Who Loses *in a* Sino-U.S. Trade War?

By Chi Lo

The non-Chinese Asian economies could be hit hard.

The Trump administration has started getting tough on the United States' trading partners in an attempt to reduce the trade deficit by imposing high tariffs on various imports. Imbedded in the tougher trade policy is an escalation of Sino-U.S. economic conflict, which has also been manifested in national security concerns by the United States. Hence, late 2017 saw the release of U.S. strategy documents on national security, defense, and trade, all of which for the first time defined China as a strategic competitor and disavowed America's longstanding policy of constructive engagement. The markets tend to see all this as a rise in U.S. trade protectionism.

While a full-blown Sino-U.S. trade war is not yet a base-case scenario at the time of writing, even trade frictions could have long-term impacts on global trade and investment flows and the political power balance in the Asia-Pacific region, with implications for the United States. The short-term economic effects are likely to be unevenly distributed across the global markets. The impact on China may be much less than what President Trump thinks, but the collateral damage to the Asian regional economies could be large. The more concerning aspect of rising Sino-U.S. trade conflicts is the possibility that U.S. international economic policy may be driven by long-term zero-sum national security thinking, which

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will have far-reaching implications for global economic (notably inflation) and geopolitical risks.

THE STUBBORN U.S. TRADE DEFICIT WITH CHINA

The pressure point of Sino-U.S. trade frictions lies in the stubborn U.S. trade deficit with China. That deficit is more than five times larger than the United States' second-largest bilateral trade deficit with Mexico. Furthermore,

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So President Trump has a strong justification for getting tough on trade with China. After imposing import duties of 30 percent and 20 percent on solar panels and washing machines, respectively, in January 2018, the Trump administration imposed tariffs of 25 percent on steel and 10 percent on aluminum imports. China is the world's largest producer for both commodities. Then in April, the administration upped the ante by proposing another 25 percent in tariffs on $50 billion in Chinese imports to protest Beijing's alleged theft of American technology. All this was met by tit-for-tat retaliation by the Chinese. More tariff moves may be likely in the short term as Trump seeks to increase pressure on China to address the trade imbalance.

If these tariffs were aimed at paring the United States' trade deficit with China, they would not deliver the expected results. This is because the key products that contribute to the massive U.S.-China trade deficit are electronic and labor-intensive products, including telephones, data processing machines, communications equipment, toys, furniture, footwear, and plastics.

These products are hard for the United States to target because, first, electronics are an integral part of U.S. production in the global supply chain, so that increasing import tariffs would also raise the costs for U.S. companies. Second, the United States has no comparative advantage in making those labor-intensive products anymore, so tariffs will only be a tax on U.S. consumers.

SINO-U.S. INVENTIVE INCOMPATIBILITY

China and the United States have totally different incentives on their negotiation tactics. China has a strong incentive to insist on foreign technology transfer so that Chinese firms can catch up more quickly with the technological capabilities of developed-market economies. Beijing believes that China's tech sector is in the early stages of development, and could suffer from direct and open competition with foreign firms. So it argues that its industrial policy is typical of any developing market protecting its new industries. This perspective clashes with the United States' developed market policy of championing free and fair market access. These underlying ideological differences will be difficult to bridge in the short term.

Crucially, the Trump administration is increasingly worried about Beijing's "Made in China 2025" strategy of turning China's tech sector into a dominant global leader. Note that 70 percent of the 1,333 Chinese products that are subject to the 25 percent U.S. tariff proposal are related to industries in China's "Made in China 2025" strategy. This strategic concern suggests that restrictions on Chinese investments in U.S. high-tech firms could be made permanent, rather than serving as temporary leverage for changing China's intellectual property technology transfer practices. If Trump is really seeking trade policy

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outcomes that would limit the competitive threat posed by China's technology sector, successfully concluding negotiations on the full range of trade issues will prove even more challenging.

THE COLLATERAL DAMAGE

The markets see these moves as a vindication of Trump's protectionist policies. However, gross trade data can be misleading, because over one-third of China's exports, including to the United States, are foreign value-added content, mostly from other Asian countries.

This means that rising U.S. protectionism, as manifested in Sino-U.S. trade frictions, could hurt other

A better strategy would be to work with economic allies.

economies that supply parts and components to China. The potential collateral damage can be estimated by stripping out the foreign value-added content in China's gross exports to the United States and reassigning it back to its original source countries to assess their ultimate export exposure to the United States.

The point is clear: An escalation of U.S. trade protectionism would be quite damaging to most of Asia's export-oriented economies, with six of the top ten most-exposed countries being Asian. The damage to China is rather limited. From an asset allocation perspective, all else being equal, China seems to be the least affected Asian market in the case of a rise in Sino-U.S. trade frictions. A market study also finds that of the Asian countries most exposed to the United States, the industries that could be hit by U.S. trade measures are textiles, leather, and footwear in Vietnam, computers and electronics in Taiwan and Malaysia, and chemicals and petroleum products from Singapore.

STRATEGIC CALCULATIONS AND MISCALCULATIONS

In 2017, U.S. trade policy was subordinated to two other goals: gaining China's help in dealing with the North Korean crisis, and passing a tax cut bill. With the North Korean crisis risk stabilizing and the tax bill passed, tough trade policy has taken priority in Trump's political agenda, with a short-term aim of buying votes for the mid-term elections in November 2018.

