How Serious is the Trade War?

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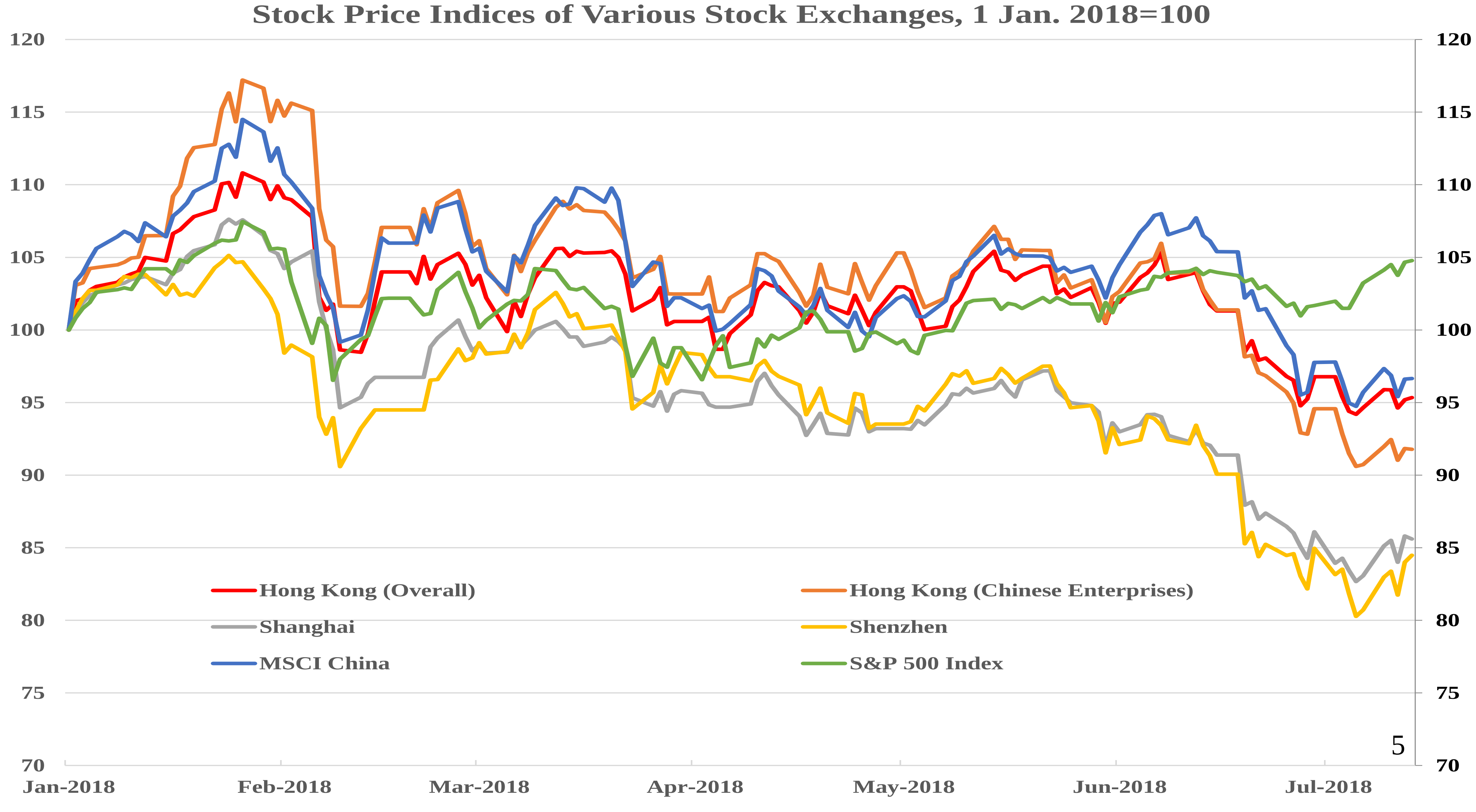
Introduction

- While the immediate direct impacts on the Chinese economy are certainly negative, they are small in real terms, affecting less than 0.5 percent of GDP, and quite manageable. There is no need to panic.
- But it is not likely to end soon, at least not before the U.S. mid-term elections.
- However, the trade war itself may do damage to the longer-term relations between China and the U.S.
- It is a reflection of the underlying China-U.S. competition for economic and technological dominance and the rise of populism, isolationism and protectionism almost everywhere in the world.

