MINERVA

INVESTMENT MANAGEMENT SOCIETY

SUMMARY OF US-CHINA TRADE WAR

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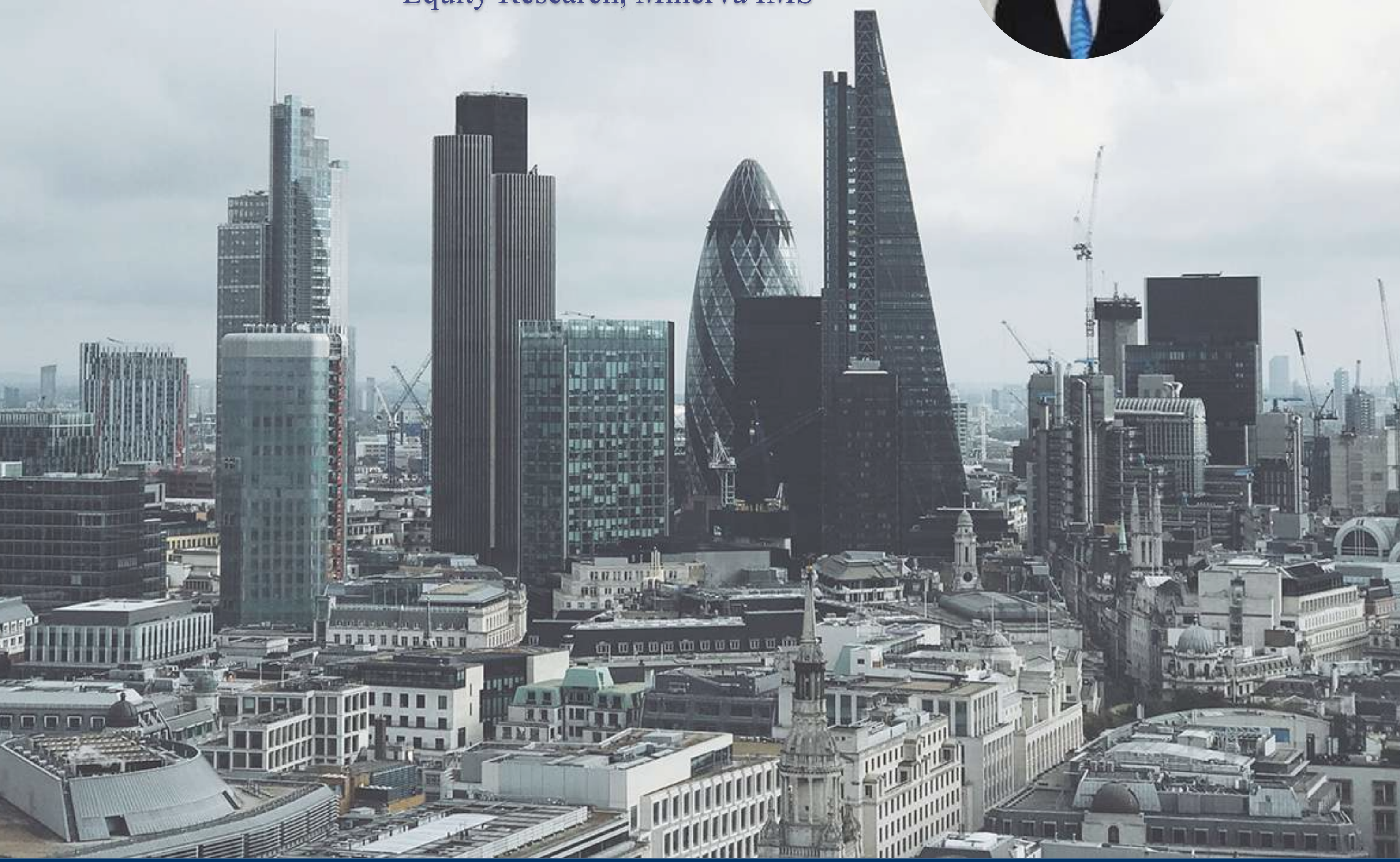

PREMISE

The USA and China have had a good relationship as trading partners ever since the US helped China enter the WTO in 2001. However, President Trump has always been an advocate, since his first public appearances in the 1980s, of imposing tariffs in order to reduce the US trade deficit, especially with China. The White House also claimed China was engaging in unfair trade practices, accusing China of intellectual property theft with an estimated annual cost to the US between $225 billion and $600 billion. While running for President, Trump pledged to correct the trade deficit with China, which in 2016 was $346.9 billion, and since January 2018 he has been trying to do just that. This has resulted in the ongoing trade war with China.

