US-China Trade Spat: Not Much Winning

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- **Today's increase in US tariffs on USD 200 bn of imports from China has been softened by the US decision not to apply the 25% rate to goods that are already in transit. This leaves room for President Trump to both look tough and to walk back the tariff increase in the next few weeks.**
- **There is little evidence so far that the US is winning its trade spat with China in terms of the goals President Trump has identified: the bilateral trade deficit has widened, and the burden of the US tariffs is being borne by American industry and consumers, which has generated net losses for the US economy.**
- **An eventual US deal with China is likely to feature supposed 'wins' that could have been achieved without this trade spat and that probably won't compensate for the losses generated by US tariffs.**

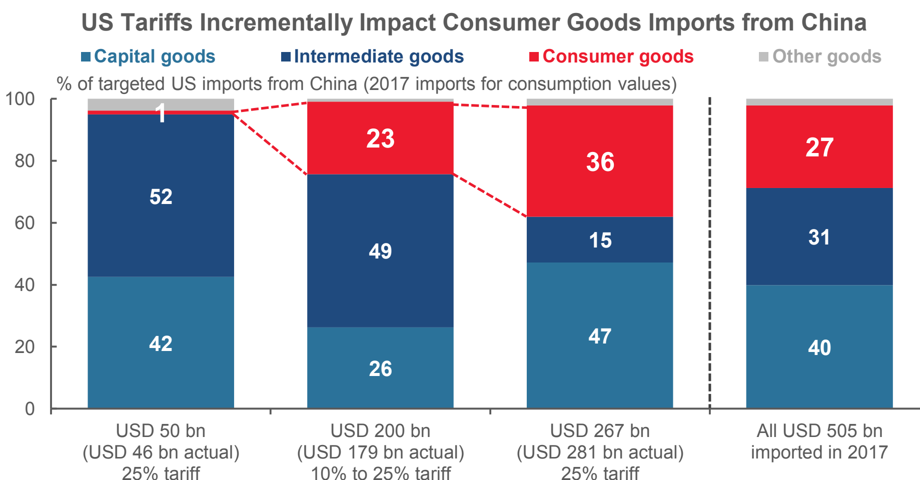
US FINALLY RAISES CHINA TARIFFS AGAIN…

The US Administration has followed through on its threat to raise its punitive Section 301 tariffs from 10% to 25% on USD 200 bn of imports from China. This duty increase follows on from the implementation of three major rounds of exceptional tariff hikes in the White House's ongoing effort to wring trade concessions from China:

- The first tranche of US tariffs saw 25% duties imposed in two steps in July and August 2018 on USD 34 bn and USD 16 bn worth of imports from China, respectively, for a total coverage of USD 50 bn in trade flows (chart 1, first column); and
- A second list of USD 200 bn of imports from China were hit with 10% tariffs in late-September 2018 (chart 1, second column).

Today's duty increase makes good on a long-standing—but also long-deferred—White House threat to push tariffs to 25% on nearly half of all US

Chart 1



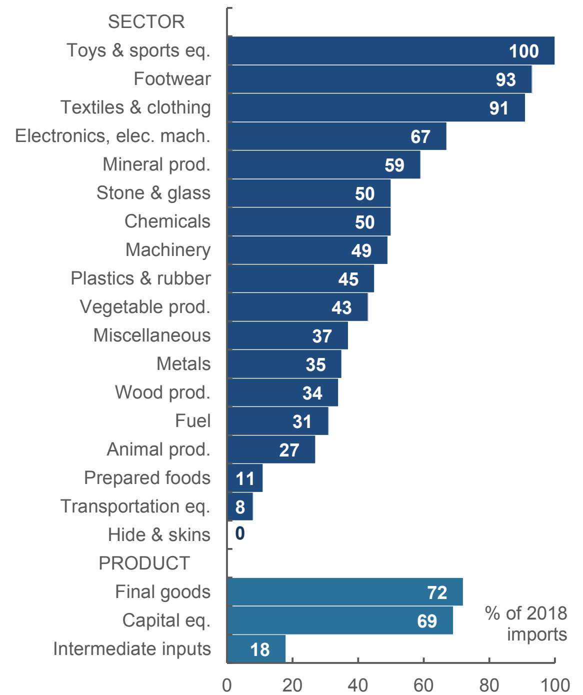
Sources: Scotiabank Economics, USITC, International Trade Centre, USTR.

imports from China. The 10% tariff rate on this second USD 200 bn tranche of imports was initially set to increase to 25% on January 1, 2019. The jump was first delayed to March 1, 2019 following the start of US-China talks at the G20 Summit in Buenos Aires at end-November, 2018. The White House further let the March 1 deadline pass due to progress in its talks with Beijing.