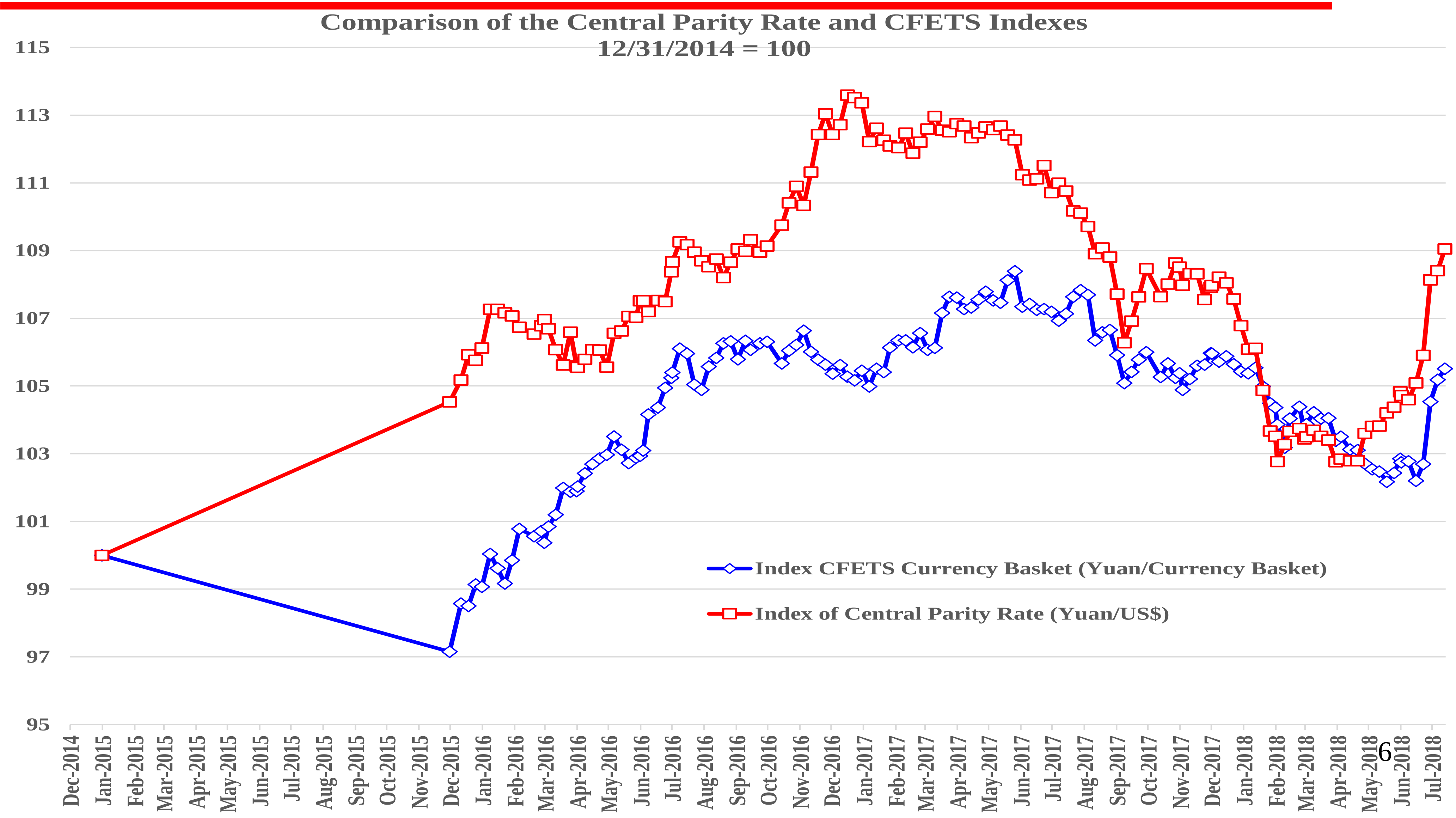
Immediate Impacts

- The stock markets—psychological factor predominates; most Mainland investors are short-term traders.
- The Renminbi exchange rate—the focus should be on the central parity rate (onshore rate) rather than the offshore rate.
- It is in China’s interests to maintain a relatively stable Renminbi exchange rate. It is the only way for the internationalisation of the Renminbi to become a reality.

