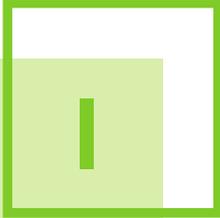




# Investment Note



26 March 2018

## New US-China tariffs point to need for bilateral negotiations

On 22 March, US President Donald Trump announced tariffs on up to US\$60 billion of Chinese imports. He also called for tighter restrictions on acquisitions and technology transfers between the two countries. Geoff Lewis, Senior Asia Strategist, believes this round of proposed tariffs, similar to the last, is not the opening salvo in a trade war. Rather, it is an invitation to enter serious bilateral negotiations to resolve structural economic imbalances in the US-China trade relationship.

The Trump administration announced plans last Thursday to impose tariffs on up to US \$60 billion in annual imports from China, raising fears of a trade war between the world's two largest economies and sending global stocks sharply lower. The Dow Jones Industrial Average index plummeted by roughly 3% on the day of the announcement. Asian bourses followed through: The Nikkei 225 index declined by 4.5%, followed by the Shanghai Composite index (-3.4%) and the KOSPI index (-3.2%)<sup>1</sup>.

### US ups the stakes on US-China trade

Last Thursday has proved to many investors how serious the Trump administration is about foreign trade and the need to reduce US trade deficit. The earlier tariffs on solar panels, washing machines, steel, and aluminium, which only applied to potential trade flows of around US\$9 billion in total.<sup>2</sup> The tariffs announced yesterday are far more substantial in nature. The latest threat from President Trump is for a tariff of 25% on US\$60 billion of imports together with much tighter restrictions on the acquisition of US companies by Chinese companies as well as technology transfers.<sup>1</sup> But we still do not believe that President Trump wishes to engage in a “trade war” with China, or that he really thinks that such a war could be easily won.

What happens next? First, the US Trade Representative will within 15 days publish a list of which electronics and other products are going to be subject to the new tariff. There then follows a period of 30 days for public consultation. This target list focuses on high tech imports of items such as aviation, high speed rail, new energy vehicles, and other high-tech products with tariff rates of up to 25%.<sup>1</sup> The sum quoted of US\$60 billion is over 10% of Chinese exports to the US but is still less than 3% of China's global exports, which amounted to US\$2.2 trillion last year.

The China Economics team at HSBC estimates that due to these higher tariffs, China's nominal GDP could be reduced in the first instance by around 0.1 to 0.2%.<sup>3</sup> This is non-zero, but hardly constitutes a major shock or recession threat to an economy whose growth rate is close to 6.5%. CLSA's Chief

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<sup>1</sup> Financial Times, 23 March 2018; Bloomberg, 26 March 2018.

<sup>2</sup> Strategas' estimates, “Strategas Policy Outlook”, 13 March 2018.

<sup>3</sup> See HSBC Global Research, “US-China Trade Relations V,” 23 March 2018.

Economist, Eric Fishwick, notes that if the average price elasticity for the products in question is equal to 0.5, then a 25% tariff would reduce Chinese exports to the US by US\$6 billion per annum. Against total exports of US\$2.3 trillion this is tiny, around ¼ of 1.0%. So, really there is nothing much to get too worried about, so far.

## **The main goal is bilateral negotiations, not a trade war**

Regarding US-China bilateral trade, President Trump is declaring that business as usual is no longer an option. Some things must change.

We think that last Thursday's message to China from President Trump is nothing more than a repeat of the one he gave on 15 March. It is an invitation to China to sit down and start serious negotiations on some of the key trade issues that the US believes require some adjustment on China's part. That said, we would stress that no amount of selective trade measures can eliminate the large US trade imbalance, of which China accounts for the lion's share. That is because the US trade deficit is essentially driven more by more by macro-economic factors, such as the very low US national savings rate, than it is by relative trade price.

In our view, we think President Trump is within his rights to seek to negotiate over certain Chinese trade practices. China is a much different economy than it was 10 years ago; trade practices that were acceptable then are no longer acceptable as the second-largest economy. This, we think, is the real trade agenda for President Trump, and the endgame will be an "Omnibus Trade Deal" that is acceptable to both sides and which sets the framework for bilateral US-China trade relations for the next decade. We take some comfort in the fact that the Trump Administration has included a consultation period before any of the planned tariffs come into force. That gives China time to respond. Even if China now implements counter tariffs of its own on US exports, we expect only a measured, moderate response. Indeed, China has said it plans a reciprocal tariff measure on just US\$3 billion of US products, with a 25% tariff on US pork and 15% tariff on US steel pipes, fruit and wine.

China may protest vigorously in public. But looking at the big picture, this is probably not the time for President Xi to counter attack on trade. President Xi needs to focus on his new cabinet and the economic and financial reforms announced at the National People's Congress that concluded on 20 March. While the Chinese economy overall may be less dependent on exports to sustain growth than, say, ten years ago, many jobs still depend on export-oriented manufacturers in the coastal factory belt. These firms typically enjoy thin margins and have only just emerged from a tough couple of years. It would be quite risky to expose them to trade pressures now when financial conditions in China are becoming tighter due to ongoing financial deleveraging.

## **Investors should remain vigilant**

Further bouts of market volatility driven by trade protection concerns are to be expected, as financial markets simply hate uncertainty and that is all US-China trade relations have to offer for now. Even if the impact of the latest import tariffs on the US and Chinese economies are quite minor, foreign trade will be an additional source of volatility for markets in coming months. While markets were surprised, tariffs on steel and aluminium have been under discussion for some months. With China as the world's largest steel producer, the move is consistent with President Trump's determination to address the US-China trade relationship head on. Global trade watchers continue watching closely as countries position themselves among the uncertainty. Protectionist tendencies are being felt throughout the global economy and the expected path of continued trade liberalisation is now much less certain.

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