The implementation of the new 25% tariffs allows President Trump to appear tough while leaving some room for further US-China talks to yield a breakthrough: the new tariffs apply only to goods shipped from China after 12:01am EDT today. Affected goods already in transit from China will be charged only the existing 10% tariff that has been assessed since September 2018. This provides a little more time for negotiators to reach an agreement before the increased tariff rate begins to bite.

Earlier this week, the US Trade Representative's (USTR) office also gave notice that it would seek public input on the possible future imposition of 25% tariffs on goods in the remaining third tranche of USD 267 bn of imports from China (chart 1, third column). Regardless of President Trump's erroneous reference on Twitter to imposing 25% tariffs "shortly" on a remaining USD 325 bn of imports, it's clear that this last set of tariffs, if implemented, would be defined to ensure all US imports from China are covered by special duties.

Chart 2



Sources: Scotiabank Economics, PIIE.

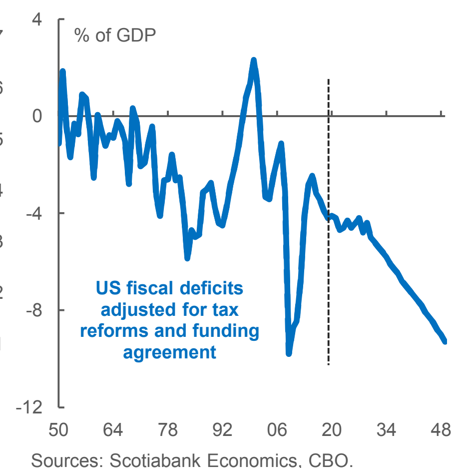
…BUT LIKELY NOT FOR LONG

We were skeptical that the White House would make good on its threat to impose additional tariffs on imports from China—and we remain doubtful that these stepped-up tariffs will remain in place for long. As chart 1 shows, final consumer items account for only 1% of the first list of tariffed goods, but about 23% of goods in the second list. Consumer goods make up 36% of the pending third list of goods on which Section 301 tariffs have not yet been imposed. Today's tariff increase and the possible further 25% tariffs on the remaining third list of goods would cause much more obvious and immediate pain for average American households—including the White House's political base—than the three rounds of tariffs imposed in 2018. A 25% increase in the prices of smart phones, tablets, and computers heading into the 2020 vote has never struck us as a winning electoral strategy.

Chart 3

Sources: Scotiabank Economics, US Federal Reserve, BEA.

Chart 4



Sources: Scotiabank Economics, CBO.

Put another way, even after today's tariff increase, the White House has only just begun to test the willingness of American voters to accept the pain of tariffs: only about a quarter of all final consumer goods imports to the US from China have had Section 301 tariffs imposed on them. White House follow-through on the US President's threat to hit the third list of goods would impose a new 25% price increase on the remaining 67% of electronic and electrical imports from China, 91% of textile and clothing imports, 93% of footwear imports, and 100% of imports of toys and sports equipment that haven't yet been hit by Section 301 tariffs (chart 2).

So far, the Trump Administration has not removed any of the tariffs it has imposed under the President's relatively narrow and specific powers on trade. On one hand, this implies a willingness to keep intensifying the White House's

protectionist efforts; on the other hand, it also implies a high bar for additional tariffs if they're very unlikely to be unwound even when US negotiating objectives are met. Canada and Mexico's experience with the US's Section 232 tariffs on metals is instructive: despite assurances from the USTR that they would be dealt with once the replacement for the North American Free Trade Agreement (NAFTA) was negotiated, these metals tariffs remain in place.

