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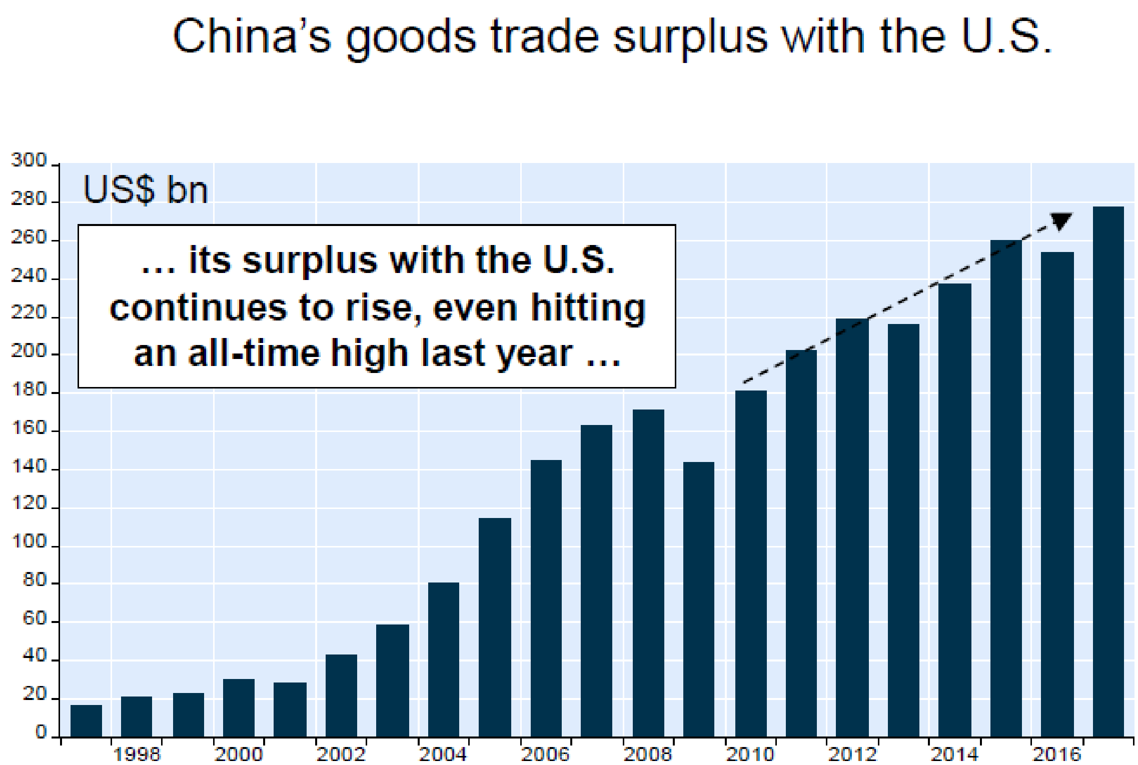
Why heightened trade tensions between China and the United States is the new normal

Introduction

Now that the threat of NAFTA being shredded has abated, attention has turned to the two countries that have always been at the center of the world's trade tensions: China and the United States.



Source: NBF Economic and Strategy (Data via DataStream)

The good news is that, in the short term, both sides will likely step back from a full-blown trade war and sit down at the bargaining table. America's waiting period before officially implementing its most severe tariffs and China's decision to not include such items as soybeans and aircraft in its initial package of counter tariffs indicate a willingness on both sides to negotiate. The United States also doesn't want any major geopolitical headwinds to disrupt its economy and financial markets, particularly before the upcoming mid-term congressional elections.

As for China, it can ill-afford a full-blown trade war at a time when it is trying to implement major structural reforms. It is also dealing with the challenges of rising wages, high debt levels, a rapidly ageing population and significant air/water pollution. Complicating matters further is the widely held view among leading nations that China must change its trade practices.

The bad news is that, whether or not a preliminary trade agreement is struck between China and the United States, heightened trade tensions between the two will be the new normal for the foreseeable future. This is because the stakes are too high. Indeed, even more important than trade deficits is the battle to see which country will control the world's next cutting-edge technologies and emerge as the dominant global power. The chances of China completely backing off from its state-led industrial policy or of Washington ceasing its push for reciprocal trade are very slim at best. This point was recently underscored by President Trump: **"The word that I want to use is reciprocal. If they charge us, we charge them the same thing."**

***This report explores the factors shaping this new trade landscape*.**

How U.S. views on China have evolved since China joined the WTO

In 2001, when China first joined the WTO, U.S. business and government elites generally believed that China's economic rise would ultimately make it more democratic and less protectionist. President Bill remarked in 1999: "I don't think there is any way that anyone who disagrees with that in China can hold back that [liberty], just as eventually the Berlin Wall fell" and "I just think it's inevitable." The sentiment was echoed by President George W. Bush, a year before he became President: "Trade freely with China, and time is on our side."

