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US-China Trade War of 2018 and Its Consequences

The trade war between the United States and China has become one of the main events in the global economy this year. What could be its consequences for the US and China, and how might it affect other countries – for example, Russia?

Chronology of the trade war

Donald Trump started the war, raising import tariffs on solar panels in January 2018, of which the main supplier is China. In response, on April 2nd, China raised import duties on 128 commodities originating from the United States. On July 6th, the US increased tariffs on Chinese goods by 25 pp., imports worth $34 billion. China responded symmetrically. In August, the United States increased the tariffs on another $16 billion of imported goods from China, to which a symmetrical response again followed. In September, the United States again applied higher tariffs for $200 billion of Chinese exports, and China for $60 billion of US exports. At each stage of the conflict escalation, China appealed to the WTO with complaints about the actions of the United States, pointing to the inconsistency of their actions with the obligations and principles of the WTO. There were several meetings of official representatives from the United States and China - without any significant results.

What are the main reasons for this unprecedented escalation?

Imbalance and intellectual property

The economies of the US and China today are by far the largest in the world, and the trade turnover between the two countries is one of the most important. A remarkable feature of these trade flows over last decades is their imbalance. In 2017, the United States imported $526 billion worth of goods from China, while China's imports from the United States amounted to $154 billion. Part of the this imbalance is offset by trade in services, but it is not enough to even it out: in the same the year the United States delivered $57 billion worth of services to China while importing services of $17 billion from China.

Experts have different views on this imbalance. On the one hand, there is a perception that it is a source of world economy vulnerability, a source of potential crisis. Therefore, it is necessary to reduce the trade deficit. Another point of view is that this imbalance merely reflects the fact that the US economy and its assets are very attractive to investors from all over the world, including Chinese - and that, in turn, requires that the surplus of capital flows biased to US side, was compensated by the corresponding deficit of trade in goods and services. One such investor is the Chinese state itself, which for many years has been pursuing a policy of exchange rate undervaluation in order to promote foreign trade. It led to enormous accumulation of foreign exchange reserves and as of January 2018, China held $1.17 trillion of US bonds and was the largest creditor of US government.

US President Donald Trump referred to this trade imbalance as one of the reasons for the outbreak of this trade war against China. Trump aims at reducing the deficit by $100 billion from the current $375 billion. The unilateral increase in import tariffs applied to Chinese goods was the first action of the US administration in this direction.

The second, no less important, formal reason for the trade war is the inadequate protection of intellectual property rights in China. China's production of counterfeit products, the lack of adequate practices and laws to protect foreign technologies from illegal dissemination in the country, is not news to anyone. And although the almost two decades since China's WTO accession have meant a largely modernized legal framework in this regard, a number of important provisions are still inconsistent with international practices, and the implementation of existing intellectual property rights leaves much to be desired. Established in 2012, The Commission on the Theft of American Intellectual Property identifies China as the most malicious violator of US rights. The exact damage is not known, but the commission assessment of the losses to the American economy due to the forced transfer of technology to Chinese partners – which is an unspoken condition of foreign manufacturers access to the Chinese market – industrial espionage, contradictions in legislation, requirements for the storage of sensitive data in China are in the range from $225 to $600 billion per year (Office of US Trade Representative, 2018).

While both the trade deficit and the intellectual property rights issue were recognized for many years, it was in 2018 that Trump started acting on them. Therefore, in order to discuss the potential impact of the conflict between the world's largest economies on themselves and other economies, such as Russia, it is important to understand what drives the actions undertaken by Trump’s administration.

Populism

Trump won the elections in 2016 with a minimum margin against the Democratic rival. To provide support for his decisions and to increase the chances of being reelected for the next term in 2020, it is crucial to maximize the pool of his supporters. Trade policy measures aimed at import substitution are very effective populist policies in any country. One of the first steps made by the US toward trade war was the increase in import tariffs on steel and aluminum - for all countries. Metallurgy and coal industries are among the most organized and strong lobbyists in any country. The European Union as an economic organization started with the European Coal and Steel Association. By aligning interests with these sectors much can be achieved in relation to trade liberalization, and vice versa - by increasing the level of protectionism, a significant popularity increase can be among voters whose incomes depend on the success of companies in these industries.

Deterrence

China works hard raising the technological level of its economy. In recent years the Chinese government and Communist party launched a number of ambitious programs aimed at achieving a technological breakthrough, lessening the dependence on imported technologies by substituting them with ones produced by domestic innovation centers. These programs specify the priority sectors, in which state subsidies are provided for the acquisition of foreign technologies by Chinese companies and their adaptation. One of the common arguments was that the United States believes that powerful state support for technology sectors in China, along with the existing problems in protecting intellectual property rights, increases the risks and potential losses of American companies.

