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Research Briefing | China

Impact of US trade action on China to be manageable

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- **We expect the US to soon roll out further trade restrictions specifically targeting China, as well as restrictions on Chinese investment in the US. The large share of China's exports to the US that is US-branded and/or coming from supply chains where US firms are involved will constrain the extent of tariff imposition, while China's response should remain relatively restrained. Although this should limit the economic damage, risks of further escalation exist.**

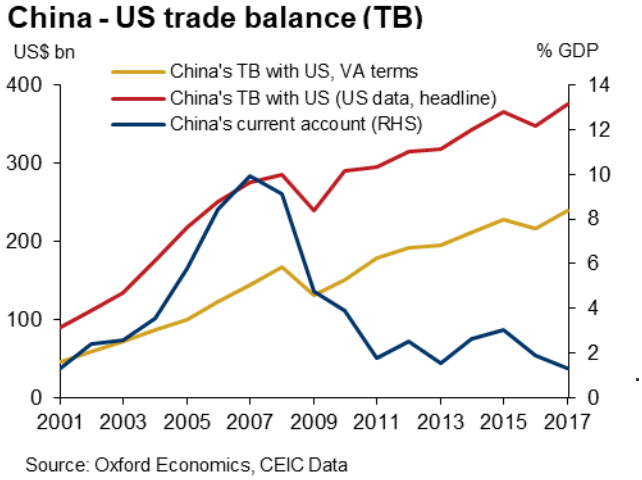
- Because of its success in scaling up manufacturing exports and the particular position it has in many key supply chains, China is the main target of the US's protectionist trade policies. The US administration is very actively exploring imposing tariffs on Chinese exports as well as placing restrictions on Chinese investment in the US and student visas.

- While we expect both tariffs and restrictions on Chinese investment to be introduced soon, the large share of US imports from China that is US-branded and/or features significant involvement of US companies in the supply chain constrains the range of Chinese exports at risk of major US trade restrictions. This is especially true for information technology, electronics and telecom products.

- Such considerations may explain why the US administration is apparently targeting tariffs on imports worth US$60 billion, about one-eighth of total Chinese exports to the US and 2.6% of total Chinese exports.

- While China will surely respond, we continue to expect its response to be relatively restrained and our baseline scenario implies modest economic damage. But there are risks of more pronounced escalation, leading to significantly larger economic impacts.

Chart 1



While the US runs a large trade deficit with China, China's overall external surplus was only 1.4% of GDP in 2017. In value added terms, the US bilateral deficit with China was 36% lower than the headline number.

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What will the US do?

China's particular position in the global trading system leaves it vulnerable to US politics

While the US's turn to protectionist trade policies potentially affects many countries, China is the main target. That is because China is the largest exporter to the US and, at US$375 billion in 2017 (based on US data), the bilateral goods trade deficit with China is by far its largest. A key hub in global trade, China combines trade deficits with some countries with surpluses with other countries, and its overall current account surplus is now quite modest (1.4% of GDP in 2017), not pointing to mercantilism or currency undervaluation (Chart 1). But its large bilateral surplus with the US leaves it open to US politics.

China-targeted measures have relatively strong political support in the US

While global supply chains for many products end in China, substantial value is added to them in other economies. That is an important reason why US-China trade friction will cause "collateral damage", especially in other Asian economies. Indeed, in value added terms, the US bilateral trade deficit with China was "only" US$239 billion in 2017, 36% lower than the headline number. Nonetheless, such "nuances" get lost in the political debate. Meanwhile, **although some of the Trump administration's protectionist policies are controversial in the US, China-targeted measures are much less so**; they command a reasonable degree of support in Congress.

The tariffs on steel and aluminum are meant to help the US steel and aluminum industry in the face of competitive pressure stemming in part from Chinese exports. While many countries export steel and aluminum to the US, several allies are likely to get exemptions. **More importantly, the US is conducting a "Section 301" investigation into alleged Chinese "theft" of intellectual property (IP).** The administration may announce an estimate of US$1 trillion of damage to US industry by alleged "theft of IP" and forced technology transfer in many sectors. **This investigation is now the basis for proposals to impose tariffs on a broad range of goods.**

It is highly unlikely that China can stave off US measures by reducing the bilateral trade imbalance by US$100 billion

During the recent visit to Washington DC of Liu He, President Xi Jinping's trusted aid on economic matters, the Trump team allegedly told him that **China could avoid major restrictions on trade and investment if it could present a concrete plan on how it intended to cut the bilateral US-China trade deficit by US$100 billion.**

This will be very hard to achieve. Amid solid growth and expansionary US fiscal policy, we expect the US overall trade deficit to rise another 10% this year, putting upward pressure on the bilateral one with China. Also, it would not be easy for China's government to reduce exports to the US by fiat (and even "window dressing" – moving the final stage of supply chains to another country – takes time). That leaves China raising imports from the US, on a structural basis. China is already exploring ways to do this – deals were announced earlier this year on more LNG imports. But imports would have to rise by a huge margin, given that China's goods imports from the US totalled only around US$130 billion in 2017.