Nearly 20 years later, the views have changed radically:

- "I don't blame China, I blame the incompetence of past Admins for allowing China to take advantage of the U.S. on trade leading up to a point where the U.S. is losing $100's of billions. How can you blame China for taking advantage of people that had no clue? I would've done same!" (Tweet from Trump, November 2017)
- "I don't agree with President Trump on a whole lot, but today I want to give him a big pat on the back. He is doing the right thing when it comes to China." (*Senate Democrat leader Chuck Schumer in a speech on the Senate floor, (March 2018)*
- "No U.S. auto company is allowed to own even 50% of their own factory in China, but there are five 100% China-owned EV auto companies in the U.S." (Tweet from Tesla founder Elon Musk, March 2018)
- In a 2017 report entitled "A Better Deal for Trade and Jobs", Senate Democrats stated that they supported the creation of "a new Independent Trade Prosecutor, which would begin rapidly challenging unfair trade practices by foreign countries, like China, that have been ignored for far too long, without relying on the years-long World Trade Organization process."
- "U.S. companies wishing to participate in China's market have had to pay an increasingly steep price for admission, surrendering technology and meeting regulatory requirements that favor Chinese firms. Large and lucrative portions of China's economy, including many high-tech sectors and financial services, are closed to foreign firms." (U.S.-China Economic and Security Review Commission, November 2017)

It is important to note, also, that today's trade tensions with China are very different from past commercial disputes the United States has had with many other countries. Historically, the United States has, up to a point, tolerated large trade deficits with Germany, Japan, and Korea because they are close allies and democratic states. In stark contrast, China is viewed as an authoritarian geopolitical rival focused on reducing America's global geopolitical and economic influence.

Examples of unfair Chinese trade practices cited by the United States include:

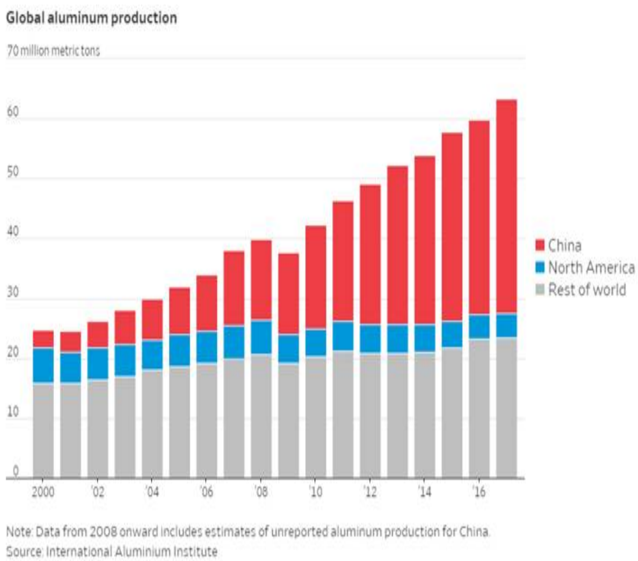
- China imposes a 25% tariff on new cars imported from the United States; the United States imposes a tariff of only 2.5% on cars imported from China.
- U.S. tech firms, like Apple, that want to offer cloud services to Chinese citizens are required to store the data in China on servers operated by a Chinese partner. The United States has no such regulation.
- China's Geely Holding Group purchased Volvo from Ford in 2010, but foreign car companies cannot buy Chinese automakers. They must enter into joint ventures to build cars in China.
- Facebook, Twitter and Google are banned from the Chinese market.
- Most of the main sectors of China's economy—including cars, telecoms, IT and healthcare—are either partially or completely closed to purchases by foreign companies.

