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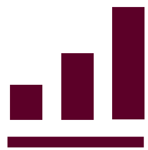

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PERCSPECTIVES ON POLICY

WHITHER THE TRADE WAR WITH CHINA?

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Two significant events took place recently in the ongoing trade dispute between the U.S. and China. First, a previously scheduled 25% punitive tariff on $16 billion of Chinese goods went into effect on August 23. Second, on the same day, the U.S. and China held their first trade talks since the previous round concluded unsuccessfully in June. The new tariff was in addition to the 25% tariff on $34 billion of Chinese goods that took effect on July 6. Further, the Trump administration has threatened another 25% tariff on $200 billion of Chinese goods by the end of September. The new trade talks were the first after more than two months of tough talk and tit-for-tat tariff measures, suggesting that both sides still have hope for a "peaceful" resolution of their dispute.

We appear to be at a crossroads, where the U.S.-China trade dispute may soon either escalate into a full-fledged trade war, or reach a resolution acceptable to both sides. Here, we provide some economic rationales for a positive outlook on the future of U.S.-China trade relations. In a nutshell, during the past couple of months, the U.S. trade policy circle has largely reached a consensus that attempting to reduce the trade deficit with China through punitive tariffs is bad policy. Instead, the discourse has shifted toward focusing on the twin goals of reducing tariff and non-tariff barriers on both sides, and on halting intellectual property theft and forced technology transfers on the Chinese side.

Before continuing, we note that voluntary technology transfers between companies can be part of any mutually beneficial agreement, and are not a barrier to trade. Government actions to force technology transfers are quite a different animal and are a barrier to trade. Such a barrier puts U.S. firms at a disadvantage when bargaining with Chinese firms and may lead to reductions in the comparative advantage U.S. firms typically enjoy in technology.

Achieving these goals would make the bilateral U.S.–China trade relationship freer. At the same time, Chinese policy makers appear to recognize the painful consequences occurring even at this early stage of a trade war with the U.S. and to better appreciate how much of China's economy depends on the health of this important bilateral trade relationship. These currently painful consequences indirectly highlight the enormous benefits China has received from the favorable trade relations with the U.S. that began in the early 1980s.

The Trump administration's trade policy actions earlier this year – including tariffs on steel and aluminum and the 25% tariff on Chinese goods – were no doubt motivated by unhappiness with the annual trade deficit that had increased to $566 billion in 2017, of which the trade deficit with China was $375 billion. However, it is far from clear that increased tariffs on imports to the U.S. will reduce the trade deficit. One impact of tariffs is clear: tariffs are taxes on imported goods, and American consumers and firms will ultimately foot the bill for most of the tariffs imposed on those goods. As with any tax, tariffs are not simply transfers from American consumers and firms to Uncle Sam; they inflate prices, reduce consumption and production, and generate efficiency losses.

Moreover, trade deficits by themselves are not necessarily good or bad; they can be partially mitigated by adjustments in the exchange rate. The trade deficit of a country exerts downward pressure on the value of domestic currency relative to foreign currencies, which causes more exports and less imports and reduces the trade deficit. Persistent trade deficits may be indicative of a country saving too little compared to the demand for investment. A nation's saving includes both private saving and government saving. In the U.S., government saving has been negative due to budget deficits - deficits that are high by historical standards as a percent of GDP,

especially when the nation is near full employment. A U.S. administration serious about reducing the trade deficit should act to reduce its budget deficit.

Another aspect of trade deficits is the strong investment demand in the U.S. Investment demand is high and national saving is low, so many foreign firms and investors come here to invest, indicative of our attractive investment environment associated with relatively strong economic growth and a stable business environment.

The above understanding of the causes of trade deficits, and the harms tariffs can do to the economy, has shifted the focus in the U.S. trade policy circle from trade deficits to reducing barriers to trade. For example, after a period of dispute between the U.S. and the European Union, largely caused by some newly-imposed U.S. tariffs and tough talk from President Trump, the two sides agreed in July to work toward zero tariffs, zero non-tariff barriers, and zero subsidies on non-auto industrial goods.