THE TIMELINE

Through January and March 2018, Mr. Trump started imposing tariffs on washing machines (20% tariff), solar panels (30% tariff), aluminum (10% tariff) and steel (25% tariff) imports; although the latter two were not specifically targeted at China. Prior to this, the US imported about 8% of solar panels from China, 3% of its steel. The Trump administration justified this first round of tariffs by saying that these imported products "are a substantial cause of serious injury to domestic manufacturers" and a cause for national security concerns. Moreover, the cheaper Chinese imports of solar panels had caused their price to drop by more than 30% since 2016, making US producers not able to compete with Chinese suppliers. For the steel and aluminum, Trump argued that a global oversupply driven by China threatened American producers. China quickly retaliated with a similarly sized tariff ($2.4 billion vs the US's $2.8 billion) on various American products including agricultural goods.

The reactions to this move were quite negative, both by firms and markets. With the threat of a trade war with China, higher prices on domestic goods, and future uncertainty in the markets, the Dow Jones closed down 420 points on March 1st. The US administration also had to intervene to subsidize American farmers for up to $12 billion for the lost sales due to foreign retaliations and uncertainties in the market. However, the steel and aluminum tariffs seemed to have a mixed effect, as in the first six months 8700 new jobs were created in the steel industry but the price of steel products increased by about 9%. Seeing these effects, Trump further increased the tariffs on $450 million worth of steel and aluminum imports.

In April 2018 China retaliated by announcing tariffs on 128 American products, ranging from 15% to 25%. After that the situation seemed to de-escalate, with Vice Premier of the PRC Liu He meeting with Trump to discuss a "significant increase" in China's purchase of American goods.

However, these ideas were later scrapped as the White House announced in June that it would impose a 25% tariff on $34 billion of Chinese exports on July 6th, and a further tariff on $16 billion to come into effect on August 23rd. Trump also said that if China retaliated, a further 10% tariff would be imposed on $200 billion worth of Chinese goods. China responded with its own tariff, also on $50 billion worth of goods, on June 19th; and when the US introduced its additional tariff China did too, taxing $60 billion American goods at 10% in September.

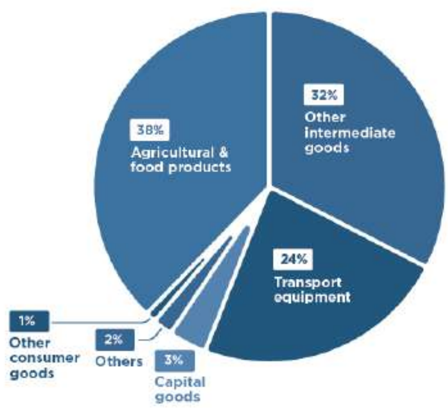

Figure 1 – US exports on China's June 19th retaliation list
Source: PIIE

China's came into effect on September 18th, the US's on September 24th 2018. In this round of tariffs, the most targeted goods by the US were intermediate and consumer goods, such as computer and auto parts, but also furniture, clothing and consumer electronics. Meanwhile, China mainly targeted agricultural imports, vehicles and mineral fuels.

On May 10th 2019 the US increased the 10% tariff on the $200 billion to 25%, as he previously stated that if no agreement would take place regarding IP protection, the tariffs would be raised. China weakened its currency by about 2% in order to prepare for the upcoming tariffs, bringing the CNY to the lowest level since 2008. The yuan went above the seven per dollar level.

Figure 2 – USD to CNY
Source: Bloomberg

Later in June 2019, China responded with its own round of tariffs at 25% on $60 billion worth of American goods. Then in August the White House proposed a further 10% tariff on $300 billion worth of Chinese imports, which would cover all the remaining Chinese imports. $112 billion of these went into effect on September 1st, and the rest were to come into effect on December 15th. A potential increase from 25% to 30% on the other $250 billion worth of Chinese goods could take place on October 1st. China retaliated with an additional tariff on $75 billion worth of goods on September 1st, and a potential further increase on December 15th.

