Trade War between the US and China

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President Donald Trump's trade war started in January 2018 and was launched against many countries, including China.

In the case of China, tit-for-tat retaliations provoked a wide-ranging escalation of tariffs until September 24, 2018 that has no precedent in the years since the Great Depression.

Escalation of announcements of new tariffs and retaliations continued after September 24, 2018. After several rounds of negotiations, the US administration announced it would not impose any new tariffs if China honours its pledge to increase its imports from the United States and makes progress in enforcing intellectual property rights and opening its market to foreign firms and products.

Until recently, the vast majority of US tariffs were justified as countervailing and antidumping duties.

Under President Trump, the Department of Commerce has begun 122 investigations into anti-dumping/countervailing duties. These tariffs have targeted all corners of the globe, reaching 31 countries in total.

China represented about 40% of the total.

There is nothing new in 2018 with the US government being concerned with China's policies or choosing to act on them.

On the multilateral front, after a five-year grace period following China's WTO accession in 2001, the United States and other countries began challenging Beijing's policies in significant numbers through formal dispute settlement.

Roughly 20 percent of all disputes brought to the WTO between 2006 and 2018 were filed against China, and the United States was involved in most as a complaining country.

- **Until the recent past, <u>most of the trade disputes were treated through the WTO</u>.**

- **Moreover, the United States established a <u>long-term strategy of writing new trading rules through megaregional agreements</u> like the Trans-Pacific Partnership, to address many of the limitations of current trade agreements. These rules were written with China in mind, anticipating that economic incentives would push Beijing to seek accession to the agreement. President Trump withdrew the United States from the TPP agreement.**

- **The Trump administration has mostly <u>ignored the high-level, institutionalized bilateral talks</u> undertaken by the previous two administrations.**

- **Trump has invoked US trade laws that afford the Executive branch of the US government <u>enormous discretion</u> to impose new trade restrictions, thus <u>instigating new trade conflicts</u>.**

Basic principles of the multilateral trading system

3 functions of WTO:

- **Setting out regulations for the conduct of international trade**
- **Making provisions for the settlements of disputes and retaliatory actions**
- **Providing a framework for multilateral negotiations to liberalize world trade**

The system is based on 3 principles:

- **Tariff reduction**
- **Reciprocity**
- **Non-discrimination (MFN clause)**

WTO members commit themselves not to raise their tariffs above bound levels; agree not to provide export subsidies or subsidies that favour the use of domestic over foreign products and agree to protect the intellectual property of other members.

If they believe other members have violated the agreement, they agree not to take unilateral actions but to bring their disputes to the WTO Dispute Settlement Body (DSB). Although retaliation may be permitted, the DSB must authorize both the nature and value of the retaliation.

Only under special circumstances can countries impose tariffs or duties on foreign products. These include:

- **safeguard measures when imports cause or threaten to cause substantial injury;**
- **antidumping duties when products are sold at less than normal value and cause injury;**
- **countervailing duties when imports have received government subsidies and cause injury;**
- **measures that are necessary for national defense.**

Apart from tariffs and other trade restrictions arising under the historically-used US trade laws of antidumping and countervailing duties, Trump's protectionist measures fall into <u>three categories</u>:

1) **renewed use of safeguard protection, on products like solar panels and washing machines.**

2) **national security tariffs on steel and aluminum.**

3) **tariffs and other remedies to address China's potential misuse of American intellectual property, forced technology transfer, and cybertheft.**

1. Safeguard tariffs because solar panel and washing machine imports injure US industries

In 2018, the Trump administration imposed global safeguard trade restrictions on imports of solar panels and washing machines from almost all sources, not only China, on the ground that imports have caused injury to the US solar panel and washing machine industries. Most of the US imports of solar panels and washing machines in 2017 were not from China, but from other trading partners.

Beijing retaliated by announcing a new antidumping and countervailing duty investigation of roughly $1 billion of sorghum imports from the United States

The WTO permits safeguard tariffs when a country faces serious injury due to a surge in imports of a particular product. But it has to be shown that the increase in imports is due to "unforeseen circumstances.". Moreover, unless special conditions are met, the country implementing the safeguards must compensate its trading partners in other areas or face retaliation.