DESPITE US TARIFFS, US IMPORTS FROM CHINA HIT A NEW RECORD IN 2018

Despite the White House's efforts over the last year to implement a range of protectionist policies, US imports from China rose in 2018 to their highest annual value ever at USD 539 bn. The expansion in US imports from China points to the ongoing futility of trying to alter bilateral trade balances with tariffs when macroeconomic policies aren't aligned with the goal of smaller trade deficits. US absorption of more Chinese imports reflects, at least in part, prior US dollar strength (chart 3) and US domestic demand driven higher by growing US fiscal deficits (chart 4). Charts 3 and 4 imply that US trade deficits are likely to set new records under Trump—underpinned by growing US government red ink financed by external borrowing from China and other surplus countries—regardless of any further increases in tariffs.

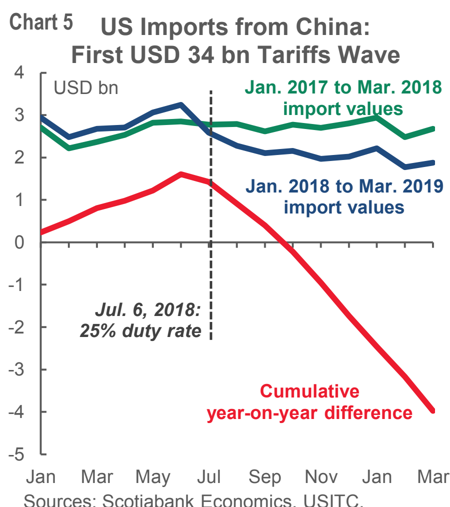
US imports of all of the Chinese goods on which tariffs were imposed in 2018 still rose by USD 23 bn in 2018, a 10% y/y increase. Imports of goods in the initial 25% tariff wave fell by 5.4%, while imports of the second wave of goods facing 25% duties rose by 8.4% during 2018 (charts 5 and 6). Imports in the second list hit in September 2018 by 10% tariffs were up 13% last year (chart 7).

Nevertheless, monthly trade data have recently moved more closely in line with White House expectations (charts 5,6, and 7, again). In March, US imports from China fell by 17% y/y and the US trade deficit with China for the month was the lowest since June 2016, at USD 28.3 bn. But one month does not (yet) make a trend.

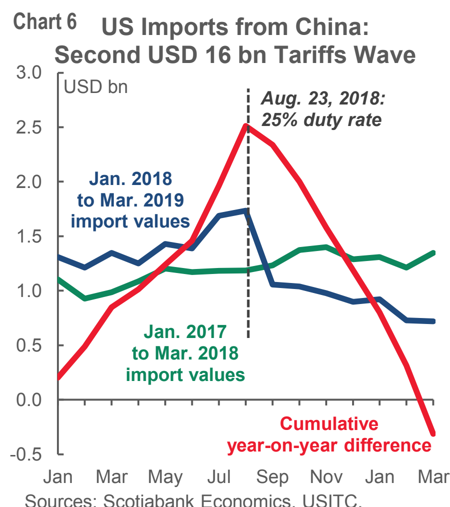
US TARIFFS INITIALLY INDUCED MORE IMPORTS FROM CHINA

US firms appear to have stockpiled inventory ahead of each spike in White House threats to impose or raise punitive tariffs on Chinese imports. As charts 6 and 7 show, US imports of Chinese goods targeted by the White House jumped ahead of the tariffs' arrival when there was sufficient time for importers to take action. Imports of goods in the USD 16 bn wave spiked by 36% y/y in the 3 months prior to the tariffs' introduction in August 2018; similarly, US firms ramped up their purchases of Chinese goods in the second tranche of tariffed imports by 8% y/y during Q4-2018 to get ahead of a possible increase to the 25% tariff at the turn of the year. In contrast, goods included in the first USD 34 bn wave (chart 5) did not post a surge in imports prior to the early-July tariffs since the lag between the tariffs' announcement and implementation was shorter.