Trump and many U.S. officials seem to think that China still depends heavily on foreign trade for growth and has such a fragile financial system that unilateral pressure from the United States could force China to cave to American demands. They have overestimated America's ability to force China's hand, and their understanding of China's economic structure is outdated, in my view. Since 2009, the contribution of net exports to China's GDP growth has largely been zero or negative, suggesting that its economy has already shifted from export-led to domestic-led growth.

Market research estimates that a permanent 10 percent drop in China's exports to the United States would cut Chinese GDP by about 0.3 percentage points. This is material, but can easily be offset by domestic infrastructure spending and/or an increase in Chinese exports to other markets under the Belt and Road Initiative. Furthermore, the power of China's domestic innovation to generate growth has improved significantly. Its industrial upgrading process under the "Made in China 2025" industrial policy has been backed by hundreds of billions of dollars in government venture capital funds in addition to traditional subsidies.

In the short term, a persistent U.S. campaign of economic pressure on China would bolster the view that the United States is in a long-term fight to reduce its trade deficit, possibly using a weak U.S. dollar as a tool. U.S. Treasury Secretary Steven Mnuchin raised exactly this fear in January 2018 by commenting on the benefits of a weak dollar. Though senior U.S. officials hastily reaffirmed a strong dollar policy afterwards, the market has grown skeptical because cutting the trade deficit is now a stated policy goal of Trump. U.S. research also shows that cutting the U.S. current account deficit from 4 percent to 2–3 percent of U.S. GDP would require a 10 percent depreciation of the U.S. real exchange rate.

In the longer term, both China and the United States seem to be striving for onshoring the globalized production chains built over the past three decades, with China doing it through import substitution to minimize the foreign share of its industrial base, and the United States doing it through America-first policies. Even partial success of these initiatives could be damaging.

First, breaking up the global supply chains will likely bring back inflation by reversing the disinflationary forces brought about by globalization. Second, cross-border production chains are a force for peace and stability, as they raise the cost of armed conflicts. Reverting back to national production structures raises the possibility that big countries would try to settle their differences by force. It may be too early to be alarmed, but the direction is worrying.

The related concern is whether the United States is edging towards an all-out economic and technological

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confrontation with China driven by zero-sum national security thinking over the longer term. There are two conflicting forces in the United States affecting its international economic policy. The first is the globalist faction, which has worked hard to contain protectionist impulses in the country. The second is the alliance (out of convenience) between the trade hawks and the national security hardliners. This

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second force has the ardent support of President Trump, whose policy has a stated goal of cutting the United States' bilateral trade deficits by forcing China into abandoning its unfair trade practices of state subsidies and financing.

It is too early to say how effective the trade and national security hawks will be in pushing their agenda into America's international economic policy. The desire for a tougher policy stance against China has gained support across the U.S. political and business spectra due to frustration over China's high and invisible trade barriers, its efforts to force technology transfer, and state support for local champions.

However, there is no consensus on the specific measures that will inflict serious pains on China without causing equal or greater harm to U.S. companies, because China is too large, too self-sufficient, and too well-financed to succumb to direct economic pressure from the United States. A better strategy would be to work with economic allies and revamp the international economic system in a way that would raise both the costs to China of its discriminatory policies and the benefits of adapting to a more liberal and market-based framework. This was indeed the idea behind the Trans-Pacific Partnership, but President Trump rejected it.

A lack of coordination between the trade and national security hawks has also created inconsistency in the U.S. policy strategy. While the security hardliners would like to ensure that key U.S. allies such as Japan, South Korea, and Germany are on board with their efforts to contain China's threat, the trade hawks have backed unilateral actions, such as the steel and aluminium tariffs, that have hurt U.S. allies and undermined any coalition-building efforts.

Many U.S. businesses are ambivalent on the China issue. They are unhappy with China's discriminatory policies. But China remains a huge market and source of growth for most firms, which still see China as a top investment and trade target. So far, U.S. companies have sided with the globalists to defend against the trade and national security hawks. However, unless the globalists can gather stronger support from the companies whose fortunes are tied to the Chinese market, the odds are that the trade and security hawks' strategies will gain an upper hand.

THE RISKS THAT GO BEYOND AFFECTING CHINA

The biggest problem for the global system is that if zero-sum national security thinking begins to drive American international economic policy, U.S. protectionism will rise beyond short-term political considerations. For China, this means more trade and investment sectors will be affected, with collateral damages on other Asian economies due to their roles in the global supply chain. For the world, it will harm growth and investment due to fears of an escalating trade war. Inflation will return due to the breaking up of the global supply chain; geopolitical risk may also increase due to the reduction in the cost of armed conflicts as the global supply chain that has cemented the countries together is dismantled.

Finally, for the United States, its recent economic and political actions are eroding its influence in the Asia-Pacific area, affecting the power balance in the region. Many Southeast Asian countries are now seeking to diversify their strategic partnership beyond a binary choice between China and the United States due to their uneasiness over China's rising influence and perceptions of an unpredictable While House.

Previously, many Southeast Asian nations turned to Washington for leadership. But Trump's controversial policies have unnerved America's Asian allies. Singaporean Prime Minister Lee Hsien Loong was quoted saying bluntly at a lecture that marked the fiftieth anniversary of the ISEAS-Yusof Ishak Institute, a Singapore-based research center focused on Southeast Asian studies, that "ASEAN must adjust to a new power balance in Asia," and he suggested the bloc should look more to China and India for hedging its risks.

The premium for risk assets will rise under these circumstances in the longer term, all else being equal. ◆