The last time the United States used safeguard tariffs was in 2002, when President George W. Bush imposed them on steel imports, but these had to be removed, when the WTO ruled they had not met the requirements for their imposition.

2. Steel and aluminum as national security threats

In March 1, 2018 Trump announces forthcoming tariffs on all trading partners of 25 percent on steel and 10 percent on aluminum under national security grounds. Mostly from allies such as Canada, the European Union, Turkey, Mexico, and South Korea. Only 6 percent of the imports covered derive from China.

Until June 2018, exemptions for the European Union, South Korea, Brazil, Argentina, and Australia—in addition to Canada and Mexico.

China imposes retaliatory tariffs on aluminum waste and scrap, pork, fruits and nuts, and other US products

Korea agrees to reduce steel exports to the United States in return for a permanent exemption from the steel tariff (steel quota)

Argentina has quotas for steel and aluminum in return for permanent tariff exemptions for both metals. Brazil has quotas on steel, with differing amounts on semi-finished and finished steel products, and a 10 percent tariff on aluminum.

Australia remains the only trading partner for steel and aluminum without trade restrictions.

Controversial legal justification that imports of steel and aluminum threaten American national security.

GATT Article XXI provides an exception for measures taken to protect national security., but only in rare circumstances.

Under Section 232 of the Trade Expansion Act of 1962 the US adopted a very broad definition of national security. It also allows wide discretion to modify the terms of the protection, seemingly with little notice, by adding or subtracting countries and products, changing the tariff levels. For instance, the US administration did not exempt from tariffs countries such as Japan and China with whom the United States has trade deficits that Trump deems too large and has used the tariffs as a bargaining chip in some cases with a view to obtaining quota protection.

Doubtful that national security could be invoked in the case of China:

a) China accounted for only 16 percent of the of US steel and aluminum imports over which Trump imposed tariffs. China's exports of steel and aluminum to the United States are relatively small because more than 90 percent of these exports are already subject to special tariffs (safeguards, antidumping, and countervailing duties), most of which were imposed long before Trump assumed office in 2017.

b) Chinese exports of steel and aluminium had not been increasing in absolute terms. So it was within its rights to demand compensation (retaliation) by imposing its own tariffs on roughly an equivalent amount of US exports.

Thus, several WTO rules and practices have been undermined:

- **In the WTO, countries are supposed to negotiate through reciprocal concessions not threats, but the Trump administration has explicitly used the national security measure to enhance US bargaining power in bilateral trade negotiations.**

- **The selective nature of the action appears to violate the MFN principle of the multilateral system, which ensures equal rather than exclusive trading privileges between two partners.**

- **US actions have provoked other members to retaliate without obtaining permission from the WTO.**

- **The US has provided such a liberal interpretation of national security that the exception could now be used to undermine the value of market access concessions in almost any product.**

3. Unfair trade practices for technology transfer and intellectual property (IP) protection (Section 301 of the Trade Act of 1974)

- ✓ **April 3, 2018**

The Trump administration accuses China of conducting unfair trade practices related to technology transfer, intellectual property and innovation under Section 301 of the Trade Act of 1974 and releases a list of 1,333 Chinese products under consideration for 25 percent tariffs.

- ✓ **April 4, 2018**

China publishes its list of 106 products subject to forthcoming 25 percent tariffs as retaliation for Trump's Section 301 tariffs.

- ✓ **Escalation continues until September 24, 2018. Then, after several rounds of negotiations, the administration announced it would not impose any new tariffs if China honours its pledge to increase its imports from the United States and makes progress in enforcing intellectual property rights and opening its market to foreign firms and products.**

Four main complaints from the US:

1. **The use of foreign ownership restrictions such as opaque and discretionary administrative approvals and requirements for joint ventures to pressure the transfer of technologies and intellectual property to Chinese companies.**

2. **A set of Chinese laws and regulations that force American companies seeking to license their technologies to Chinese counterparts to do so on unfavourable, nonmarket terms. Part of this claim is that China has imposed different requirements on foreign and domestic firms.**

3. **China has been facilitating the acquisition by Chinese companies of US companies in the United States to obtain strategically important technologies.**

4. **The Chinese government has supported a policy of cyber-intrusion into the commercial operations of American companies, which has allowed it to steal trade secrets and other proprietary business information.**

Are these these concerns well grounded?