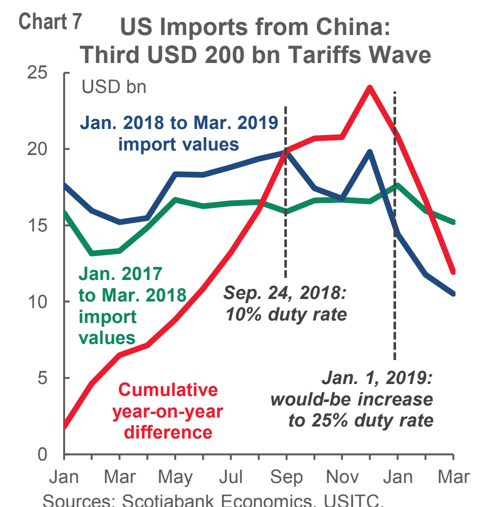
These efforts to front-run the US tariffs on China have been only partially unwound following the implementation of the duties. Charts 5 and 6 together show that imports of Chinese goods hit by the first tranche of tariffs have declined by a cumulative total of USD 4.3 bn over the 14 months since January 2018. In contrast, imports in the second, larger list worth about



Sources: Scotiabank Economics, USITC.



Sources: Scotiabank Economics, USITC.



Sources: Scotiabank Economics, USITC.

USD 200 bn, are still up an accumulated USD 12 bn since then (chart 7). Together, goods imports subject to the two sets of China tariffs remain up by USD 7.7 bn since January 2018.

Still-elevated US imports from China may simply mean that the tariffs take longer and need to be higher to crimp US demand for Chinese goods—not that tariffs don't have any of their intended effects. At 25%, the tariffs on the first list are higher, and have been in place longer, than the 10% tariff on the second list that was imposed from September 2018 to May 2019. Given a bit more time, the new 25% tariff on the second list may induce cumulative imports on these goods to contract back to below their pre-tariff levels.

INCIDENCE OF THE TARIFFS SQUARELY ON THE US

China appears to have allowed the CNY to depreciate in 2018 to cushion the immediate impact of US tariffs and to reduce pressure on its exporters to reduce their prices (chart 8). That 10% depreciation would have fully compensated for the tariffs imposed on the first list of Chinese goods. While about a third of this depreciation was temporarily unwound in early 2019, it could be fully restored in response to today's US tariff hike.

The US government, business, and consumers, not Chinese sellers, have footed the bill for the White House's punitive tariffs—regardless of President Trump's assertions to the contrary. Efforts by US importers to front-run the tariffs and the still-elevated import volumes for goods in the second list (chart 7) imply a fair degree of price inelasticity in US demand for these goods and a limited range of available substitutes.

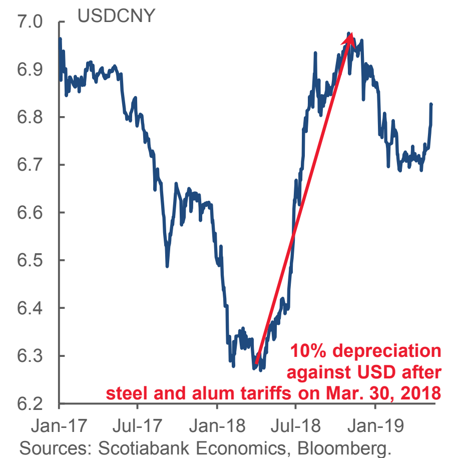
Researchers at UCLA and Princeton have found that the burden of US tariffs has been borne entirely by Americans. US tariffs haven't forced down Chinese prices—instead, they've pushed up US prices for the affected goods. Consumer losses and reduced exports owing to Chinese retaliatory tariffs have been compensated to some extent by the higher prices charged by US firms in protected industries and tariff revenue collected by the US government. Nevertheless, both studies find net overall losses for the US economy.

US DUTIES COLLECTED OFFSET BY LOSSES

The Trump Administration's claim that duties on Chinese products would provide a boon to public coffers has been flawed from the start. US importers dispensed an additional USD 9 bn in US customs duties on targeted Chinese products in 2018 relative to the previous year; as imports of these goods rose by 10%, duties paid soared by 200% compared with 2017 (charts 9). US importers are currently facing the highest average effective duty rates since 1993 on Chinese goods (chart 10). Additionally, the value of US duties collected on Chinese imports is well below the USD 16 bn in lost exports of goods to China.