Thus, the US administration is bound to continue exploring imposing tariffs as well as placing restrictions on Chinese investment in the US. In our view, more restrictions on Chinese investment are very likely, given the fairly broad support in the US. In 2017 a bi-partisan group of senators already proposed the expansion of the jurisdiction of the Committee on Foreign Investment in the US (CFIUS), and widening its jurisdiction to a broader range of transactions. Also, the US administration is apparently planning to restrict visas for Chinese students.

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Which Chinese exports are most at risk of facing tariffs?

As shown by the tariffs on washing machines, solar panels and metals, the **Chinese exports most at risk of protectionist measures by the US are those that compete with US-based production and are produced via Chinese (or Asian) supply chains with little involvement of US firms and products.** Other items that fit these criteria include portions of China-made furniture, textiles, shoes, toys, as well as China-branded information technology (IT), electronics and telecom products.

The large share of US imports from China that is US-branded and/or features significant involvement of US companies in the supply chain constrains the range of Chinese exports at risk of US trade measures

However, a large share of US imports from China is US-branded and/or features significant involvement of US companies in the supply chain. This is especially so for big categories such as IT, consumer electronics and telecom products (see Table). Obvious examples are Apple iPhones and HP laptops. While it does not guarantee exemption from US tariffs, **it makes such products less obvious targets in practice**, in our view.

Trade between US and China (2017)

US$ billion

	China's exports	US' exports
Total	506	130
Food, animals, bev., fuels, minerals	9	42
Chemicals and allied industries	18	16
Manufactured goods	54	5
Iron and steel	2	0
Manufacturers of metals	21	1
Machinery and transport equipment,	268	56
Industry machinery	36	11
Office machinery and equipment	73	2
Telecommunications equipment	96	2
Electrical machinery & appliances	47	11
Transport equipment	15	29
Other	157	12
Furniture & bedding	24	0
Articles of apparel and clothing	31	0
Footwear	14	0
Articles of plastics	12	1
Toys and sporting goods	26	0
Other	49	11

Source: Oxford Economics, US Census Bureau

Thus, while we expect the US to raise tariffs on imports from China, we think that their overall extent will be constrained by the involvement of US companies. Such considerations could explain why, according to press reports, the US administration may raise tariffs targeting imports from China worth US$60 billion. That is about one-eighth of total Chinese exports to the US (based on US data) and 2.6% of total Chinese exports. The list is rumoured to feature various kind of products.

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What about China's response and the economic impact?

While China will surely respond, we continue to expect its response to be relatively restrained

If the US introduces significant but still manageable new trade tariffs targeting China, we expect China to respond but to remain relatively restrained. By now, Beijing sees further steps by the Trump administration impeding imports and restricting investment from China as unavoidable. Beijing will not want to be seen as being soft vis-a-vis the US. Its response will surely include strong protests, and probably also some trade measures targeting the US. Another possibility would be to exert pressure on US businesses in China by means of further inspections, tests and delays in procedures.

But China realises that, with its exports to the US so much larger than its imports from the country, it is more vulnerable in a trade war. At the same time, China assumes that, while causing some damage, US measures along the lines outlined above will not cripple its economy. This is in part because China's economy is now much less export-dependent than a decade ago. Moreover, **a restrained response would allow China to keep "the moral high ground" as a supporter of globalization and the rules-based multilateral trading system**.

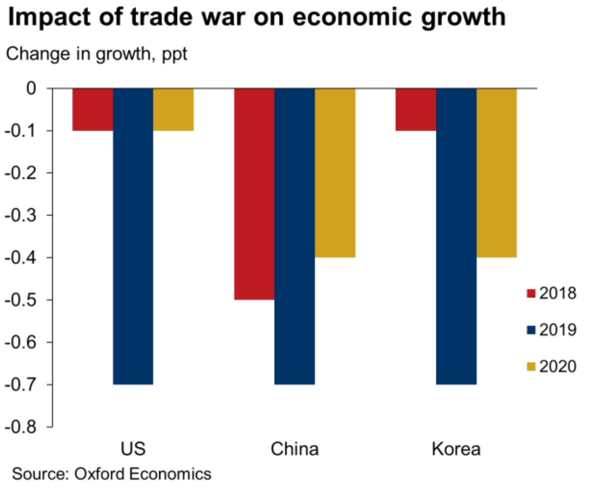
Thus, our baseline scenario implies only modest economic damage

Although such a scenario implies economic damage, it would remain limited. Our simulations suggest that a 25% US tariff on US$60 billion worth of Chinese exports, with comparable retaliation, would reduce China's GDP growth by around 0.1 ppt in 2018 and somewhat less in 2019, with a slightly smaller impact in the US.

But there may be a more pronounced escalation and more significant impacts

Of course, the key risk is that it does not end with this modest baseline scenario. More measures may follow, and 'tit-for-tat' responses could lead to escalation. Also, as noted above, collateral damage in other economies will be significant and could further complicate the trade friction. Our new Global Scenario Service report highlights how a full-blown trade war would lead to much greater economic impacts on China, the US and globally (Chart 2). While this remains a risk, for now we consider it a modest one.

Chart 2



A full-blown trade war, with the US imposing 25% on all imports from China, 10% on imports from South Korea and Taiwan, full retaliation, as well as the US leaving NAFTA, would cause major economic damage globally.

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