The positions of the US administration and the Chinese government in these cases seem to differ not on principle, but on whether the Chinese government should be held responsible for the behaviour of entities that are not part of the government that do participate in such activities.

Foreign firms believe that China's actions under its new industrial policy program, <u>Made in China 2025</u>, are unfair to American companies, because they would provide <u>large, low-interest loans from state-owned investment funds and development banks; assistance in buying foreign competitors; and extensive research subsidies</u>, all with the goal of making China largely self-sufficient in the targeted industries.

One apparent <u>difference of opinion</u> is about whether an agreement between a foreign company and a Chinese company that requires the foreign company to transfer technology in order to invest is simply a market-based transaction or unwarranted government intervention.

The Trump administration has <u>not used the negotiations over a US-China bilateral investment treaty</u>, which were launched by the Obama administration.

Nor did it <u>challenge the subsidies being given to domestic firms under the WTO subsidies code</u>, which prohibits such subsidies.

Also dealing with threats of stealing trade secrets requires <u>security actions</u> rather than trade measures.

On the contrary, it has <u>tried to gain leverage by threatening to use tariffs</u> and failing to exhaust the options that are available to it under the WTO rules

Moreover, it chose to <u>threaten suspension of concessions</u>, which clearly breaches WTO rules. The WTO allows suspension of concessions only when a violation has been proven and when the amount and nature of the retaliation has been authorized.

Given US actions, <u>China has felt obliged to respond with threats of its own, and as a result the two largest members of the trading system are no longer respecting the rules.</u>

One fallacious economic motivation for the trade war: trade deficit

SOME BASIC FACTS:

- ✓ **US trade in goods has registered a continuous deficit with the world since 1975.**
- ✓ **The US trade deficit in goods with China started climbing in the mid-80s and reached $375.2 billion in 2017 (46.3 percent of the total deficit with the world).**
- ✓ **The US deficit in goods with China was larger than that of the next eight countries combined.**

President Donald Trump's preoccupation with negative trade balances in goods, both bilateral and total, has led to protectionist trade policies at home—primarily to minimize imports and offshoring by US firms—and aggressive demands for more market opening abroad.

President Trump appears to view trade not as an activity from which all nations can gain but rather as a zero-sum game in which some win and some lose.

But we live today in the world of global value chains. The meaning of trade balances relevant for economic policy decisions is different in terms of value added trade than in conventional gross terms.

To understand how the measurement of trade in value-added affects bilateral trade balances, let us assume that 10 million iPhones are exported from China to the US (equal to a value of USD 1,875 million).

In gross terms, the iPhone trade represents for the US economy a trade deficit with China of USD 1,646 million (the difference between US exports of intermediate inputs to China –USD 229 million– and US imports of assembled iPhones –USD 1,875 million–.

However, in value-added terms China adds only a small share of domestic value-added to the iPhone, corresponding to the value of the assembly work.

Most of the components of the iPhone are sourced from economies outside China. In value-added terms, the US trade deficit is only marginally with China, while mostly with Taiwan, Germany, Korea and the rest of the world.

As a whole, the Chinese domestic value added of exports accounts for one-third of China's trade surplus with the United States and foreign-funded enterprises account for about 45 percent of China's trade surplus

If the US imposes a tariff on imports from China, it would mostly affect producers from other countries, including the US.

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Two further considerations limit the importance of the nominal trade deficit:

1. **China runs a deficit in services trade with the US, which increased significantly in recent years. It accounts for 11 percent of the US-China trade deficit in goods in 2016.**

2. **Trade between China and the United States has remained largely in balance from the perspective of aggregate sales. In 2015 the aggregate sales of Chinese companies to the United States amounted to $402 billion, while the aggregate sales of US companies to China were $372 billion. The US deficit with China in 2015 thus amounted to only $30 billion in terms of aggregate sales.**

What has caused the US trade deficit with China?