The Chinese, Hong Kong and U.S. Stock Market Indexes, Year to Date



The Renminbi Central Parity Exchange Rate and the CFETS Index



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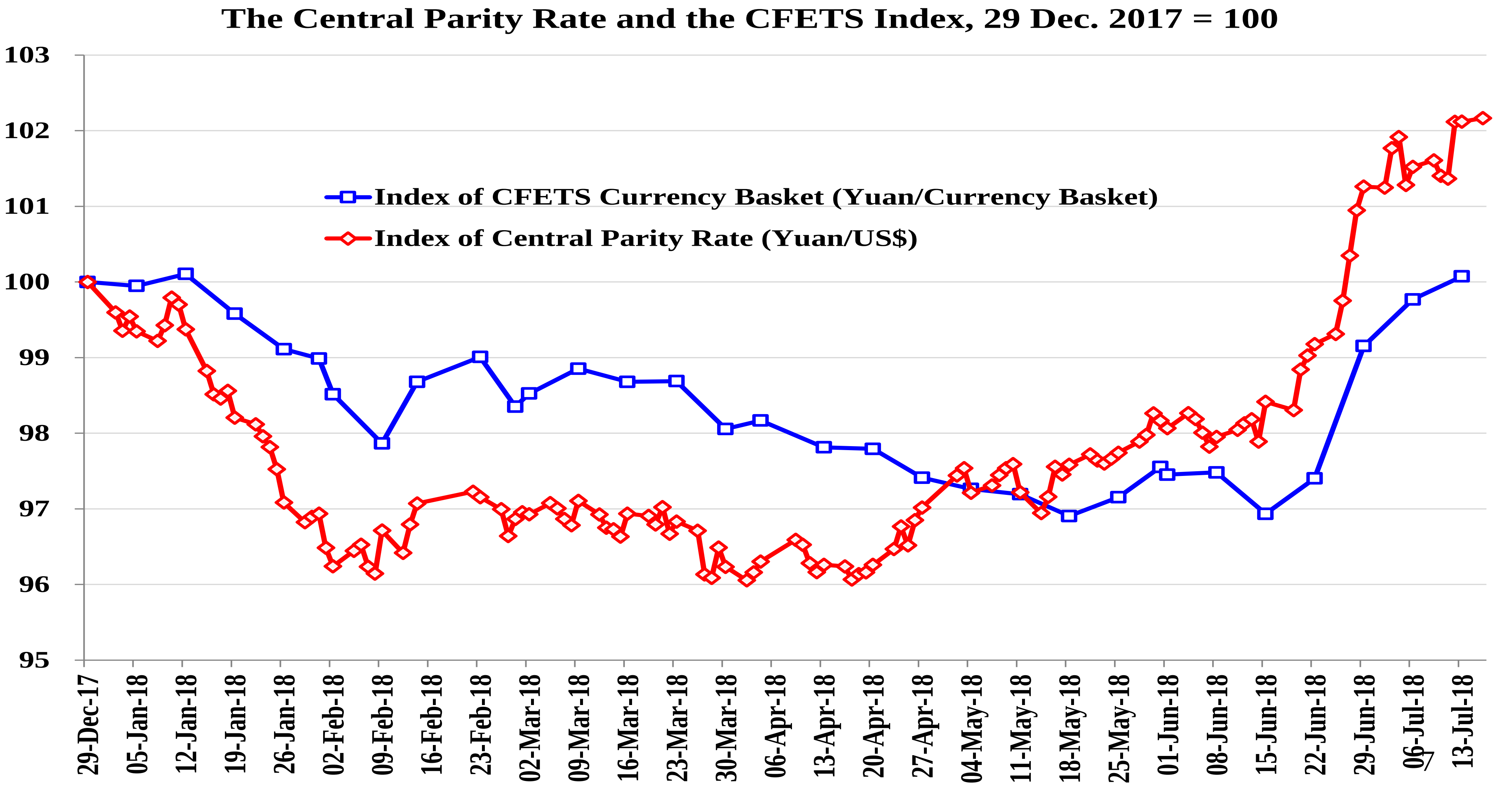
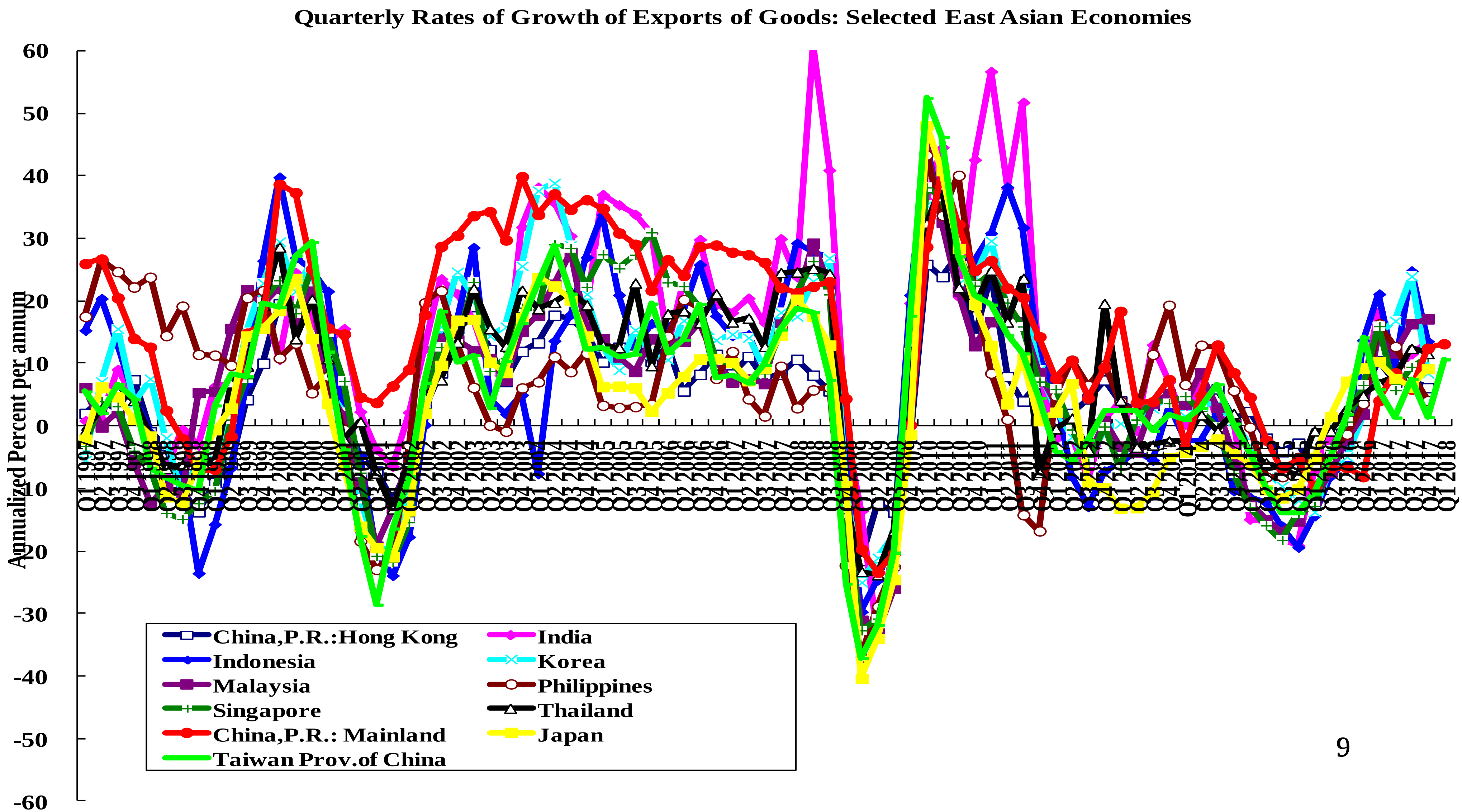