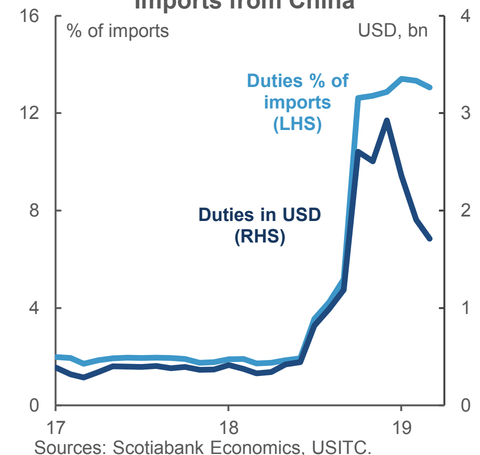
In response to the loss in exports due to Chinese retaliatory measures, the Trump Administration has promised to compensate farmers negatively affected by the trade spat The US Department of Agriculture (USDA) has authorised up to USD 12 bn in funds for support to farmers affected by reduced sales to China. In the 12 months ending in March 2019, the latest month for which data are

Chart 8



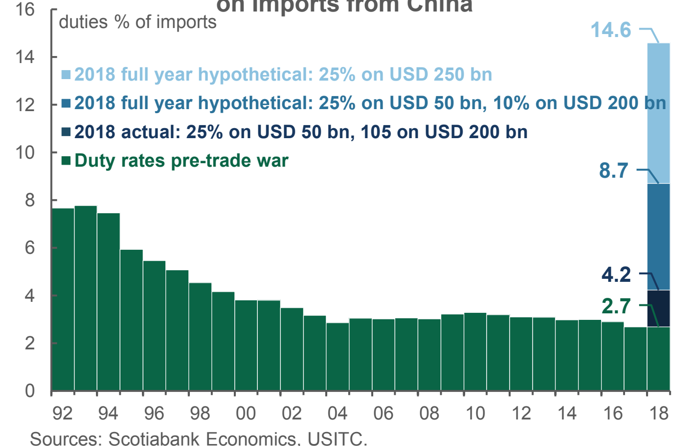
Sources: Scotiabank Economics, Bloomberg.

Chart 9



Sources: Scotiabank Economics, USITC.

Chart 10



Sources: Scotiabank Economics, USITC.

available, the US customs service collected roughly USD 13.5 bn in new, additional duties on targeted Chinese goods. All of this will likely go into compensation to farmers. The bulk of the USDA's payments are being granted under its market facilitation program, which according to the Agency had disbursed over USD 8.3 bn to about 600,000 applicants as of late-April 2019; around 80% of the funds under this initiative are earmarked for soybean producers.

CHINA'S RETALIATORY ACTIONS HAVE BEEN EFFECTIVE

China's retaliatory measures have taken two forms:

- **First, China imposed tariffs on about USD 110 bn of goods imports from the US, equivalent to 91% of all US goods exports to China.** These tariffs were imposed in two steps: 25% tariffs on a first set of USD 50 bn worth of goods, and a second set of tariffs of 5–10% on USD 60 bn of imports from the US (charts 11, 12, and 13); and

- **Second, Chinese state-owned enterprises, government agencies, and large firms have made a concerted effort to cut purchases of major commodities and manufactured goods from the US.**

Consequently, US exports to China of targeted merchandise fell by 14% in 2018 (chart 14). Alongside the rise in imports from China detailed above, US exports to China fell by USD 16 bn during 2018. As a result, the US's trade deficit in two-way tariffed goods widened by USD 40 bn, or 0.2% of GDP, in 2018 (chart 14).

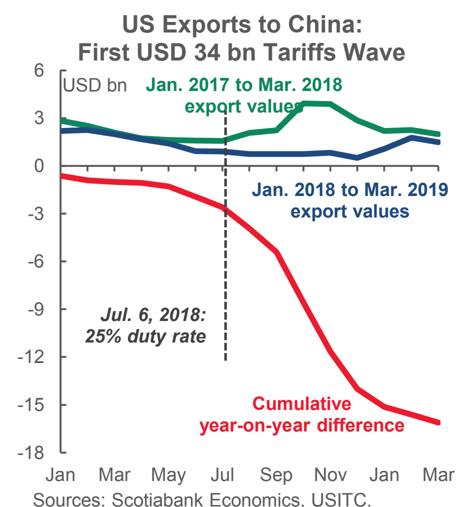
Soybean farmers have been among the hardest hit by the US-China trade war: US soybean exports have accounted for roughly half of the contraction in US exports of tariffed products to China. In volume terms, US soybean shipments to China fell by 80% in 2018, equivalent to a USD 9 bn loss relative to 2017 (chart 15). While US farmers have found willing buyers in other countries—namely the EU, Argentina, Iran, and Egypt—total US soybean exports dropped by close to 20% in volume terms in 2018.

