ISSUE BRIEF

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THE US-CHINA TRADE WAR 2018

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(Views expressed in the brief are those of the author, and do not represent those of ISSI)

With all the recent hostilities over trade, it's easy to forget that China and the United States have been top trading partners for years. While trade relations between the two economic powerhouses have not always been smooth, they changed dramatically on July 6, 2018, when Washington imposed the first wave of tariffs on $34 billion worth of Chinese goods, prompting an immediate retaliation from Beijing.[1] If President Trump's threats throughout May and June 2018 are to be taken seriously, nearly a third of Chinese imports to the United States could be affected by tariffs in coming months.

The tariffs on China represent a fundamental retreat by the US from the global trading system. US President Donald Trump has rallied against trade imbalances, particularly with China, on various occasions as he seeks to renegotiate America's economic relationship with other nations he accuses of exploiting the US. This threatens to cast a dark shadow over the global economy. Beijing appeared stunned that Trump failed to share China's sentiment that the US has ignored the economic and trade cooperation with mutual benefit and win-win results over the last 40 years. President Trump announced earlier this year that he would levy tariffs on imported steel and aluminium, including products from China. He also signed a memorandum seeking tariffs on $60 bn worth of Chinese goods. China responded with retaliatory tariffs on food imports from the US. Trump's declaration

[1] Rebecca Tan, "The U.S.-China trade war has begun. Here's how things got to this point", *Washington Post*, July 6, 2018. https://www.washingtonpost.com/news/worldviews/wp/2018/07/05/a-timeline-of-how-the-u-s-china-trade-war-led-us-to-this-code-red-situation/?noredirect=on&utm_term=.6a454fddc894

coincided with the signing by 11 countries of a new Trans-Pacific trade pact that the United States withdrew from in 2017. The US had a $375.2 bn trade deficit with China in 2017 and had demanded the deficit be slashed by at least $200 bn by 2020. [2] The announcement underlines concern about rising US protectionism across the world Both the US and China are targeting each other's weakest points — the US is targeting China's future technological capacity, and China is responding by targeting US exporters' present revenues.[3]

The Trump administration argues that in addition to undermining US competitiveness in strategic sectors, Chinese state intervention distorts the global market place through inefficient mergers and acquisitions that artificially inflate the prices of potential acquisition targets and pair lesser Chinese firms with more productive US partners. Ultimately, Chinese market distorting policies, as advanced through the 'Made in China' 2025 program, blunt US innovation and corrode its distinct competitive advantage. For years, China defended these practices on the grounds that it was a developing country. However, now that China has grown to become the world's second largest economy, a consensus is building in the US that Beijing can no longer go on hoodwinking the international order by pursuing such blatantly mercantilist policies.[4]

The US cannot solve trade deficits bilaterally, particularly with China, where trade relations are particularly complex as US companies have moved their production to China. In practice, the US deficit with China has fallen and China's barriers to imports have been reduced. Modern industrial production takes place within complex international networks and protection is not going to bring whole industries back to the US. The world's two largest economies account for 40% of global GDP, a quarter of all exported goods, and 30% of the world's Foreign Direct Investment (FDI) outflows and inflows. Their fates are inextricably linked. In a way, they complement and need each other.[5]

The trade war between the US and China carries a major risk of escalation that could weaken investment, depress spending, unsettle financial markets and slow the global economy. These initial tariffs are unlikely to inflict serious harm to the world's two biggest economies. But the conflict could soon escalate. Even before the first shots, the prospect of a trade war was worrying investors. The Dow Jones industrial average has shed hundreds of points since June 11, 2018. But the risks are

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[2] Jeremy B White, "US-China trade war 'on hold' as America backs off on tariffs", *Independent*, May 20, 2018. https://www.independent.co.uk/news/world/americas/us-politics/trump-tariffs-china-trade-war-aluminum-steel-steve-mnuchin-a8360536.html

[3] http://bruegel.org/2018/04/what-are-the-targets-in-the-u-s-china-trade-war/

[4] Tom Holland, "Trump. Here's What it is About", *South China Morning Post*, April 23, 2018, https://www.scmp.com/week-asia/opinion/article/2142568/us-china-trade-war-not-about-trade-not-about-trump-heres-what-it

[5] Manish Singh, "Are we in for a US-China trade war?", *Crossbridge Capital*, March 2018, http://www.crossbridgecapital.com/?post_type=marketview-points&p=2609

now priced into the market, and the Dow actually rose nearly 100 points on 13/7/2018 to 24,456.48. China's currency, the Yuan, has dropped 3.5% against the dollar over June 2018, giving Chinese companies a price edge over their US competition.[6] The drop might reflect a deliberate devaluation by Beijing to signal its displeasure over the state of trade negotiations. Beijing needs a Plan B to deal with any potential fallout. If relations with Washington deteriorate any further and the trade war escalates, China's policymakers will need to step up their game, making up for any shortfall in demand. One thing is very clear, monetary conditions must be kept loose for as long as possible to boost domestic reflation hopes.

In conclusion, it can be said that the US is an advanced industrialized economy that relies upon liberal, free market principles to spur innovation and growth of its economy. In contrast, China seeks to occupy a similar position in global commerce, but through a managed economy led by national champions, often state-owned enterprises, and a top-down industrial policy. While there are missing nuances in this characterization, this fundamental difference should be the starting point for any level-headed approach to addressing the dispute. The US objective, it seems, is not to win trade concessions, which would be meaningless against such a backdrop, but to force a change in China's whole economic and industrial policy approach. Hence, Washington's preparedness to take actions against companies like against ZTE, a Chinese telecom giant threaten to harm, not improve, the US trade balance with China. A trade-war scenario between the US and China suggests that the US, and especially its consumers, would be amongst the biggest losers. Given globalised supply chains, however, the ramifications would be felt by producers and consumers far and wide.

[6] "US-China trade war to weaken investment, slow down global economy, say experts", *Firstpost*, September 6, 2018https://www.firstpost.com/world/us-china-trade-war-to-weaken-investment-slow-down-global-economy-say-experts-4685521.html