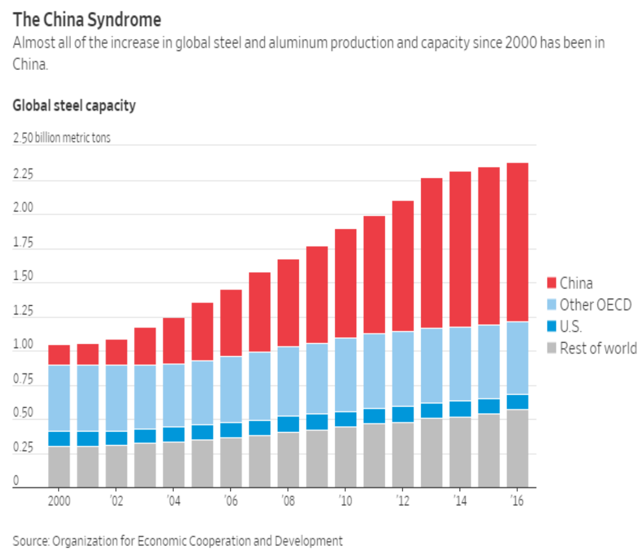
Most democrats and republicans agree that the United States should treat Chinese investment the same way that China treats U.S. investments. China's recent promise to lift many restrictions has been met with skepticism by the Trump

administration. A U.S. government report notes that China has never followed through on its promises (made at least eight times since 2010) to halt its policy of forced technology transfers in exchange for market access.[1]

The real target of the steel and aluminum tariffs

When the Trump administration first announced its tariffs on all steel (25%) and aluminum (10%) imports, the main criticism was that they barely affected China, which most countries blame for the global glut in production. China accounts for only 6% of steel and aluminum imports in the United States, compared with 26% for Canada and 16% for the EU.





Source: "Trump Alienates Allies Needed for a Trade Fight With China," Wall Street Journal, March 7, 2018

The United States felt it had little choice but to initially impose tariffs across the board because China would otherwise circumvent trade restrictions by exporting unfinished steel/aluminum to third countries who would then re-export it to the United States after only minor modifications.

The United States has reportedly offered countries exemptions from these tariffs in return for a combination of the following:

- Implementing measures to prevent countries from becoming a back-door conduit for foreign steel to enter the United States.
- Limiting steel and aluminum exports to the United States to at least 2017 levels.
- Co-operating with the United States against alleged Chinese trade abuses.[2]

To date, the United States has temporarily exempted the European Union, Canada, Mexico, South Korea, Australia, Argentina and Brazil from the tariffs until May 1. These countries have reportedly agreed to keep their U.S. sales at about 2017 levels (S. Korea agreed to even lower levels) and to not re-export cheap steel/aluminum from China and other countries to the United States. For example, the EU recently re-imposed duties on Chinese exports of pipes and tubes and Canada granted its Border Services Agency extra powers to head off a possible flood of cheap foreign steel and aluminum from countries trying to avoid duties by selling their products to a third country not subject to the tariffs.

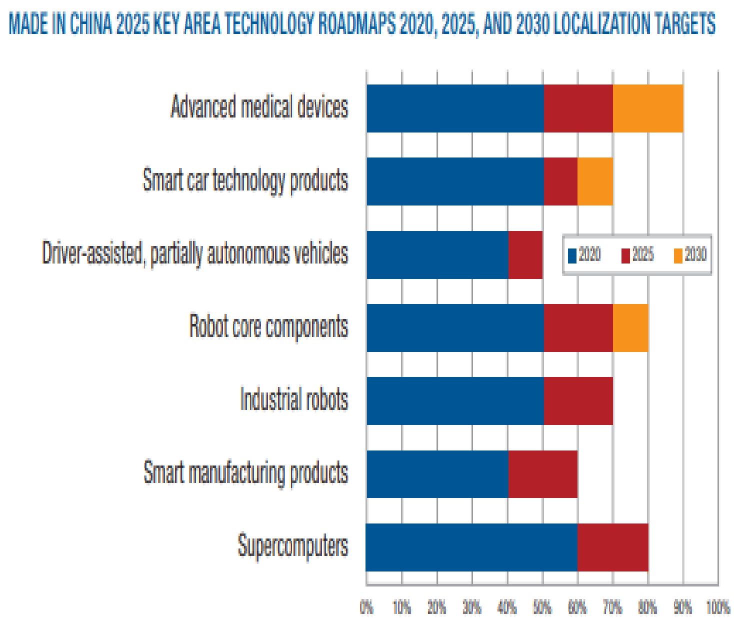
China-U.S. tensions over IP theft and market access

