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China’s retaliation in a longer-term context

Tit-for-tat or tat-for-tit? Third party mediation could help the ‘lose-lose’ process

The latest escalation in the US-China trade war came as a surprise to asset markets and increased risk aversion. Not only will the US and China most likely be affected negatively, but global trade and corporate willingness to invest will probably take another hit. While we believe China will remain focused on its longer-term targets, a pause to reflect with the help of third party mediators could help both countries.

Source: iStock

> “The US is starting to lose China, while China has lost the US already.”
>
> Hu Xijin (China 'Global Times' editor-in-chief)

While earlier trade frictions between the US and China were seen as a tariff tiff, we believe the term ‘trade war’ is now justified following the recent escalation between the two leading economic powers. We also believe, however, that a temporary solution will be found, but the dispute is perhaps a harbinger of the longer-term issues the two competing economic superpowers are likely to face.

A look back at what has happened so far

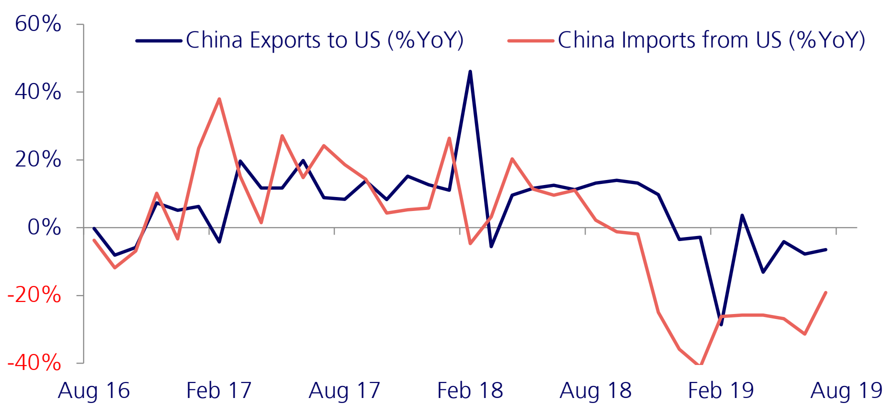
Following years of US criticism about unfair trade practices by China in conjunction with China’s huge trade surplus versus the US and issues about the misuse of intellectual property rights, President Trump put a 25% tariff on Chinese imports worth USD 50bn effective as of July/August last year. Another 10% tariff was imposed on imports worth USD 60bn in September. These tariffs were expanded to 25% in May this year to urge China to increase US imports and to resolve the intellectual property rights issues. In addition, US firms were prohibited from delivering critical components to China’s Huawei. These sanctions were later relaxed. It seemed that frictions were tackled to some extent during the G10 meeting in Osaka, Japan at the end of June when Presidents Trump and Xi discussed trade issues, avoiding further escalations.

Subsequent negotiations were described as ‘constructive’ by both sides. It thus came as a surprise that President Trump increased pressure on China again by raising a new 10% tariff on USD 300bn of Chinese imports that were so far not affected, valid as of September 1. Some of these tariffs were later postponed to December 15, in order to allow for smooth pre-Christmas trade.

China labelled as a currency manipulator

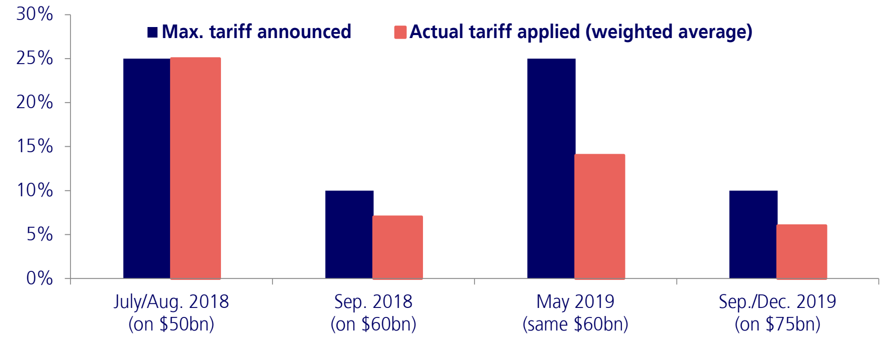
China had retaliated last summer by imposing duties of 25% on USD 50bn worth of US imports and later an additional 5%-25% of tariffs on imports worth USD 60bn. Recently, China loosened its grip on the USDCNY exchange rate, initially from 6.7 to 6.9 and then to a range of 7 to 7.2. We believe this step was taken to relieve pressure on China’s

China's trade with the US has taken a beating



Source: PRC Customs General Administration, Bloomberg

China's effective retaliation tariffs are lower than announced



Source: PRC Ministry of Finance, Capital Economics

exporters and to serve as a warning signal towards the US. The US, which for some time had had China on a watch list together with other nations, immediately labelled China a currency manipulator.