The stated U.S. goals in the trade talks with China have recently shifted to reducing or even eliminating tariff and non-tariff barriers on both sides and halting intellectual property theft and forced technology transfers on the Chinese side. This new set of goals promises benefits for both sides and is perhaps more feasible to achieve compared to prior insistence on reducing trade deficits. It also has the benefit of being more defensible on economic grounds.

There have been a few significant developments in both economies since the first words about a trade war were uttered in March. Taken together, these seem to show that China is more vulnerable than the U.S. to a deteriorating trade relationship between the two countries.

The U.S. economy grew at an annualized 3.1% rate for the first half of 2018, riding high on the waves of the biggest tax reform in decades. This is very good news for the U.S. economy, as policy analysts had earlier this year cast doubt on the likelihood of even a 3% growth rate for GDP. In addition, the already-impressive GDP growth rate for the first half of the year continues to rise - the economy grew at 4.2% during the second quarter.

On the equity and currency fronts, which perhaps reflect confidence as much as underlying fundamentals, both the S&P 500 and Nasdaq closed at record highs on August 24, just one day after the U.S. and China mutually subjected each other to an additional $16 billion of goods to the 25% tariff. Moreover, the U.S. Dollar Index – a measure of the value of the U.S. dollar relative to a basket of foreign currencies – has been generally rising since early April, from below 90.0 to above 95.0, implying that foreign investment in the U.S. remains strong.

In sharp contrast to the good news emanating from the U.S., China's GDP growth has recently decreased to the lowest in decades, accompanied by its equity dropping and currency, the yuan, under pressure. Indeed, the yuan has dropped 9% against the U.S. dollar between mid-April and mid-August. This drop in the value of the yuan reflects foreign investors' concern about the business environment in China and is linked to the ongoing trade dispute. Many foreign firms in China have signaled that a perpetual 25% tariff on Chinese exports to the U.S. would wipe out their comparative production advantage and would lead to their relocation outside of China.

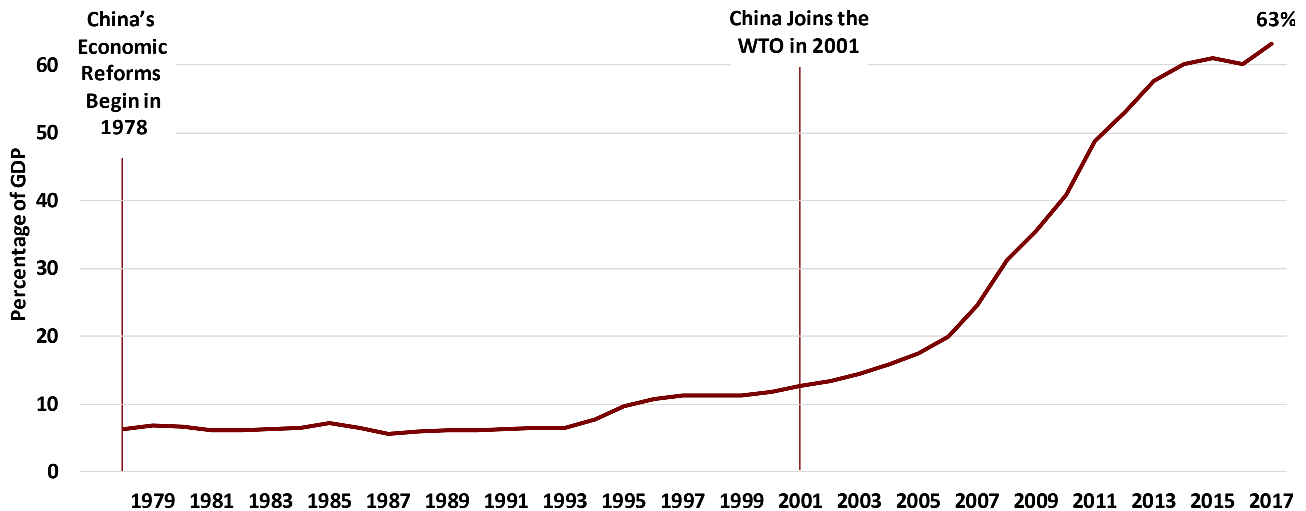
These recent developments in both economies provide early evidence that China seems more dependent on the bilateral trade relationship than is the U.S. We have no doubt that the U.S. economy would grow even faster, and the U.S. equity and currency would perform even better, without the ongoing trade war with China. But to date the asymmetric consequences of the trade war on the two economies suggest that China is the more vulnerable party.