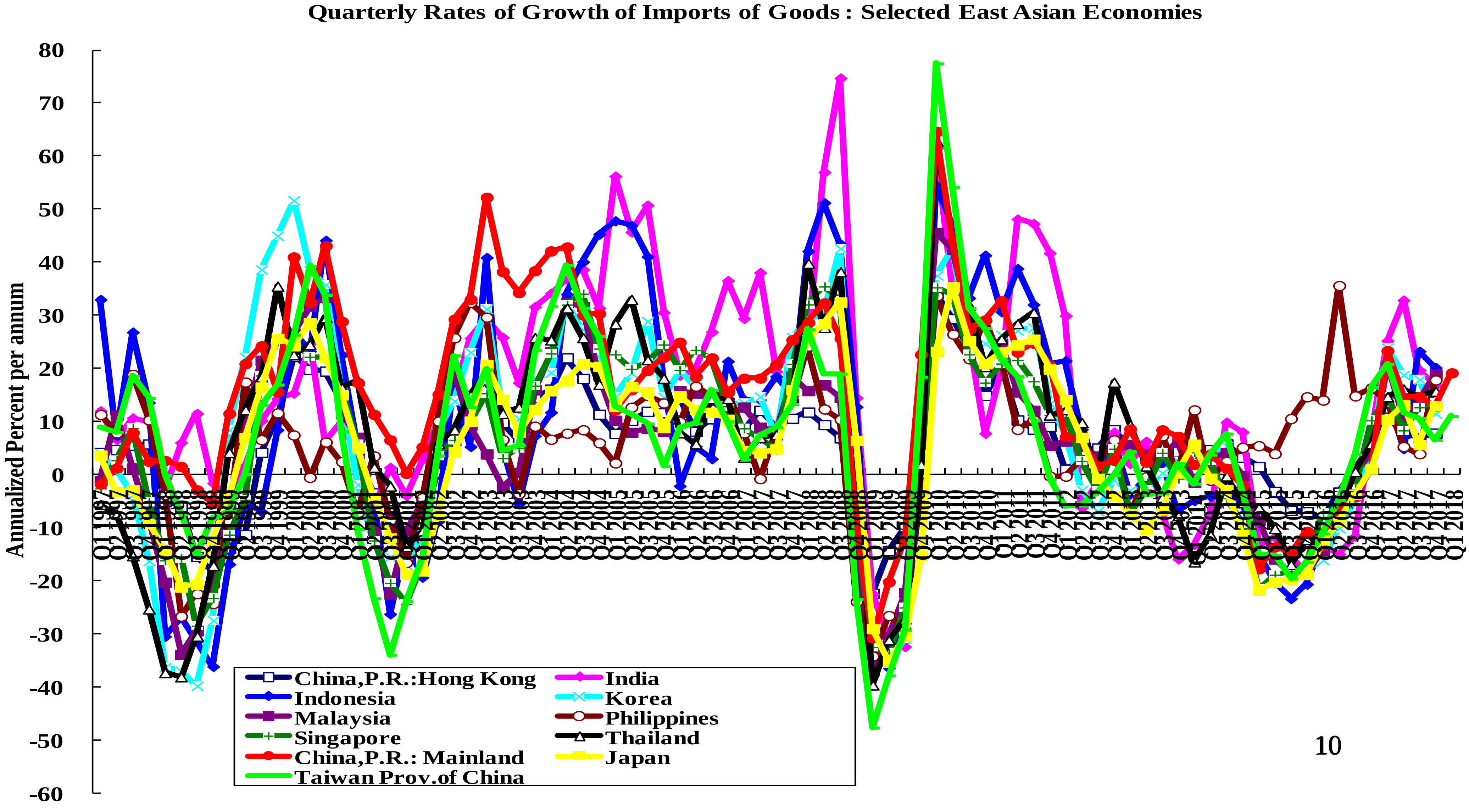
Real Impacts

- China, as a large continental economy with a huge domestic market, has a low export dependence.
- Chinese exports of goods and services as a percent of GDP is low (18.1% for goods alone in 2017).
- Chinese exports of goods and services to the U.S. is also low (3.4% for goods alone as a percent of Chinese GDP in 2017).
- Growth of exports of goods to the world and to the U.S. has slowed considerably over the past decade.
- New U.S. tariffs on US$250 billion of Chinese exports to the U.S. (approximately equal to US$227 (250 x 10/11) billion, f.o.b.) or half of Chinese exports of goods to the U.S.
- Thus, Chinese exports of goods amounting to 1.7% of Chinese GDP will be affected.

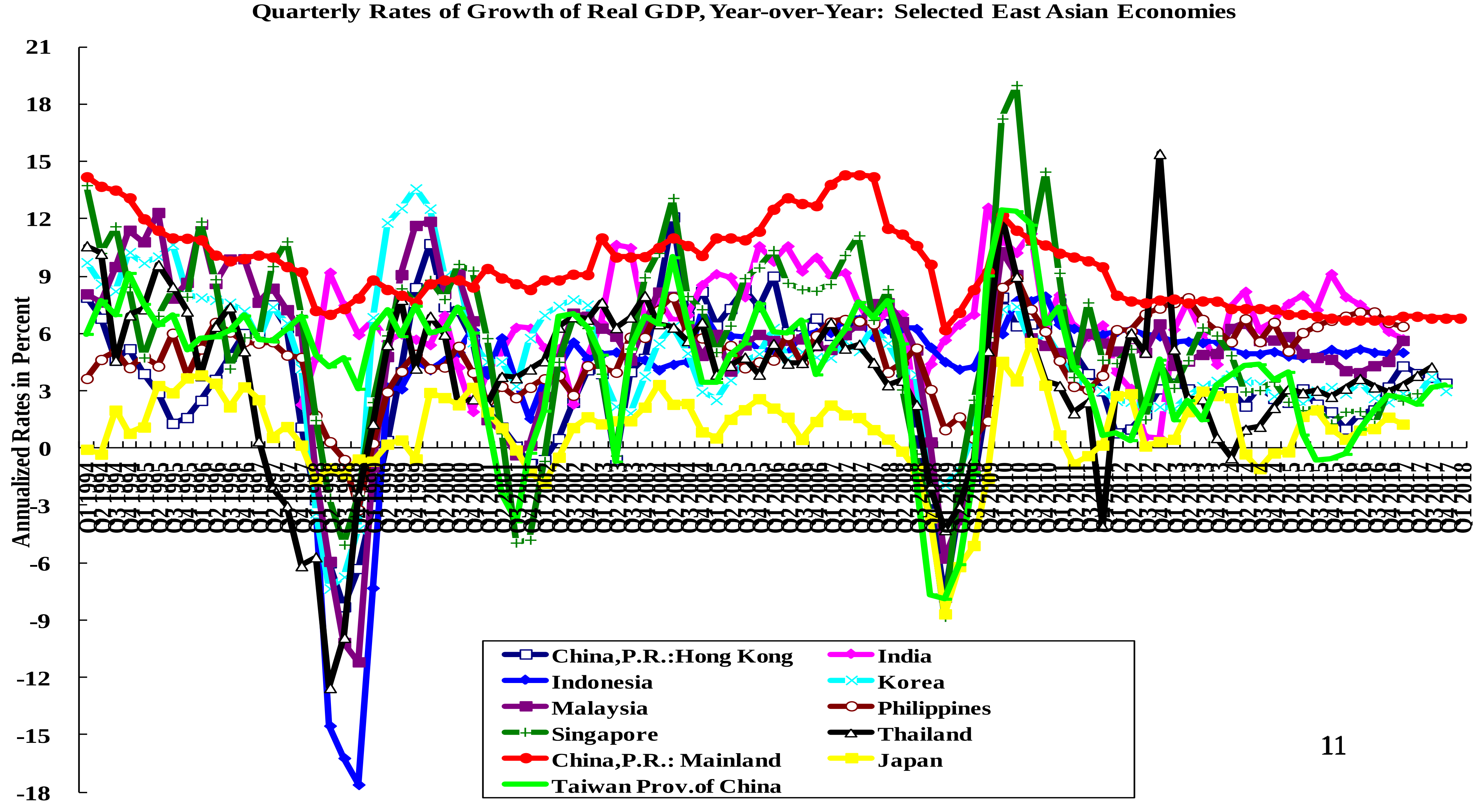
Quarterly Rates of Growth of Exports of Goods: Selected Asian Economies



