major economy. In addition, a 2011 report by the U.S. International Trade Commission that intensively reviewed trade in 2009 estimated IP-intensive U.S. firms lost approximately $50 billion in profits due to inadequate protection of intellectual property, similar to the number arrived at by the Trump administration's recent study that led to the initial $50 billion in tariffs. The U.S. Chamber of Commerce's Global Innovation Policy Center also notes in its 2018 rankings of intellectual property rights that the level of IP infringement in China remains high.
- Strong Political Base—President Trump's political base may have a fairly high pain tolerance if it believes in the president's goals, potentially limiting the impact of China focusing its tariffs on politically sensitive areas.
- Credible Threats—Finally, President Trump's aggressive trade stance makes threats credible that might be otherwise dismissed as unlikely, which solidifies his bargaining position.

ADVANTAGE CHINA

- Minimal Political Pressure—China's President Xi doesn't have to face reelection and U.S. midterms are around the corner, making the political pain of an extended trade dispute potentially higher in the U.S.
- More Pressure Points Than Just Tariffs—China has many ways to push back on U.S. tariffs outside of corresponding tariffs on goods. For example,

informal state-directed consumer boycotts were very effective in a trade dispute with Korea, and U.S. business interests in China are estimated to be roughly in line with China's $500 billion of goods exports to the United States. For example, a cup of coffee at Starbucks is not an export, but a boycott of Starbucks would certainly still hurt the bottom line of that U.S. business. In addition, China could make access to its 1.4 billion consumers and more than 6% gross domestic product (GDP) growth even more restrictive.

- Multi-Front Trade Disputes—Despite a shared interest among the U.S. and its allies in reforming China's international trade relations, simultaneous trade disputes or renegotiations between the U.S. and its major trading partners may limit the pressure other trading partners put on China as they look after their own interest while potentially benefitting from Chinese pressure on the U.S.
- Consumer Price Sensitivity—Consumer prices are likely more sensitive to Chinese exports to the U.S., which have a greater proportion of consumer end products, than U.S. exports to China, which have more intermediate goods [Figure 2].
- The Treasury Option—Dumping some of its vast holdings of Treasuries has been called China's "nuclear option" and would likely cause too much pain to China to be attractive. However, China also has the option of reducing purchases of Treasuries, or even using targeted disruptive selling as midterm elections approach. In fact, China could have an impact on Treasury markets simply by floating the idea that it was considering such an approach.

2 CHINESE TARIFFS ARE MORE LIKELY TO IMPACT CONSUMER PRICES

Top 5 U.S. Exports to China	Top 5 Chinese Exports to U.S.
1. Civilian Aircraft, Engines, Equipment, and Parts	1. Electric Machinery
2. Soybeans	2. Machinery
3. Passenger Cars	3. Furniture and Bedding
4. Semiconductors	4. Toys and Sports Equipment
5. Industrial Machines	5. Footwear

Source: Office of the United States Trade Representative 06/25/18

CONCLUSION

As trade tensions with China rise, it's important to remember that this is still a slow-moving negotiation and that at least some concessions from China were likely from the start. China was already on the path to needed trade reforms as it tried to improve its profile on the world economic stage. While pundits can debate whether the Trump administration's plan for accelerating reforms is the most efficient, it certainly was necessary. We have yet to see the final cost of likely measures, and both sides certainly have the ability to cause more pain. Nevertheless, despite rising concern and heavy market and media attention, any negative impact thus far has been minimal. While we do expect trade disputes to take a small bite out of the impact of financial stimulus, likely 0.1–0.2% of GDP, and anecdotal reports of businesses delaying business investment pending outcomes are already appearing, we expect the impact of fiscal stimulus to be the main player in the direction of the U.S. economy over the next year or longer. ■

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