Before the consequences of the initial stage of the trade war played out, many observers downplayed the effects of the U.S.-China trade war on the Chinese economy. In 2017, China's exports to the U.S. were worth $505 billion, or 4.1% of China's GDP. By comparison, U.S. exports to China were $130 billion or 0.7% of its GDP. Based on these facts and the assumption that in any realistic trade war scenario the trade between these two economies would not be completely eliminated and China's exports would find buyers elsewhere, some estimates suggested that the dent of the trade war on China's economic growth would be well below one percentage point.

Recent events suggest otherwise. The initial estimates of the risk to China may be understated. Based on the observed effects of the trade war – still in its early stage and in relatively small scale – on China's economic growth, the damage to China from a prolonged, full-scale trade war with the U.S. would likely be well above 1% of GDP.

By the time China had joined the World Trade

FIGURE 1. CHINA'S GDP AS A PERCENT OF U.S. GDP



Source: From World Bank, World Bank national accounts data, and OECD national accounts data files.

Organization (WTO) in 2001 the composition of its exports had shifted from mainly manufactured goods based on natural resources or low level technology to a greater share of high-tech exports. This increase in high-tech exports indicates the critical role of trade with technologically advanced partners, primarily Japan and the U.S., in advancing the country's own technological capabilities.

The vital economic interest China has in a normal trade relationship with the U.S. can be best seen from a historical perspective. The figure depicts China's GDP as a percentage of U.S. GDP from 1978-2017.

The "economic reform and opening up" policies adopted in 1978 mark the start of the transformation of the Chinese economy from a centrally-planned to a market-oriented economy, and from a closed to an open economy. This economic reform, including the opening of the economy to trade, has transformed the Chinese economy from one that was a mere 6% the size of the U.S. economy in 1978 to one that is 63% the size of the U.S. economy in 2017.

The favorable trade environment facilitated by the goodwill from the U.S. played a critical role in this transformation. For every year between 1980 and 2000, China was unilaterally granted "most favored nation" trade status by the U.S., a status which gave China all of the trade advantages enjoyed by any other nation, despite occasional disputes over human rights and other political/diplomatic issues. During this period, China's economy grew relative to the US economy from about 7% in 1980 to about 12% in 2000.

In 2000, the U.S. made China's favorable trade treatment permanent, giving the green light for China to join the WTO in 2001. As the figure shows, China's economy grew rapidly relative to the US economy after joining the WTO, particularly for the years 2006 to 2014. It is important that, prior to China joining the WTO, the "most favored nation" status essentially allowed China to impose tariffs on its imports from the U.S. that were three times as high as the tariffs the U.S. imposed on its imports from China.

Forty years after the landmark 1978 reform, China is at another crossroad today. China's long-time trade benefactor, the U.S., wants to change the status quo in the bilateral trade relation. The U.S. has demanded reducing or even eliminating tariff and non-tariff barriers to trade on both sides and halting intellectual property theft and forced technology transfers on the Chinese side. The U.S. has threatened to escalate the ongoing trade war if these demands are not met.

Given that these U.S. demands are consistent with the WTO rules and the fact that China has benefited tremendously from a normalized trade relationship with the U.S., it would seem to be in China's rational self-interest to take this opportunity to make another great transformation, one from being a major beneficiary of the international trading system to one of being an equal contributor to that system.

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