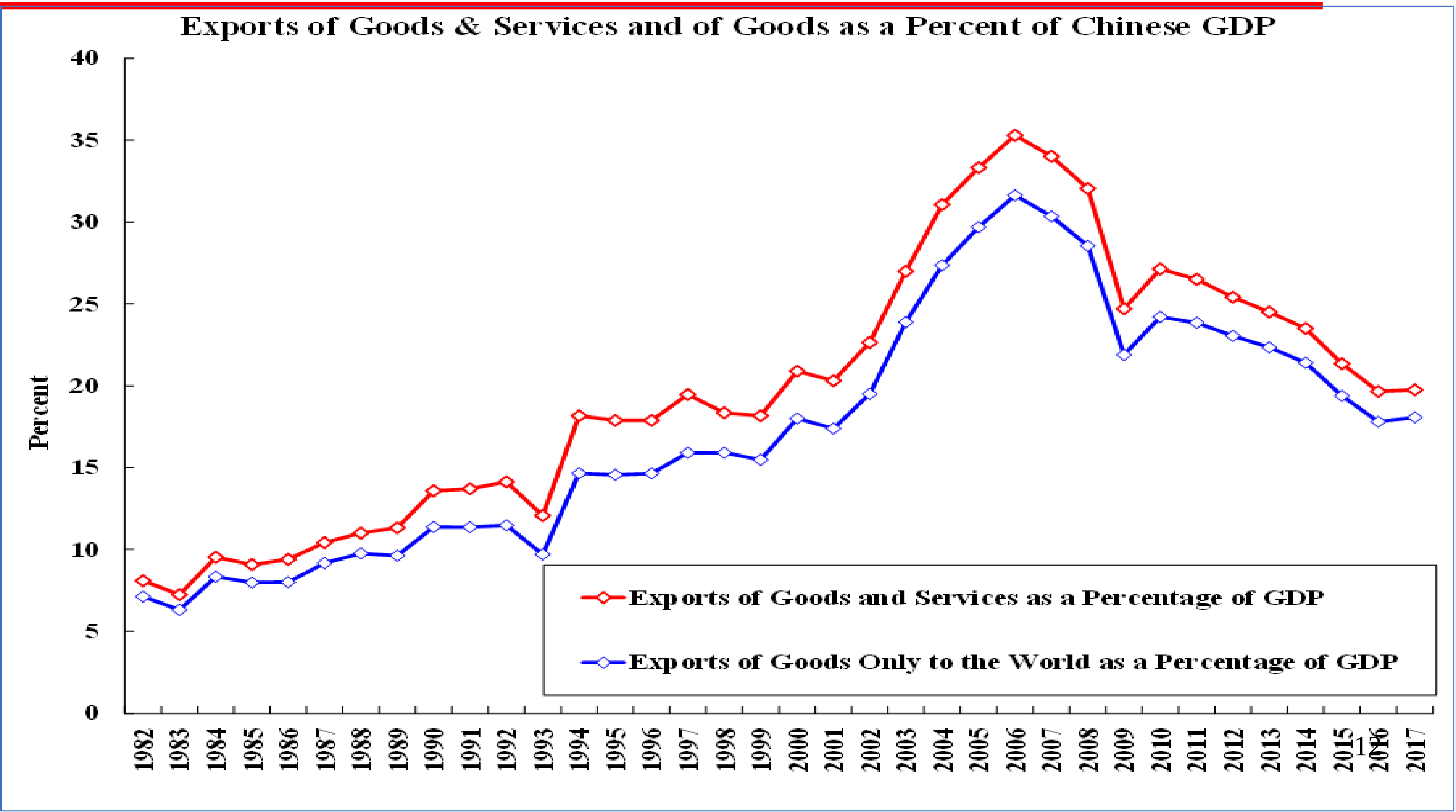
Quarterly Rates of Growth of Imports of Goods: Selected Asian Economies