Soybean growers saw some respite in early-2019 as China appears to have accelerated its purchases from the US alongside positive developments in negotiations. However, any recent gains are vulnerable after today's US tariff hike: the Chinese state has shown that it can halt soybean imports from the US just as quickly as it can increase them.

TRUMP ADMINISTRATION 'WINS' CONSISTENTLY LESS THAN ADVERTISED

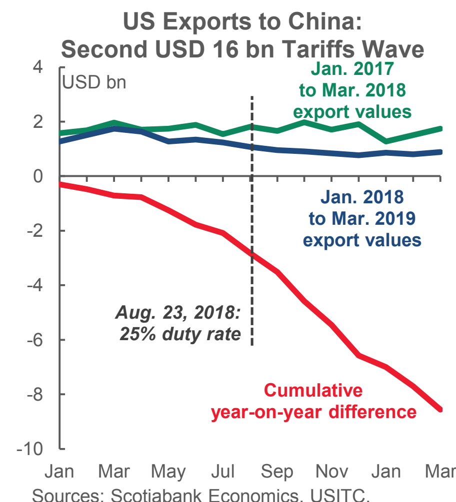
US trade negotiations under the Trump Administration have established a pattern of re-achieving gains that have already been won. An eventual agreement with China is likely to repackage victories the US could have had without inflicting tariff-related damage on its own economy. The renewed KORUS free-trade agreement with Korea saw few changes beyond the loosening of Korean restrictions that have not been binding on US exporters. Similarly, supposed concessions wrung from Canada and Mexico under the new United States-Mexico-Canada Agreement (USMCA) are in many cases previously agreed measures that the US lost two years ago when President Trump withdrew the US from the Trans-Pacific Partnership (TPP). An eventual agreement with China is likely to follow similar lines—which implies a few years of tit-for-tat tariffs won't have been worth the trouble.

Chart 11



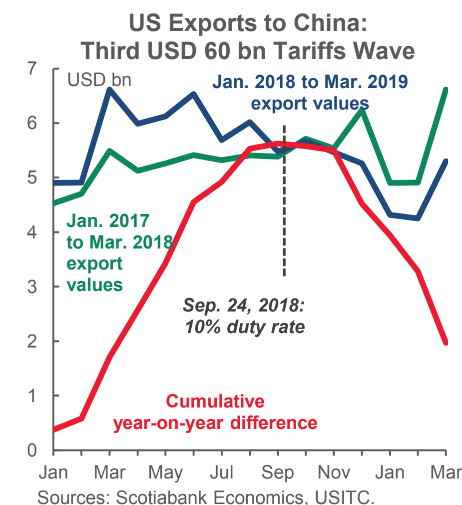
Sources: Scotiabank Economics, USITC.

Chart 12



Sources: Scotiabank Economics, USITC.

Chart 13



Sources: Scotiabank Economics, USITC.

China significantly lowered its tariff barriers in the years leading up to 2018—and was set to keep lowering them further—but the trade spat with the US has significantly reversed this trend back to 1993 levels (chart 16). Prior to China joining the WTO, US exports to China faced average duty rates above 16% in weighted terms, over ten percentage points higher than duties imposed on US goods after China's WTO accession. To date, China's existing retaliatory tariffs translate into a 15.6% weighted average duty on imports from the US. If Chinese authorities respond to Trump's tariff hike with a similar increase to 25% on all of its USD 110 bn in imports from the US, US goods would face a weighted average duty of 23.3%. Unwinding China's recent and prospective retaliatory tariffs would simply take us back to where Chinese tariffs already were—but with soured relations, dented trust, and dimmer prospects of further progress under a weakened multilateral trading system.

