US-China Trade Spat: Two Decades of Chinese Liberalization Undone

- **China's retaliatory response to the May 10 increase in US tariffs undoes two decades of Chinese liberalization by taking duties on US imports back to pre-WTO accession levels.**
- **The self-inflicted wounds caused by these tariffs are relatively limited for the Chinese economy compared with the concentrated pain that China can inflict on US exporters by adding non-tariff frictions to trade and diverting Chinese demand to other countries' suppliers.**
- **Beijing has only limited room to manage its currency or reduce its exposure to US Treasuries, but it has more ample space to sustain Chinese growth through domestic fiscal and credit stimulus.**

CONTACTS

Brett House, VP & Deputy Chief Economist
416.863.7463
Scotiabank Economics
brett.house@scotiabank.com
@BrettEHouse

Juan Manuel Herrera, Economist
416.866.6781
Scotiabank Economics
juanmanuel.herrera@scotiabank.com
@JM_HerreraB

Tuuli McCully, Head of Asia-Pacific Economics
65.6305.8313 (Singapore)
Scotiabank Economics
tuuli.mccully@scotiabank.com
@TuuliMccully

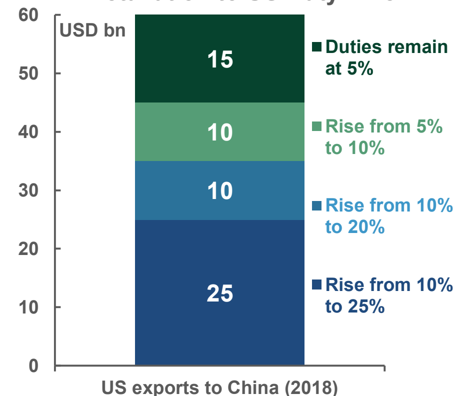
TARIFF FOR TAT

Following the long-delayed move on May 10 by the US to raise tariffs from 10% to 25% on USD 200 bn of imports from China, Chinese authorities announced on May 13 that they would respond by hiking their existing retaliatory tariffs on USD 60 bn of imports from the US. The Chinese tariff boost, programmed to kick in on June 1, will see punitive duties increase as follows (chart 1) on machinery, electrical equipment and electronics, and specialized instruments, with some additional specific goods targeted:

- from 10% to 25% on about USD 25 bn of imports from the US, with wood items also a major part of this list;
- from 10% to 20% on about USD 10 bn of goods, where precious stones and metals make up a substantial share of this bucket; and
- from 5% to 10% on a further USD 10 bn of goods, in which plastics are an important slice of this sub-set of goods; while
- a remaining USD 15 bn of US goods see their Chinese tariffs held unchanged at 5%, with wood, pulp, and paper appearing as important components of this sub-set of goods that rounds out the full USD 60 bn affected.

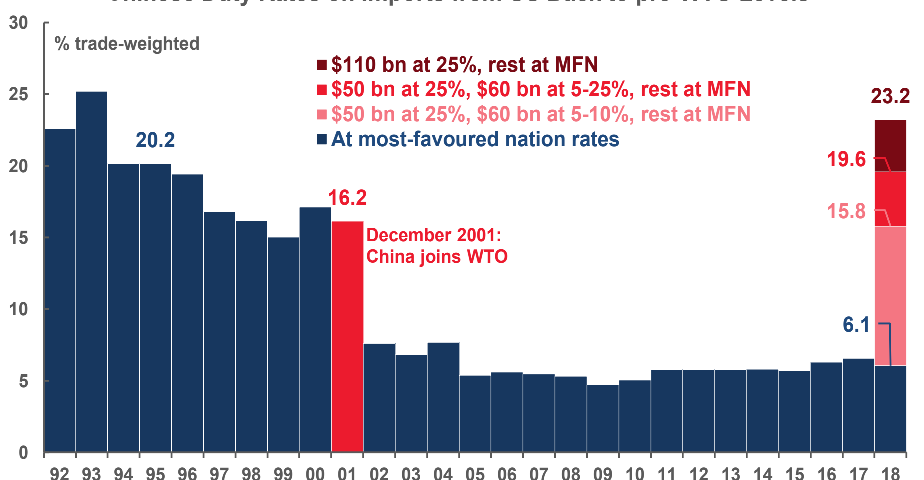
The weighted-average tariff increase on these goods amounts to about 8.75 percentage points (ppts) compared with the 15 ppts increase the US has imposed on USD 200 bn worth of Chinese goods. China can't match the scale and coverage of the Trump tariffs because it imports only around a fifth as much from the US as the US imports from China. But it does have other tools it can employ to respond to the US.