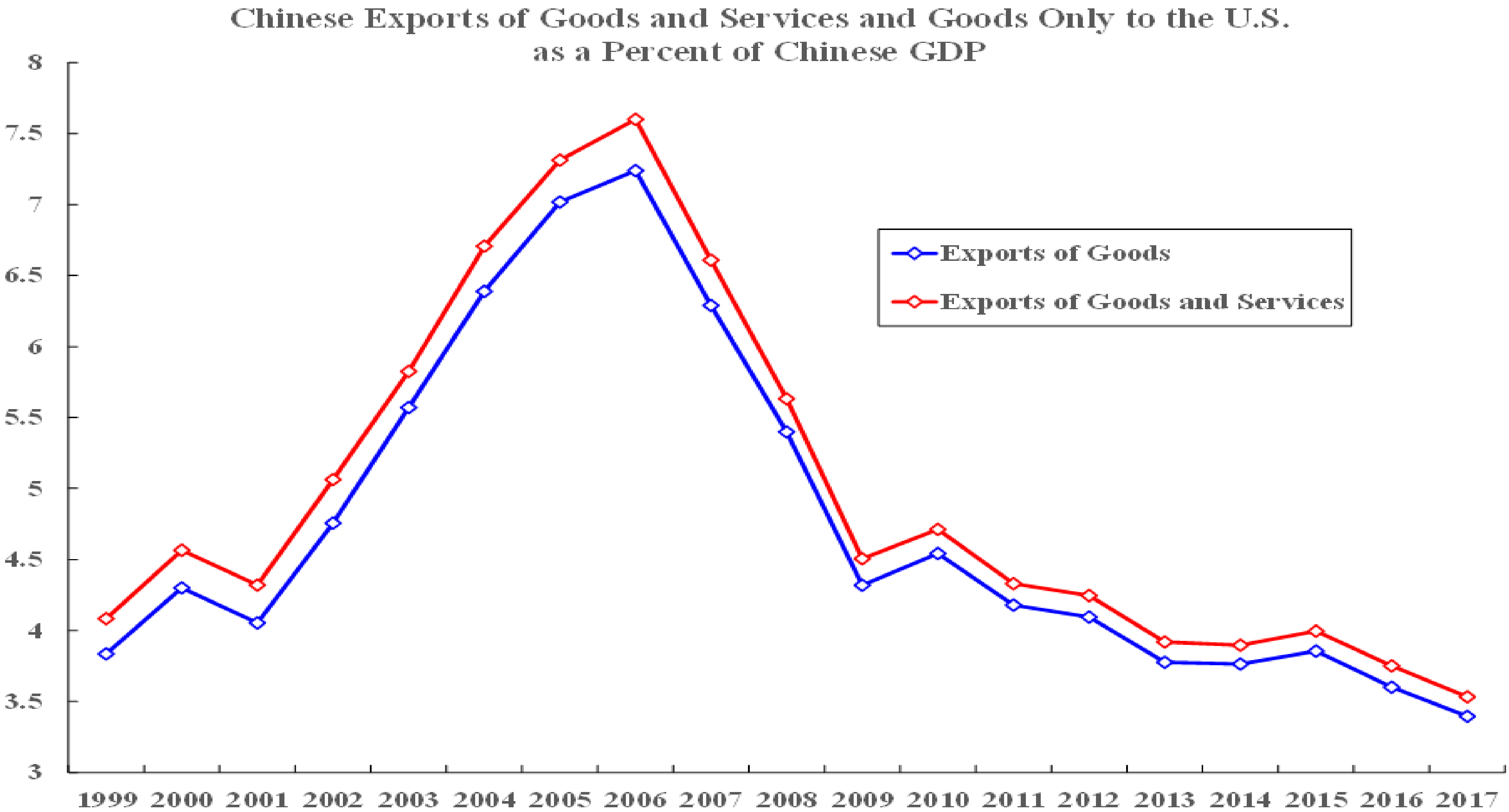
Quarterly Rates of Growth of Real GDP, Year-on-Year: Selected Asian Economies



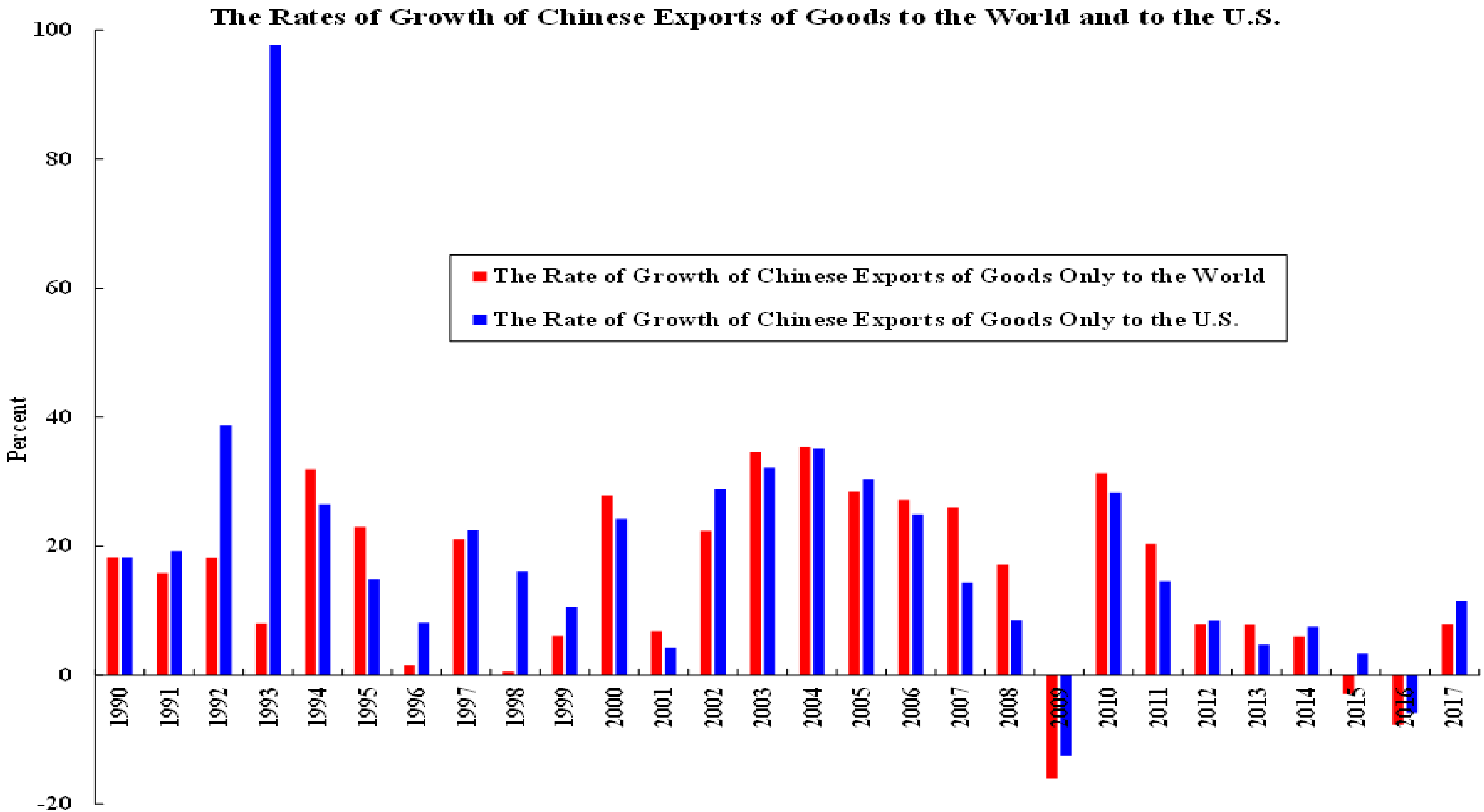
Chinese Exports of Goods and Services and Goods Only as a Percent of Chinese GDP