However, while these concerns seem reasonable at first, they should not be taken at the face value.

China's ability to push out American companies in the high-tech sector on the world market seems rather limited. So far, China has only succeeded in increasing its share in the middle and low technology segments. Instead, in recent years, China is rapidly increasing its defense spending, which in 2017, for the first time, reached a level of 1 trillion yuan (about $150 billion). China's defense spending is the second highest in the world after the United States. Moreover, it’s growing very fast. While in 2005 the Chinese nominal defense expenses were only 10% of American expenses, in 2018 they are already around 40%. The dominance of state enterprises in the defense industry in China implies that the real purchasing value of these expenditures is quite comparable. New and existing Chinese industrial policy programs target military and dual-use industries among others. Therefore whilst addressing the intellectual property rights problem in China now, Trump’s administration also aims at preserving US leadership position in the military sector, which finds widespread support in Trump's main voter groups among Republicans.

Obsolete weapon

Historically, trade wars implied tariff escalations to protect domestic industries from foreign competition. Today, the Trump administration behaves in a similar manner. However, the circumstances now are fundamentally different from those in the first half of 20th century and earlier. Firms not only trade in final goods, but more and more they trade in intermediate products and within firms themselves (Baldwin, 2012). The distribution of the production process to many companies across different countries of the world leads to two important effects, which were not observed in previous trade wars.

First, it is the effect of the escalation of tariff protection in the framework of the value chains. The import tariff is applied to the gross value of the product crossing the customs border. However, the exporting firm's contribution to the gross value might be quite small. So the effective level of the tariff will be higher than the nominal level of the tariff, known as a so called amplification effect (World Bank, 2017, page 98). It means that the effective growth of the tariff by 25 percentage points in relation to Chinese imports will significantly exceed 25 % and in some cases can even become prohibitive. So, the tariff warfare will result in significantly greater losses for the sectors involved in the value chains, compared to the sectors less exposed to them. It means that foreign investors and multinational companies in China will suffer bigger losses compared to purely domestic Chinese companies. The Peterson Institute for International Economics made an assessment and confirmed these observations (Lovely and Yang, 2018).

Second, China's participation in international multinational companies most often occurs in the assembly segments, while developed countries' companies contribute at other stages, such as with innovation, design, financial and consulting services, marketing, and after-sales services. Then, the protectionist measures against goods produced in China by multinational companies will hit an American economy, generating losses in the service segments. A similar episode happened, for example, in 2006, when the European Union introduced anti-dumping duties on imported footwear from China and Vietnam, which in turn lead to a decline in the services sector in Europe - imported footwear contained a significant share of the value added created by European designers and distributors (World Bank, 2017). Obviously, we will observe the same consequences in the United States now, since the role of the American services sector in creating and promoting Chinese goods on the American market is significant and according to World Bank estimates in 2011, the contribution of value added generated by foreign services in China's gross exports amounted to about 15% (World Bank, 2017).

Thus, not only the economy of China, but also the US economy itself will suffer from the growth of import tariffs in the USA. The USA is not an exception here - the governments of most countries continue to live in the paradigm of trade policy, which suits the structure of the world trade as at the beginning of the 20th century, while trade has gone far ahead and requires much more elaborate effective regulatory tools than tariffs on imported goods.

Consequences for Russia

The consequences of the US trade war with China for the Russian economy depend on what the main goals of the war are. If the motive is primarily electoral – to secure enough support in 2020, one can expect that the protective measures will be short-lived, and the geographical distribution of investment flows will remain almost intact and that China will remain an important location for global value chains transactions. The trade war will in this case lead to some economic slowdown in the short term. The main effects will be related to the redistribution of income within economies, where protected sectors will benefit on the expense of all other sectors. In these circumstances, Russia would suffer direct losses from the growth of tariffs on their exports to US (now it is predominantly steel and aluminum), but for the economy as a whole, the losses will not be significant, especially relative to the losses Russia bears because of sanctions.

However, if the main reason for the trade war has a long-term perspective, the investors will be forced to adjust the geography of their investment plans and China will face a significant outflow of foreign investments, which will significantly affect Chinese – and global – economic growth. In this case, both for Russia and for the whole world, the indirect effect of the US-Chinese trade conflict will be quite noticeable and it will take years to create new trade links and restore world trade and global value chains.

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Note

A longer version of this brief has been published in Russian by Republic:

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