Chart 1



Sources: Scotiabank Economics, US ITC.

Chart 2



Sources: Scotiabank Economics. USITC, WITS.

TAKING CHINESE TARIFFS 20 YEARS BACK IN TIME

China's latest tariff move will push weighted-average duty rates on US goods imports to their highest point since 1995—well above any of the levels that have prevailed since China joined the WTO in late-2001 (chart 2). In weighted-average terms, duty rates across all Chinese imports from the US are set to rise to nearly 20%—up from the 15.8% that has followed China's retaliation to the US Section 301 tariffs imposed during 2018. Even more striking, this latest move takes China's weighted-average tariff on US goods imports up a cumulative 13.5 ppts from the 6.1% charged prior to the initiation of the Trump tariffs in 2018 (chart 2 again). For perspective, the 19.6% weighted-average tariff rate on US imports is over three ppts higher than the 16.2% that prevailed prior to China's WTO accession in 2001. Chart 2 also notes that if the Chinese were to move tariffs on all USD 110 bn of imports from the States, the resulting weighted average tariff would rise further to 23.2%.

CHINESE BUSINESS BEARS THE BRUNT

The burden of the new Chinese tariffs is likely to be skewed, at least initially, toward importing firms rather than Chinese consumers. Though the new duty rates will be especially high on consumer goods, capital and intermediate goods account for 94% of the USD 60 bn affected by Beijing's announcement (chart 3) and they will see proportionately larger tariff increases. Overall, final consumer goods make up less than 10% of all US 110 bn in US exports to China (chart 4). With consumer goods sprinkled thinly across the four subsets of the USD 60 bn affected by the May 13 announcement from Beijing (chart 3 again), the weighted-average duty on these goods will increase from today's 19.4% to 29.2% in June 2019 (chart 5). On capital goods, the weighted-average tariff increases from today's 11.5% to 20.2%; on intermediate goods, the increase goes from 13.0% to 21.6% in June. Compared with the most-favoured nation (MFN) tariffs that prevailed prior to the start of the 2018 trade spat, the tariffs that apply after June 1 will be between 2.5- and 5.5-times higher.

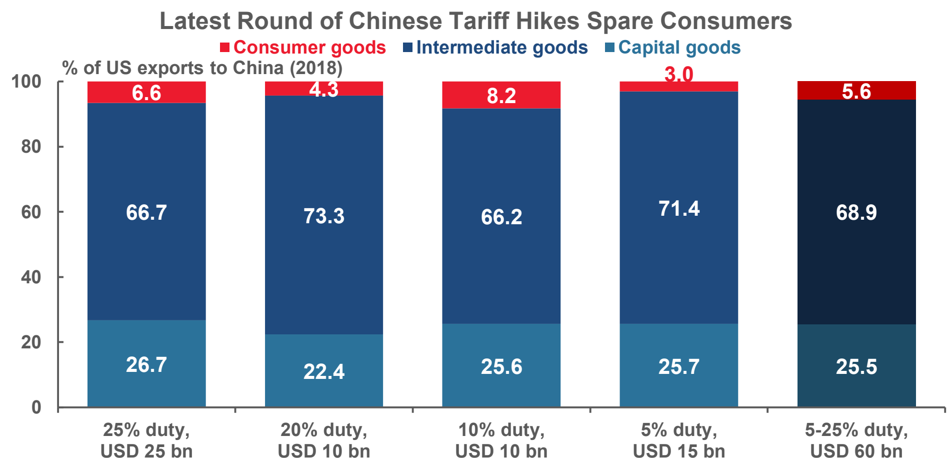
Furthermore, Chinese firms and households that import goods have also seen their purchasing power dented by the 10% depreciation in the CNY against the USD since March 2018 (chart 6).