- **The <u>Chinese government's subsidies to state-owned enterprises</u>?**

BUT: private and foreign-funded enterprises accounted for 46.5 and 43.2 percent, respectively, of China's trade surplus; state-owned and other enterprises accounted for only 10.3 percent

- **<u>Undervalued renminbi exchange rates?</u>**

BUT: although the renminbi appreciated significantly against the US dollar since2005, China's trade surplus with the United States also expanded except in 2015–16, when the renminbi depreciated against the US dollar. So the exchange rate seems hardly to be a determining factor of China's trade surplus

- **More likely a <u>structural saving deficit.</u>**

Recall the basic accounting identity for a net importing country:

GDP = C+I-NX   So GDP-C = I-NX   S=I-NX

If I exceeds S, there will be a trade deficit: so the country tends to buy more from foreign countries than it sells.

These net imports have to be financed through borrowing from foreign countries (creating future indebtedness to them).

China lends to the US by buying T bonds with which the US buy consumption goods from China. Even if China reduces its surplus with the United States, the expected increase in the investment-saving gap implies that the US trade deficit with other countries may expand.

Trade wars are not easy to win

In fact most countries lose out of a trade war

It is not a zero-sum game

The costs of the trade war

President Trump's approach appears to be one of imposing costs—some on other countries, but largely also on the United States—perhaps as a bargaining tactic.

At present the costs of conflict far outweigh the current causes of dispute in the China-US economic relationship.

Those costs are:

direct, in terms of short term losses of growth and employment

indirect, in terms of long-term damage to the world trading system, diminishing investment, efficiency and growth.

Economic Costs to the United States of China’s Retaliatory Tariffs

New Chinese tariffs on US exports of sorghum, fruits and nuts, pork, beef, and potentially soybeans will jeopardize the competitiveness of American agricultural products in China. American farmers and ranchers will lose market access not only to Chinese agricultural products but also to farm products from countries like Brazil, Argentina, Australia, and Canada, which not subject to the new Chinese tariffs. Ex.: US soybeans exports to China decreased by 96% in 2018 and their prices went down as well.

Similarly, Chinese tariffs on US manufacturing exports will make it harder for many American companies and their workers to maintain their access to the Chinese market. The biggest industries negatively affected by Chinese tariffs would be plastics, aircraft, pharmaceutical, transport vehicles, besides industries tied to agriculture.

Economic Costs to the United States of Its Own Tariffs

Broadly speaking, the Trump administration is imposing higher tariffs on two kinds of products—intermediate inputs and consumer goods. In general, tariffs impose costs on consumers:

- **higher prices**
- **lower volume**
- **reduced access to foreign varieties**

that outweigh the limited gains to local producers who face less import competition.

For consumer products such an import tax may also turn out to be regressive, if it reduces the purchasing power of lower-income Americans who spend a greater share of their household budget on consumer goods, including imports.

The new tariffs could lead to rising inflation expectations. Rising inflation expectations would force the Fed to accelerate rate hikes, which could lead to a slump in stock and property prices.

Economic Costs to the United States of Its Own Tariffs (cont.)

Tariffs on inputs like steel, aluminum, or the hundreds of "parts" on the Section 301 list, feed into US production, frequently through cross-border supply chains. Raising the prices of intermediate inputs raises the costs to downstream US industries and makes American firms less competitive both in the North American and global markets. Their peers in the rest of the world can access similar inputs at lower prices because they do not face tariffs. This cost will be increasingly difficult to reverse as other countries start to benefit from discriminatory access to the Chinese market.

US listed companies depend on their Chinese business revenues four times more than Chinese listed companies depend on their US business revenue, the risk exposure of US corporate interests in China is far greater than that of Chinese companies

An escalation of trade tensions would cause concerns among investors in the United States and trigger strong reactions, which would then affect the US economy through wealth effects and tightening financial conditions.

Example: contraction of the US stock market by about $1 trillion—about 5 percent of GDP between March and April 2018 Between March 1, 2018.

