

US and China Trade Update

May 28, 2019

LATEST DEVELOPMENTS

- On May 5, after many months of shuttle diplomacy between Washington and Beijing and a few days before what many believed would be the final round of talks before a deal was reached, President Trump issued a tweet that halted negotiations in their tracks. Trump indicated that China's latest proposal backtracked on a number of major commitments made previously and ordered that tariffs be raised from 10 percent to 25 percent on \$200 billion in Chinese imports.

President Trump also asked the USTR to put in place a process that could lead to a 25 percent tariff on all remaining Chinese imports, which have an annual value of over \$300 billion. In a May 13 release, the US Trade Representative (USTR) published the initial list of Chinese goods that could be subject to this tariff and scheduled a public hearing on June 17.

- On May 13, China responded to the US government's increase in tariffs from 10% to 25% on \$200 billion worth of Chinese goods, by increasing Chinese tariffs on \$60 billion worth of US goods. This brings the total US tariffs applied exclusively to Chinese goods to \$250 billion and total Chinese tariffs applied exclusively to US goods to \$110 billion.

At the same time, China sought mitigation of the current situation under the existing multilateral trade framework by submitting a reform proposal, which did not explicitly name the US, to the World Trade Organization (WTO). This proposal referred to the block on the appointment of WTO appeals judges and 'national security' tariffs on aluminum, steel and cars, as threats to the existence of the WTO.

- On May 15, US President Trump's Executive Order and the US Department of Commerce effectively black-listed Huawei by adding the Chinese telecom firm and 70 other companies to the US' "Entity List". These decisions mean that Chinese telecommunications companies like Huawei might be banned from selling equipment in the US, and Huawei cannot buy parts or components from US companies without the explicit approval of the US government. The Chinese Ministry of Commerce (MOFCOM) responded to these actions by stating that China will resolutely safeguard the legitimate rights of Chinese enterprises.
- On May 17 the Trump Administration announced tariffs would be lifted on imports of steel and aluminum from Canada and Mexico and that it would defer a decision on tariffs on imported autos for six months in hopes of reaching an agreement with Japan and Europe.

- The combination of all these actions in quick succession demonstrate Trump recognized that a protracted conflict with China was possible and he needed strategic partners abroad and measures to address political repercussions here at home. If this mindset persists as we think it will for the short-to-medium term, the prospects for a deal with China in the next several months is below 50 percent, Congressional passage of the USMCA is above 50 percent as is the likelihood of deals with Japan and perhaps Europe – although the agriculture issue will be a thorny one to resolve.

An additional data point on USMCA is that Pelosi and key members of her caucus are having near weekly private meetings with US Trade Representative Lighthizer and staff in the room indicate the meetings have been very positive and enough Democrats seem to want to get to yes to allow the deal to pass the House. Biggest obstacle appears to be an unrelated one - Trump's refusal to cooperate with any congressional oversight efforts.

THE VIEW FROM BEIJING

As the trade tensions escalate, three positions have endured on the Chinese side:

- **First, the Chinese government continues to position the US-side as responsible for the intensified trade-war.**

Since the beginning of trade tensions, China has positioned the negotiations and tariffs as US grievances and aggression, with media headlines dubbing it 'Donald Trump's Trade War' or the 'US's Trade War' back in 2018. Now, over one year later, party media and ministries' spokespersons emphasize that it is regrettable that the US-side has, unilaterally, continued to escalate the trade tensions and has seriously disrupted the US-China trade negotiations.

- **Second, China has the strength to overcome the impact of the trade war but both sides will be affected by the tariffs.**

The Chinese government has been bullish on the economic impact of the trade-war with Foreign Ministry spokesperson, Geng Shuang stating that the "protectionist measures" of the US will have an impact but "they can totally be overcome." The Chinese government has also voiced its support of Huawei. The Foreign Ministry spokesperson, Lu Kang, stated that "China supports Chinese enterprises to take up legal arms to defend their legitimate rights" on May 20 after Google suspended Huawei from Android services.

- **Third, China insists that the agreement be "balanced", meaning it cannot be seen as undermining the sovereignty and dignity of the country.**

Within hours of the public breakdown of the talks Vice Premier Liu He told China state media that China's three demands included "balanced text" in the agreement. From the Chinese perspective, the agreement envisioned by the U.S. required China to publicly accept one-sided demands and change its laws to do so. China President Xi Jinping and his government feel that the US demands in the trade negotiations are too high and do not align with Chinese strategy. Moreover, President Xi cannot appear to be weak, especially when it comes to communication



to the domestic audience. China and its leaders must be seen as standing on equal ground with the U.S. and Trump with the confidence that it can both press for a fair agreement and manage the consequences should such a deal prove not to be possible.