Chinese Exports of Goods and Services to the U.S. as a Percent of Chinese GDP



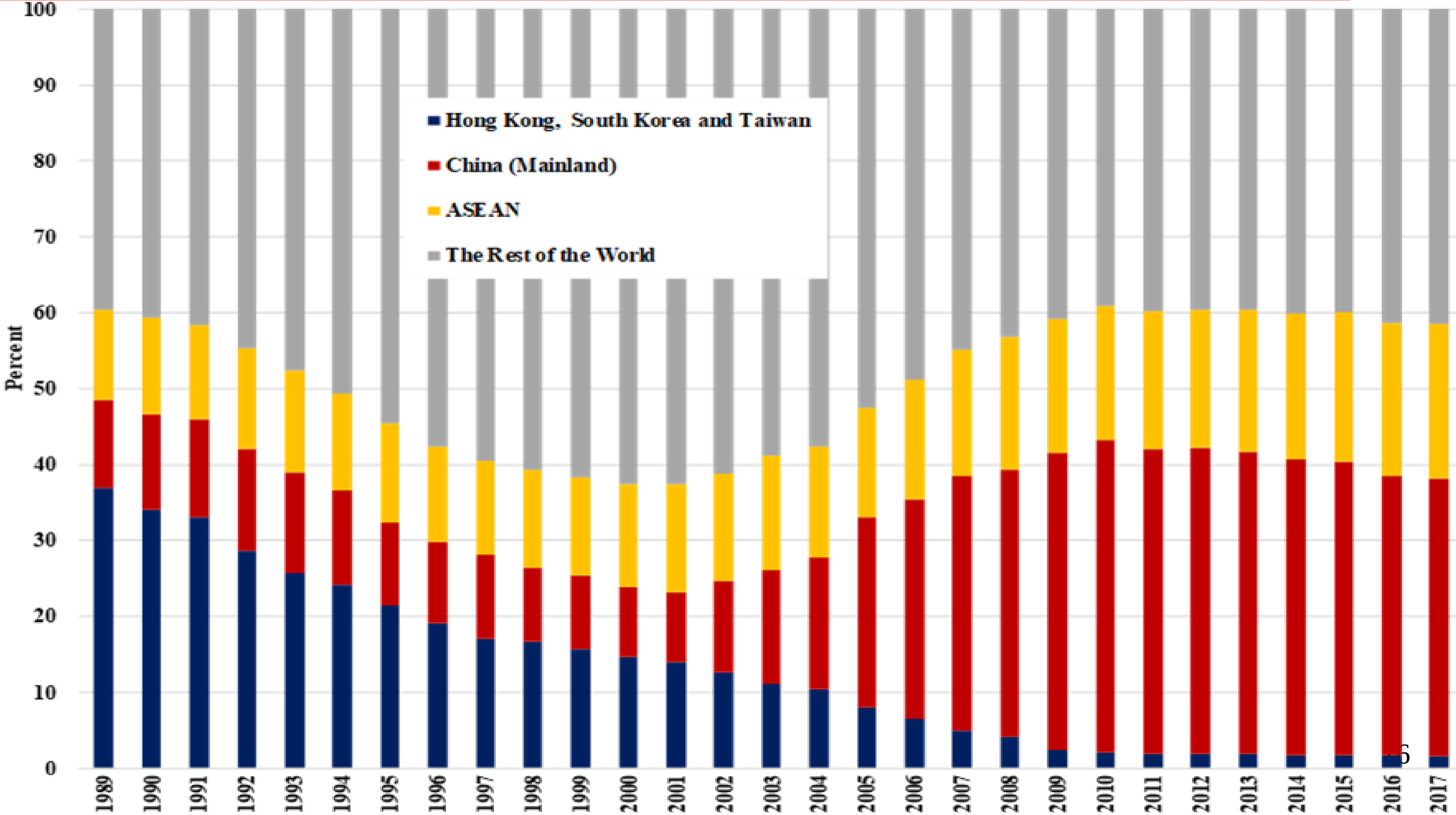
The Annual Rates of Growth of Chinese Exports of Goods to the World and to the U.S.



Real Impacts

- The direct domestic value-added content of Chinese exports to the U.S. is less than 25%. Thus, the maximum loss in Chinese GDP, assuming that half of the exports to the U.S. is completely halted, in the first instance may be estimated at 0.43% (1.7% x 0.25), a tolerable level, especially for an economy growing at an average annual real rate of 6.5 percent and with a per capita GDP of US$9,137, which is way over the subsistence level.
- With the indirect, that is, second-, third-, fourth- and higher-round effects of the reduction of exports kicking in, the total domestic value-added affected increases to 66 percent. This implies ultimately a total loss in Chinese GDP of 1.12% (1.7% x 0.66). A reduction of 1.1% from an expected annual growth rate of 6.5% leaves 5.4%, still a very respectable rate compared to the average of 3.9% for the world in 2018 projected by the International Monetary Fund.
- Moreover, even with the reduction of exports of goods amounting to 1.7% of GDP, the Chinese trade in goods and services will still remain in balance.
- Thus, there should be no pressure for the Renminbi to devalue.