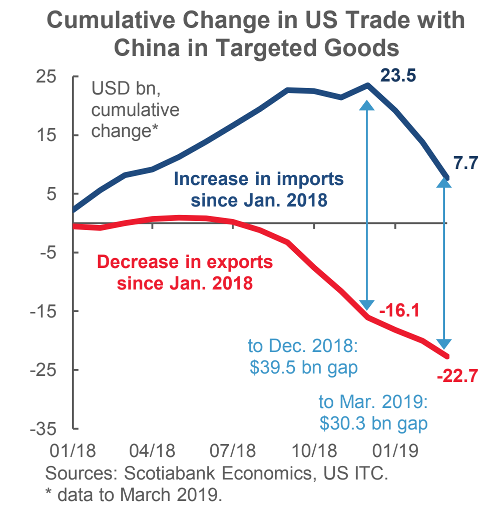
US leverage over China is more limited than US official rhetoric implies (chart 17). Chinese exports to the US account for 19% of total Chinese goods exports to the world, and US exports are equivalent to around 4% of Chinese GDP. The USD 250 bn of Chinese exports currently affected by US Section 301 tariffs are equivalent to only 2.1% of Chinese GDP. These numbers aren't insignificant, but they also imply that the US administration may be overplaying its hand.

LOOK SKEPTICALLY AT AN EVENTUAL DEAL

An eventual deal with China is likely to feature several elements that will be touted as victories, but are really either a return to pre-existing conditions or things that likely would have happened without the launch of the Trump trade spat:

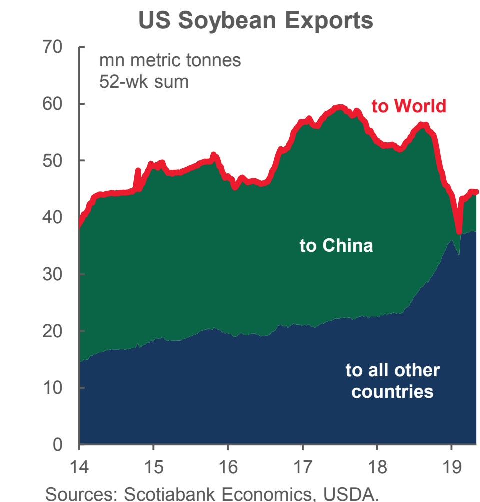
- The US has been said to be seeking USD 30 bn in Chinese agriculture purchases from the American farmers—purchases that previously were a normal feature of economic ties between the two countries;
- Beyond a roll-back of China's retaliatory tariffs on USD 110 bn of imports from the US, China may lower its duties on US agricultural, transportation, chemical, and other products in line with long-established trends in chart 16;

Chart 14



Sources: Scotiabank Economics, US ITC.
* data to March 2019.

Chart 15

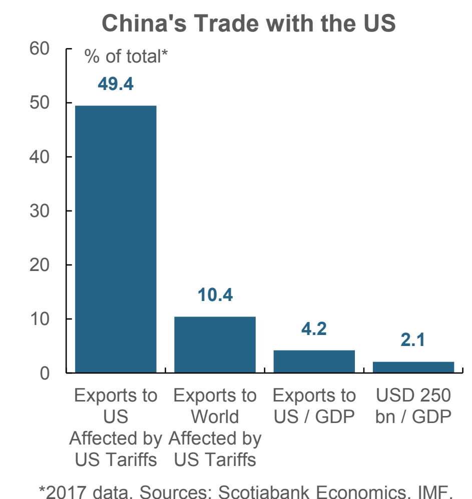


Sources: Scotiabank Economics, USDA.

Chart 16

Sources: Scotiabank Economics, WITS, USITC

Chart 17



*2017 data. Sources: Scotiabank Economics, IMF.

- An agreement to purchase USD 18 bn in natural gas from the US under a 20-year contract. China's state-owned Sinopec and Houston-based Cheniere have been set to pen a deal that would see US natural gas deliveries to China starting in 2023. The two partners had, however, reportedly already come to common terms late last year, but did not formalise the agreement in light of the already rising trade tensions between the US and China. The move to increase natural gas purchases from the US is also aligned with China's demand for petrochemicals. These are purchases that would have happened anyway; and
- Acceleration of the removal of foreign-ownership barriers in the Chinese automotive sector that currently cap foreign stakes in joint ventures at 50%. This wouldn't be new: the Chinese government announced last summer that it would fully lift the cap on foreign ownership in the auto sector within five years.

Any future claims from the White House of 'mission accomplished' when a deal with China is reached should be greeted with skepticism—and an awareness that the path to such a deal has generated enormous damage to the rules-based international trading system that has benefited the US for decades.

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