Looking Ahead

China has emphasized its resolution for structural reform at various high-level international occasions, but the reality is that the size of China's economy and the reform strategy will make the actual reform less drastic than expected, yet China still hopes to work towards an agreement. Therefore, although the Chinese government has used party media to highlight China's confidence in its ability to withstand any external risks and impacts from the ongoing trade friction with the US, at present, this strength hasn't turned to aggressive action: China's tariffs and messages of strength are a method to react and respond to the US but China has not, as of yet, shown signs that it will actively retaliate.

China understands that the world, not only the US, is watching how it responds to the tariffs and the view from many quarters within China is that the government is determined to manage the tensions successfully and cooperatively to achieve a longer-term win. The next steps from the China side will be measured – with many local voices saying they expect China to strike a balance between protecting its own economic goals but also remaining committed to progressing its position within global trade.

It is too early to anticipate concrete next steps but China continues to demonstrate its willingness to work with foreign businesses and governments: China has reemphasized its position as a partner to the world during each of its high-profile events that have been held during the trade tension times, namely, the *Two Sessions*, *Belt and Road Summit*, *Forum on China-Africa Cooperation*, *China Development Forum* and, most recently, the *Conference on Dialogue of Asian Civilizations*. At each of these events, which gather top-level Chinese officials and/or dozens of international diplomats, Chinese officials have spoken about China's opening up and support for foreign businesses.

The US, meanwhile, does not have the full support of all of its allies. The EU shares the same concerns as the US about the reform promise deficit, market entry and data security, as well as the unfair competition, but does not agree that the tit-for-tat tariffs are the best tactic. The American, European and British Chambers of Commerce in China have all expressed disappointment with the on-going tariffs and have publicly stated that they support continued negotiations as they believe these aforementioned issues must be addressed for any future international trade deal to be successful.

Impact on Enterprises

In the face of the trade tensions, the Chinese economy has slightly slowed. However, the Chinese government has not shown signs that it will intervene. In fact, despite April 2019 data that points to an ongoing economic deceleration, officials have yet to signal that a stimulus is forthcoming. The People's Bank of China also has not intervened directly, despite the *yuan* falling just over 2 percent since the beginning of May. Any intervention will depend on the



impact of the tariffs as well as future rounds of negotiations. Experts are still watching for evidence of a potential stimulus and intervention in the currency depreciation.

In the meantime, the Chinese government has said it will do what it can to support the growth of Chinese companies. The government is also supportive of international trade and needs foreign businesses in order to achieve its goals.

Further clarification from both governments is needed before it is possible to anticipate the full scope of the tariffs and tensions. Enterprise leaders are particularly uncomfortable with the uncertainty around the tariffs, as, so far, there has been no confirmed timetable for the next round of negotiations.

THE VIEW FROM WASHINGTON

In the last two weeks or so, Trump has been confronted with the prospect of a protracted fight with China and a serious structural crack in his political standing in the Midwest, the area most critical to his reelection.

In response he decided to solidify relations with Canada and Mexico by lifting tariffs on steel imported from these two countries and with Europe and Japan by delaying tariffs on imported autos. These decisions boost the prospects for Congressional passage of the USMCA and trade deals with Japan and Europe even as they and an executive order against Chinese telecommunications herald the likelihood of a something with China much bigger than a trade war. And recent private and public polls showing serious problems in the Midwest, particularly with suburban voters, forced Trump to agree to enter into discussions with Democrats on a budget deal and to distance himself from a strict Alabama abortion law.

Looking Ahead

Where things go next is murky at this point. The gap between what the Administration is demanding and what China indicated they were willing to accept in their last offer is quite wide. The Administration is seeking structural changes in critical areas of China's economy and business practices that must be approved by the Chinese legislature. In their last offer, China said they wanted to make the changes the US sought administratively through regulations.

Trump has a decision to make on the \$300 billion package sometime late next month. The immediate reaction of the political and economic markets appeared to take Trump by surprise a bit as evidenced by the large number of tweets following USTR's May 13 announcement. Trump has assured farmers and the rest of Americans that a great deal is coming and in the meantime the US is winning, and China is losing.

Both sides are likely to engage in continuous cost/benefit analysis going forward that calculates the political and economic ramifications of various scenarios. From the US perspective, it must weigh the costs of holding out for a structural agreement versus settling for something that would improve our trade balance but force fewer structural changes on China. In the former, tariffs may stay in place for a while if China can't concede, but Trump would look strong and that



plus a strong economy may convince him to sustain this course. In the latter, tariffs could end, but Trump would be open to criticism from the left and the right about failing to keep his promise to end or at least significantly alter China's bad trade practices.

China faces a similar calculation. Tariffs will end if it makes the concessions the US seeks but it will require Xi to publicly bow to Trump and pass his demands through China's legislature. On the other hand, Xi could calculate that rejecting the US demands is best for him politically, in part because he, like Trump, values looking strong and can also take steps to mitigate the pain of US tariffs.