The Distribution of U.S. Apparel Imports by Countries of Origin



Chinese Trade Surplus in Goods and Services as a Percent of GDP

Longer-Term Developments

- One of the principal causes of the current trade war between China and the United States is actually not trade itself, but the potential competition between China and the U.S. for economic and technological dominance. This competition, whether explicit or implicit, and whether intentional or not, is not going away soon. It did not begin with President Donald Trump. Both the "pivot to Asia" and the "Trans-Pacific Partnership" were initiated by President Barack Obama. It will not go away after President Trump leaves office.
- However, competition can potentially lead to constructive and positive as well as destructive and negative outcomes. For example, the competition on creating the fastest super-computer has already resulted in both countries producing better and faster super-computers. The champion in 2018 is the IBM Summit, a U.S. super-computer, which beat the Sunway TaihuLight, the champion in 2016 and 2017, a Chinese super-computer that was built entirely with indigenously designed chips.

Longer-Term Developments

- In terms of aggregate GDP, China went from only 20 percent of the U.S. GDP in 2000 to two-thirds in 2017. It is only a matter of time that the Chinese GDP will catch up with the U.S. GDP, probably in the 2030s. However, in terms of GDP per capita, China is still way behind, with US$9,137 compared to almost US$60,000 for the U.S. in 2017. My own projections suggest that it will probably take until the end of the Twenty-First Century before Chinese GDP per capita approaches the U.S. level.
- In terms of the number of nuclear-armed warheads, I believe the U.S. is way ahead by at least an order of magnitude in total and even more in per capita terms. This is not a competition that China should wish to join. However, a race to find an effective cure for cancer or Alzheimer's disease would be worthwhile for both countries and in fact for the entire humankind.

Longer-Term Developments

- U.S. grievances include intellectual property rights protection, forced transfer of technology and cyber-theft. (Note that none of these grievances have much to do with trade or tariffs.)
- Intellectual property right protection has been vastly improved in China. It should get even better over time.
- Forced transfer of technology is fast becoming a moot issue because of recent Chinese liberalisation measures. Tesla has set up a wholly-owned subsidiary in Shanghai to manufacture electric cars and General Motors has indicated that it does not plan to buy out its Chinese joint-venture partner.
- Commercial cyber-thefts should be vigourously prosecuted, with the collaboration of both governments.
- If Huawei is perceived as a national security risk by the U.S., will the Apple i-phone be considered a national security risk by China eventually?

Longer-Term Developments

- The rise of populist, isolationist and protectionist sentiments in the U.S. and elsewhere in the world will also have significant impacts on international trade and investment (and migration). This is also not created by President Donald Trump.
- Economic globalisation and innovation creates winners and losers in every country. The market will not compensate the losers. It is up to the government of each country to take care of its losers.
- The eventual solution has to be some form of redistribution within each country—taxing the winners to compensate the losers so that everyone wins.

Promoting Mutual Economic Interdependence

- The problem with a trade war is that there are no real winners—both countries lose because the feasible choices open to each of them are reduced.
- Exporters in both countries will be hurt because of the reduction in their exports, and importers in both countries will see their businesses decline. And the consumers and producers who rely on imported goods and inputs in both countries will have to pay higher prices.
- A better way to narrow the U.S. trade deficit with China is for the U.S. to increase its exports of goods and services to China, especially newly created goods and services, for example, by producing and exporting meat (beef, pork and poultry) instead of feed grains (corn and soybeans) to China, and exporting the newly developed liquefied natural gas from Alaska and shale oil from the continental U.S.

Promoting Mutual Economic Interdependence

- Another fast-growing component of U.S. exports of services to China that has huge potential for expansion is education and tourism. The expenditures of Chinese students (currently totalling 350,000) and tourists in the U.S. have been rising rapidly. Moreover, their presence in the U.S. can enhance the understanding between the Chinese and American people and improve long-term ties. U.S. students and tourists in China can also play the same role.
- A further area of significant potential win-win collaboration is the deployment of the excess Chinese savings in the U.S. for the financing of the renovation and upgrading of U.S. basic infrastructure as well as the augmentation of the equity capital of U.S. corporations.

Promoting Mutual Economic Interdependence

- It is difficult to assess which country has benefitted more. China has been able to lift 600 million of its citizens out of poverty, initially through the vast expansion of export-oriented jobs.
- The U.S. consumers have benefitted from two decades of low prices for their consumer goods. Had U.S. imports from China stayed at 1994 levels, the U.S. Consumer Price Index would have been 27 percent higher in 2017, or approximately 1 percentage point higher annually.
- Additional benefits for the U.S. include the profits of U.S. corporations earned by their operations within China, such as General Motors, Walmart, as well as the sales of Apple i-phones, which since they are finally assembled within China, are not considered U.S. exports to China.

Concluding Remarks

- The competition between China and the U.S., whether friendly or unfriendly, can be assumed to be an ongoing and long-term one. To reduce the probability of an armed conflict between China and the U.S. down the road, both countries should promote greater mutual economic interdependence, to make their relations win-win, so that a war between them would be unthinkable, just as another war between France and Germany is not possible today.
- China and the rest of the world, except possibly the U.S., will probably continue to uphold the current multilateral trading system under the World Trade Organisation (WTO). After all, they have all benefitted and will continue to benefit from it.
- However, China-U.S. relations, and in fact, China's relations with the rest of the world, in particular with the European Union and Russia, must be carefully managed going forward.