Following this major escalation, later in September, things started to calm down. China announced that it would exclude $2 billion worth of goods from its 2018 retaliatory tariffs, and Trump postponed the October 1st tariffs to October 15th and later cancelled them. He announced that the US and China had reached a tentative agreement for the "first phase" of a trade deal; and China agreed to buy up to $50 billion of agricultural products, one of the sectors that had suffered the most on the American side from this trade war. Both countries cancelled the December round of tariffs.

On January 15th 2020 the Phase One deal was finally signed. It touched on subjects like IP rights, technology transfer and exchange rate matters. Under this deal China also agreed to buy an additional $200 billion worth of US exports, but most tariffs remain in effect. China granted a tariff exemption of 696 US goods. Overall, tariffs are still more than 6 times higher than before the trade war; and all of this has left the US underprepared for the COVID-19 emergency, as purchases of medical products decreased by 17% from the beginning of the trade war due to a 25% tariff. In May 2020, the two countries agreed to strengthen co-operation over macroeconomic and public health matters; it would seem that the pandemic has not halted progress and de-escalation is likely to continue.

CONSIDERATIONS ON THE EFFECTS OF THE POLICIES

The tariffs did not seem to have much of an effect on the trade balance with China in 2018, perhaps because of the late implementation of the tariffs, whereas in 2019 there was a significant reduction in the trade deficit, by about 18% from the previous year. If this was Trump's sole goal then the whole operation could be considered a success; however this does not capture the whole picture. Many complained and felt the effects of increases in steel prices and their derivative products; as well as the many consumer goods that arrived from China. Moreover, as pointed out before, Trump did have to subsidize farmers for the loss they incurred due to the tariff on soybeans (one of the main American agricultural exports to China) and other agricultural products.

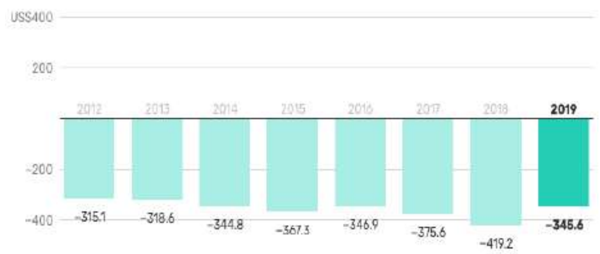

Figure 3 – US balance of trade with China
Source: US Census Bureau

It is also part of China's economic policy to be favorable to exports, much more so than the US, as seen by their partly pegged exchange rate and fairly cheap skilled labor. China's exchange rate is partially pegged to the US dollar and a basket of other currencies, and is allowed to fluctuate within 1% of either side of the reference rate. This allows the CNY to be quite stable, and since China devalues the currency, Chinese exports are cheap for other countries. In the 1990s the exchange rate was about 8.3 CNY per USD, but it was later allowed to appreciate until the pre-trade war period where the exchange rate was floating around 6.5. To stop it from appreciating too much, China has to keep buying foreign currencies, especially USD, and selling the Yuan. Over the years this has allowed China to accumulate foreign exchange reserves of around $3 trillion.

Some analysts say that China may not be able to hold up its part of the promise to the US; buying the additional $200 billion worth of American goods. Trump has threatened to terminate the Phase One deal if China is indeed unable to make this purchase. It seems unlikely however that Trump would be willing to add more strain to the economy as it is already in a precarious situation. Tensions have also risen since the signing of the phase one deal due to the coronavirus pandemic having a serious toll on both economies, and Trump accusing China of failing to prevent the pandemic has not helped either.
Nevertheless, Trump is keeping his re-election campaign in mind, so he needs to be especially careful to not undo the progress he has made. Hence, he is focusing on the internal situation in the US, as limiting the number of deaths and a strong economy are crucial for his re-election.
The COVID-19 pandemic has created unforeseen problems in the US-China relation, but his does not seem to have stopped the de-escalation, although it is not progressing as quickly as some may have wished.