WOUNDS LIKELY TO BE MINOR

In terms of the broader economic impact of the May 13 Chinese retaliation, it's worth setting the numbers in some perspective. Although these tariffs pertain to 55% of Chinese imports from the US, the implications for the broader Chinese economy are much more limited (chart 7). The affected goods are equivalent to just:

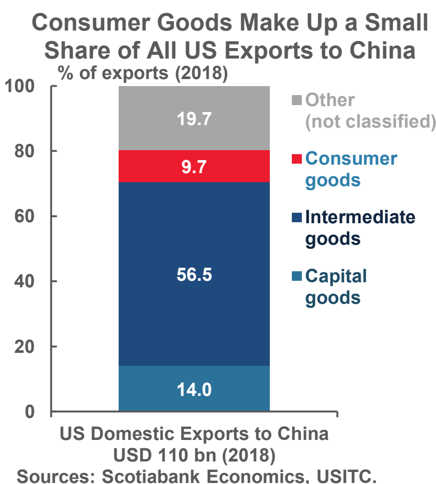
- 2.8% of all Chinese imports;
- 0.1% of total Chinese consumption;
- 0.3% of overall Chinese investment;
- 1.2% of Chinese manufacturing output; and
- 0.5% of Chinese GDP.

Chart 3



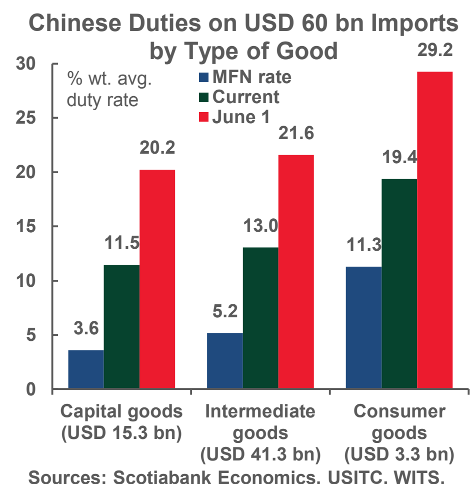
Sources: Scotiabank Economics, USITC.

Chart 4



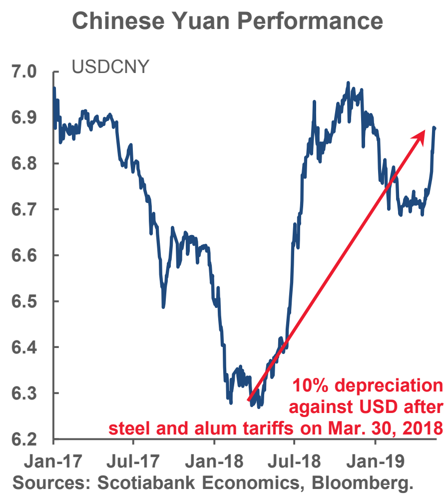
Sources: Scotiabank Economics, USITC.

Chart 5



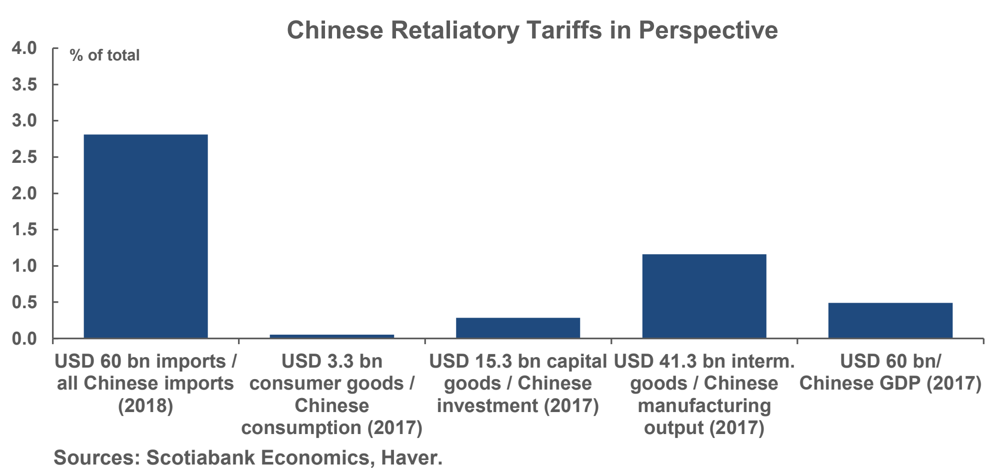
Sources: Scotiabank Economics, USITC, WITS.

Chart 6



Sources: Scotiabank Economics, Bloomberg.

Chart 7



Sources: Scotiabank Economics, Haver.

Though these import tariffs are self-inflicted wounds, China could withstand these wounds for a sustained period of time.