The longer term costs of the trade war

Trade frictions could <u>undermine global confidence in US economic policies and the international trading system</u>.

The alienation of trading partners that had previously shared common grievances will weaken international cooperation.

This cost will be increasingly difficult to reverse as <u>other countries start to benefit</u> from discriminatory access to the Chinese market that US commercial interests are abandoning due to Trump's unilateralism.

The costs to the Chinese economy

According to some, the Chinese economy will experience greater pain than the US economy, even if China takes countermeasures because:

- **China's exports to the United States account for 18.4 percent of its total exports (4 percent of its GDP), whereas US exports to China account for only 8.4 percent of its total exports (0.6percent of its GDP).**

- **US imports from China (mostly consumer goods) can be more easily substituted than Chinese imports from the United States (soybeans, machinery, high-end components). China can find substitutes for the aircraft and automobile products it imports from the United States.**

- **Some signs of negative impacts: trade war might have contributed to the slowdown of export expansion, infrastructure investment, stock exchange performance, growth rate.**

Besides the direct impact on trade, China will also face multiple second-round shocks if the trade war is long-lasting:

- **the reduction in investment and employment of exporters hit by the tariffs will weigh on Chinese exports, over and above the direct hit from tariffs.**

- **Another source of external shocks is from the disruption to global supply-chains. Over 40% of the value-added in electronics, and nearly 30% of that in machinery, is created outside China. Asia's technology leaders, such as Japan, Korea and Taiwan, are large contributors to the value embedded in Chinese exports to the US. Some European countries (e.g. Germany and UK), and even the US itself, are also part of this global production process.**

The implication for China is not straightforward. On the one hand, as China's exports to the US decline on the back of trade tensions, its imports of components and inputs from others will also decrease, effectively spreading the negative shock across the supply chain. Even for production that occurs in China, many top exporting firms are in fact foreign-owned meaning that their profits will ultimately flow outside the country. So the shock might be limited.

On the other side, a long-lasting trade war would weaken China's position in the global supply-chain. With its products restricted by the world's largest market, China's competitiveness in global manufacturing, particularly in high-value-added and sophisticated technology products, would decline, leading to lower foreign direct investment and employment. This could hinder its technology convergence over the medium-term.

Impact on the Global Economy

China is the world's largest exporter and the United States the world's largest consumer; together the two countries account for 40 percent of the world economy. The impact of a trade war on the global economy cannot be underestimated. It has the potential to drag the global economy into recession.

Economies exporting intermediate products and raw materials to China, such as South Korea and Taiwan, will be hardest hit.

In the first six months of steel tariffs, small and poor countries saw a 12 percent decline in steel export volumes to the United States and 15.5 percent less revenue, relative to the six months prior to the tariffs.

According to a study based on a multi-region dynamic general equilibrium model (GIMF) a global and generalised 10 percentage point increase in import tariffs could reduce global GDP by 1% after two years.

This effect could be amplified by a fall in productivity, a rise in the financing cost of capital and a decline in investment demand.

Taking all these factors into account could result in lowering global real GDP by up to 3% after two years.

Costs to International Cooperation of Trump's Trade Policy

Major WTO members share many US concerns with China's integration into the world trading system. Yet, the Trump administration has provoked historical allies with its trade policy actions so frequently during its first 15 months in office that long-run cooperation has been increasingly called into question.

- **pulling out of the TPP**
- **renegotiating NAFTA**
- **antidumping cases on softwood lumber and Bombardier jet became so contentious that Canadian and British leaders were forced to weigh in and threaten retaliation**
- **EU repeated threats of retaliation**
- **US failure to fully embrace the approach of the OECD's Global Forum on Steel Excess Capacity**
- **From a pro-market convergence to a pro-statist convergence?**

Costs to the WTO of Trump's Trade Policy Conduct

The Trump administration has deliberately <u>weakened the rules-based, multilateral trading system</u>.