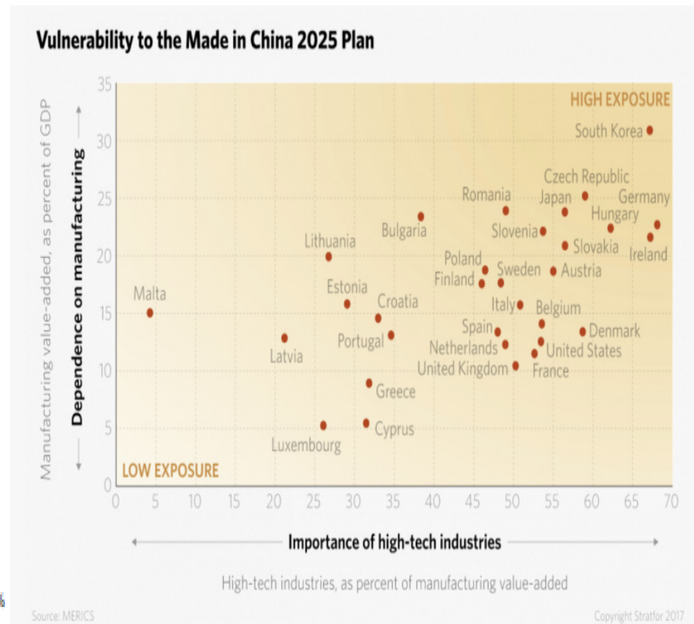
The Trump administration has accused China of pressuring American companies to transfer technology to Chinese companies in exchange for access to the Chinese market. It also claims Chinese theft of U.S. technology is rampant. This investigation was

[1] "Trump's early trade gains could come at future cost," Washington Post, March 27, 2018
[2] "U.S. Offers Trade Relief for Help in Pressuring China, Source Says," Bloomberg, March 19, 2018

undertaken under the Trade Act of 1974, which grants the President the authority to impose tariffs without congressional approval.

The intensified scrutiny came shortly after China unveiled a plan called "Made in China 2025", which aims for China to become dominant in 10 advanced industries by the middle of the next decade. Many of these sectors represent areas currently dominated by American and Western firms. China would particularly like to dominate manufacturing of semiconductors and integrated circuit boards. It imported $227.6 billion of these goods in 2016.[3] **Dominating this sector, however, would require purchasing foreign companies in possession of valuable intellectual property—something that has become much more difficult to do politically.**





Sources: U.S.-China Economic and Security Review Commission, 2017 and "The Trump Administration Reaches for a Trade Sledgehammer," Stratfor, August 2017

Chinese companies may soon find it even harder to make U.S. acquisitions

Lawmakers from both parties in Washington introduced a bill late last year to increase the powers of the Committee on Foreign Investment in the United States (Cfius) to block more types of deals. This bill would for the first time give the committee broad jurisdiction over major outbound investments made by U.S. companies. Cfius was originally created to vet inbound foreign investment for potential national security threats.

CFIUS and the Trump administration have already blocked numerous deals involving Chinese companies in the past year or two, including:

- The attempted $1.3-billion purchase of Lattice Semiconductor, a U.S. chip manufacturer, by Canyon Bridge Capital Partners, which the United States claimed was backed by Chinese state-owned enterprises.
- The attempted purchase of MoneyGram, a money-transfer service provider, by Ant Financial, a sister company of the Alibaba Group, the Chinese e-commerce giant.
- The attempted purchase of Xcerra, a provider of equipment for testing computer chips and circuit boards, by Sino IC Fund, a Chinese state-backed fund.

[3] "The Trump Administration Reaches for a Trade Sledgehammer," Stratfor, August 2017

Killed or Abandoned Under Trump

Committee on Foreign Investments in the U.S. steps up opposition to takeovers from abroad

Target	Would-be acquirer	Country	When killed	Deal size
Qualcomm	Broadcom	Singapore	Mar 2018	$117 billion
Xcerra	Hubei Xinyan Equity Investment	China	Feb 2018	$580 million
MoneyGram	Ant Financial Services Group	China	Jan 2018	$1.2 billion
Cowen	China Energy Company Limited	China	Nov 2017	$100 million
Aleris	Zhongwang USA	China	Nov 2017	$1.1 billion
HERE	NavInfo	China	Sep 2017	$330 million
Lattice Semiconductor	Canyon Bridge	China	Sep 2017	$1.3 billion
Global Eagle Entertainment	HNA Group	China	Jul 2017	$416 million
Novatel Wireless	T.C.L. Industries	China	Jun 2017	$50 million
Cree	Infineon Technologies	Germany	Feb 2017	$850 million

