The Trade War: How Will It End?

By: Jack Perkowski | September 9, 2018

Last Thursday, September 6, the comment period ended for the list of an additional $200 billion of Chinese imports slated for tariffs. Depending upon the recommendation of the United States Trade Representative ("USTR"), tariffs of 10 or 25 percent are now ready to be imposed on these products. On Friday, President Trump further raised the stakes in the ongoing Trade War with China saying that he is prepared to impose tariffs on an additional $267 billion of imports. On top of the $50 billion of imports that are already subject to tariffs, levies on an additional $467 billion of imports would mean that, effectively, all imports from China will be taxed.

Every year, China exports approximately $500 billion of products to the United States and imports about $130 billion, creating an annual trade surplus for China, and an annual trade deficit for the United States, of $370 billion. The United States is China's largest market, and total trade between the two countries represents the largest trading relationship in the world. In addition to China's private and state owned companies that sell their products to U.S. consumers, China is now such an important link in the global supply chain that China's exporters include many U.S. companies that import products from their operations in the country.

Apart from trade issues, the USTR has estimated that intellectual property ("IP") theft by Chinese companies, as well as government actions, policies and practices, including those that coerce American companies into transferring their technology and intellectual property to domestic Chinese enterprises, cost U.S. companies between $225 and $600 billion every year. IP theft and technology transfers are of special concern because they bolster China's goal of achieving international dominance in advanced technology sectors as outlined in its "*Made In China 2025*" initiative.

Rather than causing a trade war between China and the United States, the Trump Administration argues that the United States has been in a trade war for the past thirty years---a war that the United States is losing due to unfair trade practices by China and other countries---and that the imposition of tariffs are meant to bring the Sino-American relationship into balance. Through the threat of tariffs, the Trump Administration seeks to reduce the trade deficit, as well as force Beijing to address IP issues.

On March 22, President Trump announced that the United States would take multiple steps to protect American technology and intellectual property from discriminatory and burdensome trade practices. On July 6, a 25 percent tariff on $34 billion of Chinese imports went into effect, and on August 23, tariffs on an additional $16 billion of goods were imposed. China has responded in tit-for-tat fashion, and has now imposed tariffs on $50 billion of imports from the United States. China said last Friday that it would tax an additional $60 billion a year worth of imports from the United States if additional tariffs are imposed by President Trump.

The Impact

Economically, the Trade War has had a disproportionately detrimental impact on China. Since President Trump's announcement on March 22, shares on the Shanghai Stock Exchange are down 17 percent, and China's currency has depreciated by 7.5 percent against the dollar. Moreover, there are increasing signs that China's economy is slowing, caused at least in part by the Trade War. Meanwhile, the Dow Jones Industrial Average is up 8 percent over the same period, and the U.S. economy grew by 4.1 percent in the Second Quarter, its strongest pace in nearly four years.

China's Options

Because China's exports to the United States are $370 billion higher than U.S. exports to China, China will have exhausted its ability to respond (next page)

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to additional tariffs through the imposition of its own tariffs once taxes on the additional $200 billion of Chinese imports go into effect. While China does have other actions it might take, none come without substantial costs to the country.

1. Devalue the Renminbi: In order to lower the impact of tariffs, causing, or allowing, the yuan to depreciate further will only exacerbate inflation pressures in the country. In 2017, China imported $1.8 trillion of goods and is a large importer of energy, agricultural products, raw materials and the basic commodities that find their way into all areas of the economy.

2. Refrain from Buying U.S. Treasuries: China holds more than $1 trillion of U.S. Treasuries and has been the largest creditor of the United States over the past decade. If selling the U.S. Treasuries which it already owns, or refraining from new purchases, has the intended effect, interest rates in the United States will rise and more capital will flow into the United States, most likely to the detriment of China's currency and stock market.

3. Retaliate Against U.S. Firms Doing Business in China: At the end of 2017, China had $1.5 trillion of accumulated Foreign Direct Investment ("FDI"), and Hong Kong had an additional $1.9 trillion. By comparison, the United States had $4.1 trillion as of that date. China is one of the largest recipients of FDI in the world, which brings management and technology along with capital into the country. Actions against U.S. companies would not only cause U.S. companies to reconsider their China strategies, but they would also give pause to European companies and companies from other countries.

What Will Happen?

Given all of the above, China has more to lose from the Trade War than the United States, and the ball is now in its court. Moreover, the longer the TradeWar goes on, the more likely it is that companies will look for manufacturing and supply alternatives, and the supply chains centered on China that have been put in place over the past forty years will begin to change.

Andy Rothman, China Investment Strategist at Matthews Asia who has lived in China for many years and whose opinion I respect, believes that President Xi will reach out to Donald Trump in September, either by phone or in person during the UN General Assembly meeting in New York, to propose a deal that will enable President Trump to declare, well ahead of the mid-term elections, that pressure from his tariffs forced China to make unprecedented concessions that will offer more market access and better IP protection for American companies.

Given the economic circumstances in both countries, Andy's prediction is the only scenario that makes sense in my opinion. The Trade War will be over by year end.

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