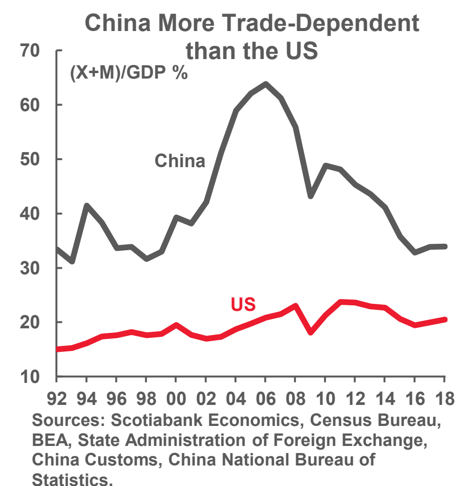
More broadly, although the US is much less dependent on trade than China, China is far less dependent on trade with the US now than it was a decade ago. Chinese trade dependence peaked in the early-2000s (chart 8), but since then it has steadily declined and Chinese exports to the US are now worth less than half as much Chinese GDP as they were in 2006 (chart 9). US trade leverage is waning.

OTHER ARROWS IN THE CHINESE TRADE QUIVER

Beijing's tit-for-tat tariff response to the latest round of Trump tariffs is only one of a handful of policy tools that the Chinese authorities can use to further their retaliation to US protectionism. China has several options beyond its just-announced tariffs, including:

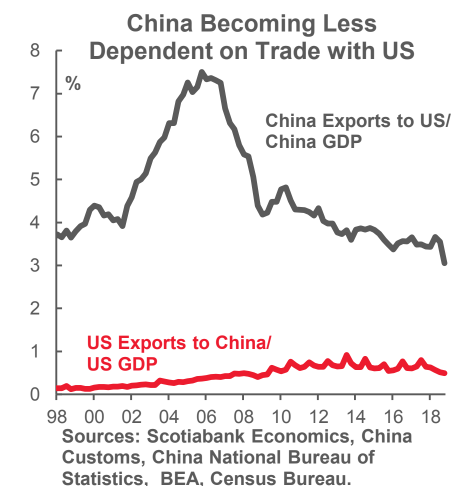
1. Fresh intervention in currency markets to weaken the CNY and keep Chinese exports competitive in US markets without pressure for wage adjustments;
2. Reduced purchases and holdings of US Treasuries in an effort to push up yields in the US, but without additional moves to mitigate the impact on the CNY, this would run at cross purposes to any direct FX market intervention to competitively depreciate the yuan;
3. Formal regulatory action and informal pressure to make operations in China more cumbersome and difficult for American companies;
4. Increased non-tariff entry frictions for US imports at ports and customs-inspection points;
5. Special instructions to Chinese state-owned enterprises (SOEs) to limit and/or reduce business with US companies and cut imports. Chinese SOEs account for a substantial share of Chinese imports of major commodities and they have already substantially cut their purchases from US suppliers (table 1). US producers of grain and soybeans have seen the results in lower export volumes and lower prices; and
6. Restrictions on or moral suasion against Chinese tourism and studies in the US.

Chart 8



Sources: Scotiabank Economics, Census Bureau, BEA, State Administration of Foreign Exchange, China Customs, China National Bureau of Statistics.

Chart 9



Sources: Scotiabank Economics, China Customs, China National Bureau of Statistics, BEA, Census Bureau.

Options 3 through 6 are already tested to varying degrees: they've either already happened in the past or they're being revved up again. Debate continues over the extent to which Beijing is likely to pursue fresh bouts of both options 1 and 2.

Table 1

Product	% 2015, Chinese SOEs share of: Chinese imports	Global imports	US Exports to China (USD bn) H2-2017	H2-2018	% change
Crude petroleum	85.6	14.5	2,623	1,027	-61
Gold	66.2	23.5	255	118	-54
Grain sorghum	52.5	43.5	448	10	-98
Soybeans	21.5	13.9	8,404	277	-97

Sources: Scotiabank Economics, US ITC, WorldBank WITS.