- **the US has been <u>blocking the appointment of Appellate Body members</u>, thus slowing the resolution of ongoing disputes and impeding the process of an important function of the rules-based system.**
- **Furthermore, it <u>claims that WTO rulings are biased against the United States</u>,**
- **Trump's <u>use of the national security exception</u> under Section 232 to impose a haphazard set of import restrictions on steel and aluminum blatantly disregards the rules.**
- **<u>Forced countries to attempt to "rebalance" bilateral trade relations</u> with legally dubious approaches of their own.**

Some countries and sectors may benefit

Certainly the American steel and aluminium producers, soybean producers, the other protected industries and the US government (through the tariff revenues) will gain from the US trade war. But, as shown previously, these gains would be more than compensated by losses of millions of consumers plus the losses of producers who suffer from the price increase of their inputs.

Certain industries in some other countries may benefit too.

For the United States, <u>countries that could replace China</u> include Mexico (electrical equipment, mech equip, furniture, toys, automobiles, plastic), Vietnam (garments, toys, shoes), Canada (auto, plastic), Malaysia (electric equip), Japan (electric and mech equip, furniture, auto).

China could <u>replace imports from the United States</u> with imports from Brazil (soybeans, wood), Germany (aircraft, mech equip, auto), Japan (electric and mech equip, auto, optical, plastic), France (aircraft), Canada (seeds, aircraft, wood), Germany (aircraft, mech equip, auto) South Korea (electric and mech equip, auto, optical, plastic).

The <u>EU could substitute to some extent China and the US in each other market</u>, if the EU is not itself the target of protectionist measures. Motor vehicles, aircraft, semiconductor, chemical, machinery, plus some consumer goods would have the best opportunities to expand their market shares. It could also attract a <u>larger share of Chinese investment</u>, as it seems to have happened in the last year.

The contest for economic power remains and looms in the back

Washington Consensus or Beijing Consensus?

The trade dispute is merely a disguise of a <u>structural conflict.</u>

Three fundamental questions:

1. **Will the relative economic power of the two countries allow, or even perhaps promote, a leadership shift any time in the near future?**

2. **Does the United States still care about leadership of the world economy or has it grown tired, and perhaps even skeptical of the desirability, of maintaining that role?**

3. **Does rising China want to fill the vacuum left by the United States, sooner or later?**

Economic power

No generalized decline of the United States in absolute or even relative terms vis à vis the <u>other main industrialized economies</u> since the end of the Cold War. US <u>military superiority</u> remains overwhelming.

The main reason for any US decline in relative terms is the <u>even faster and dramatic rise in China's economic power</u>. China and the United States are now broadly equal on several key variables, including GDP in purchasing power parity (PPP) terms and levels of trade. But China is likely to continue growing (4 to 7 percent) at double or triple the US rate (2 to 3 percent) for at least the next decade or two, as its much lower per capita income offers sizable scope for further convergence to the US frontier. Its GDP, measured in PPP terms, will probably double that of the United States by 2030 and triple it by 2040–50. China's trade level will probably also double the US level by 2030 and triple it by 2040. China's GDP at market exchange rates will probably exceed US GDP by 2030 and do so by 50 percent by 2040.

<u>Greater size does not automatically confer greater or dominant leadership</u>. The United States will remain a very large economy, with very large trade and international investment levels. Inertia is a powerful force in global economics, and the United States has been the undisputed world leader for over 70 years, without any plausible rival. Over that period, it built a formidable array of alliances and international institutions grounded in its own norms.

Even in the race for <u>artificial intelligence dominance,</u> although China appears to be stronger in terms of investment and number of patent applications, the US is still dominant from the perspective of the number of companies operating in the field, of the share of experts and papers published. Recall also that China has a GDP per capita of about one third of the US, is still very low in the ranking of density of robot workers and per capita financial assets. Finally, although China is the biggest world exporter of high tech products, about half of those exports are due to foreign funded enterprises operating in China.

The future: three possible scenarios

1. **Kindleberger trap – most likely**

2. China's ascent to leadership – possible, but unlikely to be peaceful

3. Tucydides trap – pessimistic – possible, but unlikely for the moment

But history shows that in a few cases nations may come to agreements to avoid larger conflicts!

Thank you for your attention