China's latest 'tit-for-tat' retaliation came sooner than expected

Last Friday, China responded to the latest pressure from the US by retaliating once again, a step that was expected, but not so soon. Higher tariffs will be imposed on imports from the US worth USD 75bn, focussing on specific products like autos, oil and soybeans, whereas goods for which China is more dependent on the US, including semiconductors and aircraft, will not be tariffed.

President Trump's response to these retaliation measures came quickly. The US will now impose another five percentage points of tariffs on USD 250bn worth of Chinese imports on October 1, bringing the tariffs to 30%, while the remaining imports that had not yet been tariffed will face a 15% tariff instead of the already announced 10% tariff in two tranches: USD 130bn on September 1 and USD 160bn on December 15. The Office of the US Trade Representative said it will implement the increase in tariffs on October 1 following a notice and comment period including a public hearing, which obviously may give some leeway to backtrack if required. However, the increase from 10% to 15% on the next tranche of tariffs does not require a public comment period.

Risk assets and bond yields initially collapsed

The latest move by President Trump caused a sell-off in global equity markets, the USDCNY spiking, a further fall in bond yields and another inversion of yield curves, intensifying fears of a global recession. We believe Trump's remark during the G7 meeting in Biarritz, France, that he had second thoughts about the escalating trade war could have alleviated fears, but unfortunately it was made clear that he was not thinking about de-escalation, but rather increasing tariffs even further.

News about China asking for further negotiations helped to lift the mood somewhat early this week, with equity markets recovering half of their losses. To us, the latest news was no surprise. Liu He, China's vice premier, only reiterated China's basic stance, which has been communicated frequently, namely that the government wants to solve issues through consultation. We think this should not be interpreted as blinking.

What are China's options going forward?

So far China's response to increasing pressure from the US has been twofold, retaliating and tackling some of the issues on the domestic front that have been at the centre of criticism for years. Not only the US, but other trading partners like the EU and Japan had legitimate reasons to complain, as the Chinese authorities struggled to take decisive action against domestic companies circumventing IPR legislation. We do note that China has taken significant measures to open up its financial sector to foreign competitors, with foreign majority holdings now accepted in many industries.

China likely to increase pressure

It is widely believed that China will increase its pressure on the US ahead of the US presidential elections next year, as history suggests that few Presidents get re-elected if the election is preceded by recession. There may be a hope that any successor would be less aggressive in terms of economic actions against China. However, criticism of Chinese practises when it comes to trade and foreign direct investments is not only raised by the Republicans, but also Democrats.

Placing US firms on an 'Entity List' to impose sanctions, for example by restricting production and sales activities of US firms in China, will hit China's economy and labour market. The latter is a core concern for China's Communist Party, as it wants to secure social stability and the well-being of the labour force particularly ahead of the 100th birthday of the Communist Party in 2021. We also note an asymmetry to the US Entity List against Chinese firms, like in the case of Huawei, as the negative impact on the US economy is negligible overall.

Threats of selling US Treasuries or moving towards a yuan devaluation strategy are likely unrealistic

Some market participants have highlighted China's options to reduce purchases of or even threaten to sell its huge holding of US Treasuries. China is the second biggest foreign holder of Treasuries, slightly behind Japan, and although it has been reducing its Treasury holdings in a very tempered manner since 2013, it has refrained from any drastic selling. We do not believe that it would be a realistic option for China to accelerate its selling, as it would negatively impact the value of its holdings, particularly if President Trump were to invoke the International Emergency Economic powers Act (IEEPA), enabling a taxation or ultimately a freeze of Chinese assets in the US.

We are also not big believers that China will try to significantly weaken the yuan against the US dollar. While China has demonstrated its ability to relieve some pressure on its currency in order to help its economy manage the negative impact of trade frictions, Chinese authorities will need to keep an eye on the impact their actions have on the currencies of other major trading partners, as well as the risk of increasing capital outflows. Accordingly, we believe China will refrain from manipulating its currency.

China's core focus will remain the same: the longer-term development of its economy and international standing

Instead, we believe China will continue to adjust its policies in order to guarantee long-term domestic stability, open up its economy step by step and welcome non-speculative foreign capital inflows. It has to be taken into account that President Xi has changed the constitution, thereby allowing him to be China's president for life. His attention is focussed of achieving the goals of the 'Made in China 2025' initiative, even though China has recently downplaying its ambitions to avoid international criticism. China will try to focus on becoming less dependent on US technology, and speed up its initiatives to become a global leader in the fields of artificial intelligence and clean energy. China will likely drive forward SoE reform, though we believe it will not give up complete control of its state owned companies. On the financial front, China seems likely to increase its role by opening up its financial markets and increasing its representation in global equity and fixed income indices. Finally, China will likely move forward with its global 'Belt & Road Initiative', while making adjustments and taking into account global criticism of its business behaviour in some of the B&R countries.

Employing a game theory approach

The current escalation of the trade war is a typical example of the 'prisoner's dilemma', a game theory concept that can be adopted to the current deadlock. Each country believes it is acting rationally and is waiting for the other side to blink in order to win the game. The only solution, however, will be a collective agreement to escape that spiral. A neutral third party, accepted by both sides, may help as a mediator.

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