CHINA CAN TOLERATE PAIN, BUT WILL MITIGATE IT WITH STIMULUS

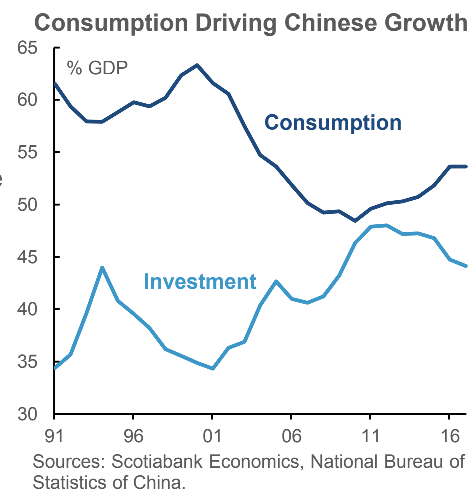
China has already allowed market forces to weaken the CNY to counter the Trump tariffs, in 2018 and more recently, as chart 6 implies, but it's unlikely to go much further as stability becomes a priority. China's experience in 2015 implies that around USDCNY 7.0 is the point where the benefits to export competitiveness from a weaker currency give way to greater costs from increased capital flight. With USDCNY currently around 6.9, there's little room left for the Chinese authorities to competitively devalue the yuan without undermining domestic confidence in the currency and potentially triggering a vicious cycle of currency depreciation. Moreover, given that foreign exchange management has been one of the key components in the trade discussions, it would seem unwise to undo any perceived progress on this front.

Chart 10

Sources: Scotiabank Economics, US Treasury, Bloomberg.

Although China's authorities appear to have already moved to decrease their purchases of US Treasuries (USTs) and reduce their holdings, we're skeptical that they'll take this effort far enough, fast enough, to inflict real pain on either the US or themselves. Chinese USD-reserves have gradually come down by about 22% since their peak in 2013, but about one-third of China's reserves—USD 1.12 tn worth—are still held as US Treasuries. Dumping a large enough share of this paper quickly enough to dislocate US yields would simultaneously slash the value of China's remaining UST holdings and could induce capital flight, buffeting the CNY with countervailing appreciating forces from the sale of the USTs and depreciating forces from Chinese capital heading out the doors. It certainly wouldn't be the kind of stable, growth-friendly scenario that Beijing is trying to engineer at least through the 2021 centenary of the Chinese Communist Party.

Chart 11



Sources: Scotiabank Economics, National Bureau of Statistics of China.

It's also not clear that international markets would play along with Chinese efforts to put pressure on US yields. A Chinese fire-sale of US Treasuries would likely induce a rush of investors into safe-haven assets, bolstering demand for USTs, thereby pushing up the USD and encouraging capital flight from China. It's telling that US 10-year yields fell from 2.75% to 2.37% during March 2019 even as China made the largest one-month reduction in its UST holdings in more than two years (chart 10): there are clearly willing buyers for this paper in an environment where risk-free assets appear to be in relatively short supply. Rather than imposing pain on the US, a move to dump USTs could leave China with nothing more than a big outflow of private capital, a large reduction in official reserves, an uncertain outcome for the CNY, and limited options to redeploy the proceeds from its UST sales.

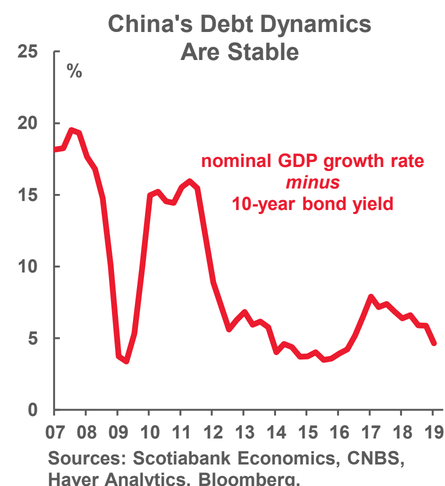
Instead, China's authorities will likely continue to stoke domestic demand through targeted credit expansion and fiscal spending, such as further tax and fee cuts—which, ironically, could sustain Trump's protectionist gambit by putting a floor under global growth and limiting the economic pain that could cause a change of course. Further stimulus could hit two policy birds with one stone: properly designed and directed, it could further China's economic transformation toward growth

that is led by consumption to an even greater extent (chart 11). China's debt dynamics imply that it shouldn't face a binding financing constraint any time soon: with nominal growth rates persistently higher than the interest rate at which China's public sector borrows (chart 12), Beijing's debt:GDP ratio should remain broadly stable over time.

Earlier today, the People's Bank of China's (PBOC) quarterly *Monetary Policy Implementation* report noted plans to maintain "prudent" monetary policy and yuan stability, but also foreshadowed "targeted" cuts to the required reserve ratio for the financial system. This points to some further credit easing, but only so much that it wouldn't threaten a breach of the USDCNY 7.0 informal ceiling. That said, with USDCNY already at 6.9 amidst some further depreciating pressure on the CNY, policymakers have room to both further loosen credit conditions and continue gradually reducing their UST exposure, which would provide some support to the yuan.

China already accounts for around a fifth of global growth and this looks set to continue.

Chart 12



Sources: Scotiabank Economics, CNBS, Haver Analytics, Bloomberg.