Source: Data compiled by Bloomberg

The United States is not the only country seeking to shield its industries from Chinese takeovers

While several European countries have pushed for an EU-wide rule to block acquisitions in sectors where European firms do not have reciprocal access in China, Germany has been the first European country to take concrete measures. In June 2017, it passed legislation allowing authorities, on national security grounds, to stop non-EU companies from acquiring more than 25% of a German firm. Further, the government can now review the security-related implications of a foreign takeover for up to five years after the deal. The turning point came in 2016, when a Chinese firm acquired KUKA, a German robotics firm, for 4.5 billion euros. It was widely covered in the press at the time that German companies would never have been allowed to purchase a similar company in China.

In Canada, Lenovo, the Chinese computer maker, abandoned its efforts to acquire BlackBerry, a manufacturer of smartphones widely used in government agencies, after Ottawa feared national security might be compromised. The government is also reviewing a proposed takeover of Aecon, a major Canadian construction firm, by CCCC International Holding, a Chinese state-owned enterprise. Officials are assessing whether national security would be undermined by the takeover. **The United States has also reportedly warned that Canadian companies bought by Chinese state-owned firms risk seeing their access to U.S. markets reduced.**

Who would win a trade war?

China is more vulnerable than the United States in one very important way. Exports account for about 20% of GDP in China, versus only 12% in for the United States. Further, the United States accounts for 23% of Chinese exports, whereas only 8% of U.S. exports go to China.[4]

China would be in an even more precarious position if many of its other major trading partners joined forces with the United States against its trade practices. U.S. allies Japan, South Korea and Germany are all top 10 destinations for Chinese exports. In an effort to encourage this co-operation, the Trump administration recently filed a complaint at the WTO accusing

[4] "A US-China Trade War? Not So Fast," Geopolitical Futures, March 23, 2018

China of IP theft and of blocking U.S. companies from competing in its market. This action was taken because the EU and Japan made their support conditional on the United States including the WTO in its trade dispute strategy.

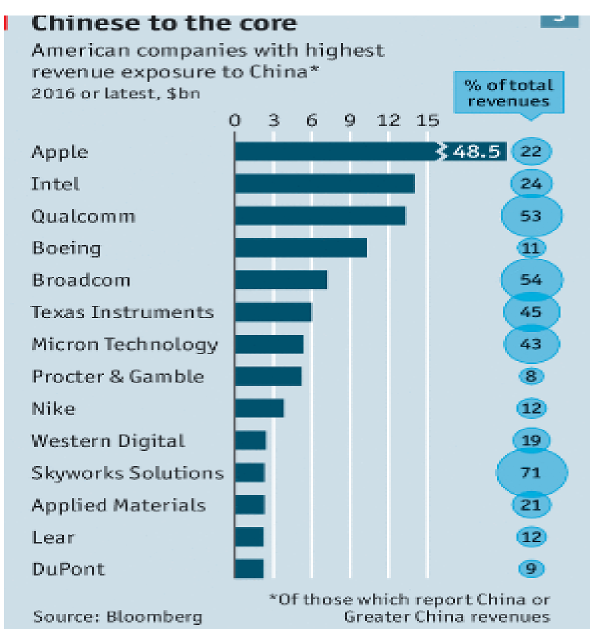
The United States, the EU and Japan are already united in their opposition to having the WTO remove China's designation as a "non-market economy." This designation makes it easier for trade partners to impose tariffs on goods they conclude have been sold below fair value. Legally implementing tariffs under WTO regulations against a market economy requires a much heavier burden of proof.