Imposition of US tariffs on the \$300B of China's remaining exports to the U.S. (so-called "List 4") could happen on the heels of the G-20 Summit in Japan at the end of June, assuming that the anticipated Trump-Xi meeting does not result in a path to resolution of the dispute. These tariffs include politically-sensitive items that will more directly impact consumers, such as consumer electronics, toys and appliances. And as in the previous rounds, China would almost certainly retaliate, with additional tariffs on US agricultural and other products likely.

To date, Congressional reaction to this tariff tit-for-tat has been muted. There is broad bipartisan support for Trump's tough on China posture and Congress has largely been content to allow the Administration as much room as possible to negotiate. Even many farmers, who have been most directly impacted by China's retaliatory tariffs, continue to support Trump's position because they have faith, he will deliver a good deal. Lifting tariffs on Mexican and Canadian steel imports, refraining from tariffs on auto imports, and providing farmers an additional aid package should all buy Trump some additional time with Congress to press his case against China.

The Trump Administration's efforts to place restrictions on Chinese technology companies may persist beyond a resolution of the current trade dispute. While the initial tariffs were focused on Chinese commodities, we've seen that this has quickly expanded to new industries and sectors of the economy. Expect that while the current tariffs may eventually get addressed by the two countries, several of the trade issues and national security issues will persist due to the fact that some in the Trump Administration believe China has been waging an economic war on the U.S. and the rest of the world for decades.

SUMMARY AND ACTION POINTS

The recent steps taken by the Administration and China, the distance between the two parties on the issues, and the internal dynamics of each side's political and economic calculations all tend to suggest each side is preparing for a protracted stalemate. Trump is shoring up or at least not aggravating trade relations with Canada, Mexico, Japan and the EU, which could help him keep the pressure on China. Lifting the steel and aluminium tariffs and making billions of dollars available to farmers can help him buy time with Congress and the American people. China for its part also appears in no hurry to conclude an agreement. President Xi took a look at what the US was asking of him and his government and concluded the price was too high. He too can take measures at home to tamp down the economic and political costs of this fight.



As a result, for the short-to-medium term, a type of economic cold war between the US and China seems most likely. Trump is now openly speculating that he doesn't need a deal before the 2020 election because holding firm against China is a winning political position. If he actually believes this, we may be in for a longer than anticipated period of volatility. Depending on how the discussions and the economic and political markets go in the coming weeks, another round of tariffs is possible, and it is far from certain a deal is in the cards anytime soon.

One other dynamic worth watching is to what extent positive movement on other trade issues, such as the USMCA, further emboldens Trump to take a hard line with China. The announcement that U.S. steel and aluminum tariffs will be lifted on Canada and Mexico is a major step forward in terms of moving USMCA through Congress. Developments that Trump views as trade wins could make it easier for him to hold firm against China, despite macroeconomic or financial market pressures.

There are reports that the next round of meetings of US and China officials is on hold due to Trump's Executive Order banning the use of telecom equipment from companies deemed to be national security threats, including China's Huawei. This only underscores how far apart the parties are currently. While the conventional wisdom has been that China and the U.S. both need a deal in the relatively near term (China for economic reasons and Trump for political reasons), consideration is now being given to the prospect of a protracted struggle, where tariffs become the new normal.

As companies consider their strategy, we would advise the following points:

1. Remain patient and positive but make alternative business plans.

It is worth noting that the newly announced tariff measures by China's Ministry of Finance will only come into effect on June 1, which leaves room for potential further negotiation as well as surprising turning points. Experts are advising that the tensions could continue into 2020 and that things won't "go back to normal" even if tariffs are lifted or reduced.

2. Make extra effort to maintain relationships with your Chinese partners including business and government contacts

Chinese businesses are also waiting, watching and nervous. When the opportunity arises to work together, your relationship and mutual trust will be more important than ever. In addition, your relationships with government agencies can help you be informed and build allies during the present low time. China definitely needs foreign investment to help shape and restructure its economy, and the government has repeated its commitment to foreign business.

3. Get your digital and cyber strategies in order.

Clarify your plan for cybersecurity and information sharing as well as the integration of 5G and other technologies. As we can see with Huawei, this trade war has officially expanded beyond physical commodities. Information transfer, IP and cyber are big concerns of both



governments, with many related laws and bills being drafted by both sides at the present moment.

4. Rather than making your own public statement, consider aligning with a business association.

Business associations and chambers of commerce, which speak on behalf of a group, are practiced in diplomacy and have government connections. They are advocating that negotiations must continue because there are issues that need to be addressed but tariffs are not the right method.

5. Continue to engage and educate US policymakers and other stakeholders about your business and priorities.

As in any public affairs and advocacy effort, it is important to engage policymakers, stakeholders and mobilize support so that your interests and positions are ultimately supported throughout the current trade war.