CHINA SYNDROME: MORE CHRONIC CONDITION THAN MELTDOWN

In a briefing on May 16, the Chinese Ministry of Commerce (MOFCOM) laid out three conditions for further negotiations toward a deal with the US:

- Cancel all tariffs imposed in 2018 and 2019, as "the practice of increasing tariffs is not conducive to the resolution of economic and trade issues";
- Use "realistic" trade procurement data in negotiations; and
- Ensure a commitment to a balanced approach that produces an agreement that respects each country's dignity.

The MOFCOM noted that China has "policy tools" to deal with the US-initiated trade war, and that it is "confident China can cope with any difficulties and challenges. China's economic and industrial system is diversified, the scale of its market is huge, its tenacity is strong, its room to manoeuvre is large, and its prospects are very bright." This isn't the tone of a government that is about to cave to US demands—and it implies that even if some kind of deal is reached at the Osaka G20 Summit at end-June, US-China trade tensions are set to be a chronic condition for the next few years.

This report has been prepared by Scotiabank Economics as a resource for the clients of Scotiabank. Opinions, estimates and projections contained herein are our own as of the date hereof and are subject to change without notice. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made as to their accuracy or completeness. Neither Scotiabank nor any of its officers, directors, partners, employees or affiliates accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or its contents.

These reports are provided to you for informational purposes only. This report is not, and is not constructed as, an offer to sell or solicitation of any offer to buy any financial instrument, nor shall this report be construed as an opinion as to whether you should enter into any swap or trading strategy involving a swap or any other transaction. The information contained in this report is not intended to be, and does not constitute, a recommendation of a swap or trading strategy involving a swap within the meaning of U.S. Commodity Futures Trading Commission Regulation 23.434 and Appendix A thereto. This material is not intended to be individually tailored to your needs or characteristics and should not be viewed as a "call to action" or suggestion that you enter into a swap or trading strategy involving a swap or any other transaction. Scotiabank may engage in transactions in a manner inconsistent with the views discussed this report and may have positions, or be in the process of acquiring or disposing of positions, referred to in this report.

Scotiabank, its affiliates and any of their respective officers, directors and employees may from time to time take positions in currencies, act as managers, co-managers or underwriters of a public offering or act as principals or agents, deal in, own or act as market makers or advisors, brokers or commercial and/or investment bankers in relation to securities or related derivatives. As a result of these actions, Scotiabank may receive remuneration. All Scotiabank products and services are subject to the terms of applicable agreements and local regulations. Officers, directors and employees of Scotiabank and its affiliates may serve as directors of corporations.

Any securities discussed in this report may not be suitable for all investors. Scotiabank recommends that investors independently evaluate any issuer and security discussed in this report, and consult with any advisors they deem necessary prior to making any investment.

This report and all information, opinions and conclusions contained in it are protected by copyright. This information may not be reproduced without the prior express written consent of Scotiabank.

™ Trademark of The Bank of Nova Scotia. Used under license, where applicable.

Scotiabank, together with "Global Banking and Markets", is a marketing name for the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and certain of its affiliates in the countries where they operate, including, Scotiabanc Inc.; Citadel Hill Advisors L.L.C.; The Bank of Nova Scotia Trust Company of New York; Scotiabank Europe plc; Scotiabank (Ireland) Limited; Scotiabank Inverlat S.A., Institución de Banca Múltiple, Scotia Inverlat Casa de Bolsa S.A. de C.V., Scotia Inverlat Derivados S.A. de C.V. – all members of the Scotiabank group and authorized users of the Scotiabank mark. The Bank of Nova Scotia is incorporated in Canada with limited liability and is authorised and regulated by the Office of the Superintendent of Financial Institutions Canada. The Bank of Nova Scotia is authorised by the UK Prudential Regulation Authority and is subject to regulation by the UK Financial Conduct Authority and limited regulation by the UK Prudential Regulation Authority. Details about the extent of The Bank of Nova Scotia's regulation by the UK Prudential Regulation Authority are available from us on request. Scotiabank Europe plc is authorised by the UK Prudential Regulation Authority and regulated by the UK Financial Conduct Authority and the UK Prudential Regulation Authority.

Scotiabank Inverlat, S.A., Scotia Inverlat Casa de Bolsa, S.A. de C.V., and Scotia Derivados, S.A. de C.V., are each authorized and regulated by the Mexican financial authorities.

Not all products and services are offered in all jurisdictions. Services described are available in jurisdictions where permitted by law.