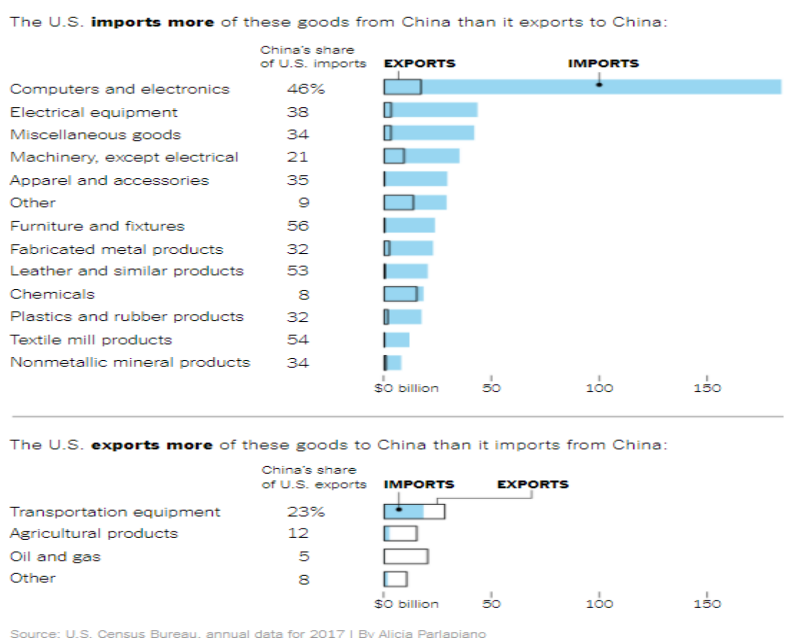
China has many areas where it could strike back at the United States

The two U.S. sectors most vulnerable to Chinese retaliation are agriculture and aircraft-related products, the only ones where the United States has a significant trade surplus with China. Indeed, one out of every four planes currently produced by Boeing is sold to Chinese buyers.

As for agriculture, China is the biggest customer for U.S. agricultural products after Canada. In 2016, 62% of U.S. soybean exports and 77% of sorghum exports went to China.[5] Tariffs would further depress farm incomes, which are expected this year to slide to their lowest level since 2006. **Chinese retaliation against farm products could also have major political repercussions, particularly with congressional elections looming. The vast majority of farm states voted for President Trump in the last election.**

China could also make it more difficult for U.S. businesses operating in China by targeting them for say regulatory or health infractions. Companies like Apple and Starbucks derive substantial revenue from Chinese-based operations, while retailers like Wal-Mart benefit from importing low-cost electronics, clothes and furniture from China. **However, if China pushes too hard on this front the U.S. could retaliate with similar measures against Chinese firms in the U.S. and/or encourage U.S. firms to migrate to lower-cost countries at a faster pace than is already occurring. Even though China is trying to move up the value-chain, it is still heavily reliant on the production of lower cost goods to employ its vast population of low-skilled workers.**





Sources: The Economist and "Trump Hits China With Stiff Trade Measures," New York Times, March 22, 2018

Moreover, unlike President Trump, China's leader controls the press and doesn't need to worry about elections. He can also immediately marshal vast financial resources to keep Chinese factories running and workers employed regardless of economic conditions in the short term. Providing similar aid to U.S. farmers would require time-consuming congressional approval.

[5] "U.S., China Sharpen Trade Swords," Wall Street Journal, March 21, 2018

Can China play the debt card?

China is the largest foreign holder of U.S. government debt. It holds $1.17 trillion or 20% of the $6 trillion in federal debt held by foreign sovereign investors.[6] If China decides to retaliate by unloading significant quantities of U.S. sovereign debt, it could cause a significant spike in rates at a time when the United States is running a high deficit and rates are already inching up.

However, playing this card could also be very detrimental to China. First, the sharp increase in rates would reduce the value of U.S. bonds in China's portfolio of foreign reserves. Second, higher borrowing costs would slow down the U.S. economy and further hurt demand for Chinese exports. **This mutual state of vulnerability most likely precludes China from taking action on this front.**

Conclusion: A more protectionist global landscape

While the U.S. and China will take measures to walk back from a full-blown trade war, heightened trade tensions between the two will be the new normal for the foreseeable future. **A game changer in America's favour would be if many of China's major trade partners (i.e., Japan, the EU, and South Korea) joined forces with the United States against its trade practices. The United States is not the only country to have complained about China's trade policies.**

In an effort to prevent this alliance forming against it, look for China to announce the opening of more sectors to foreign businesses followed by American accusations that they have not gone far enough. Or simply put, the trade road ahead is set to get bumpier.

In this new global environment, investors must do more than simply analyze a country's or a company's fundamentals. In assessing a country, they must also look at any ongoing or potential future tensions with trading partners, as such conflicts can significantly impede access to key markets.

Angelo Katsoras

[6] "Here's How China Could Really Hurt Trump in a Trade War," Fortune, March 22, 2018

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