US-China Trade Spat: Both Sides Dig in For a Fight

- **This past week marked a turning point in the trade battle between the US and China that implies that their conflict is going to remain a chronic feature of the global economy for the remainder of Pres. Trump's term in office.**

- **Tit-for-tat tariffs now threatened by Washington and Beijing would take US-China trade tension close to the full-out bilateral conflict that our modelling implies would slice about 0.5 ppts off US growth during 2019–20 and prompt an additional 25 bps rate cut from the Fed, for a total of 4 reductions in the fed funds target rate. Chances of a technical recession increase under this scenario compared with our current forecast baseline.**

AN EYE FOR AN EYE WILL LEAVE THE WHOLE WORLD BLIND

This past week's epic tit-for-tat escalation in the US-China trade conflict marked a major turning point in President Trump's trade battles with the US's major rivals and allies. We now expect that a chronic state of trade conflict will persist at least until the end of Pres. Trump's current term of office in early-2021. This increasingly negative outlook is driven by two major factors:

- **First, Pres. Trump's behaviour continues to become increasingly impulsive and unbound from existing norms.** At the same time, his advisors, the two major political parties, and Congress do not appear willing to use either their influence or their specific powers to constrain his behaviour; and

- **Second, Beijing has figured out how to play the US President very effectively and, as a result, the implied incentives are waning to pursue a negotiated settlement before the November 2020 US Presidential elections.** In the last few weeks, the Chinese have seen Pres. Trump blink on imposing tariffs he threatened on August 1 to impose on key consumer goods that dominate the Christmas season "just in case some of the tariffs would have an impact on US customers". Similarly, they've watched him browbeat the Fed to provide further monetary stimulus while he's also mulled additional fiscal stimulus through tax cuts—both implicit admissions that his economic policies aren't working. Every President knows that a combination of slowing growth and declining markets is the biggest obstacle to a second term. With the possibility that US manufacturing production is contracting for the first time since 2009, Pres. Trump is showing signs of panic.

At this point, forecasting an end-point to the US-China trade battle requires one to handicap whether China's leadership sees its interests best served by helping or hindering Pres. Trump's re-election. On the one hand, Beijing knows that Pres. Trump has a track record of reacting instantly and impulsively to Chinese actions, just as he did this week. In short, Chinas has weaponized Pres. Trump against the US economy—which could make his re-election more difficult and prospects for global growth weaker. On the other hand, Beijing may also see

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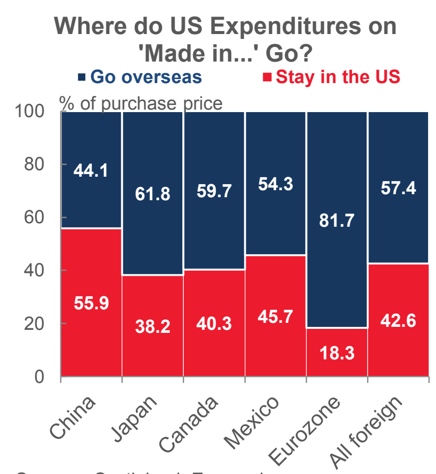
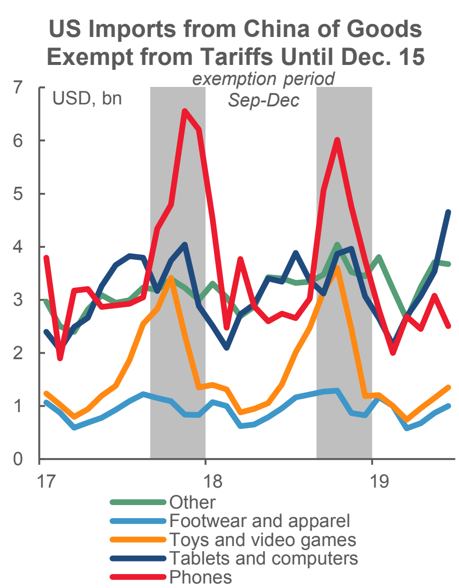
Chart 1



Sources: Scotiabank Economics, Federal Reserve Bank of San Francisco.

Chart 2



Sources: Scotiabank Economics, USITC.

its interests served by a US President who does not appear intent on preserving US strategic engagement in Asia and who provides an external threat against which the Chinese can unify. If this sense of Pres. Trump as a useful foil against internal opposition dominates Chinese thinking, there is a chance that a compromise on trade may emerge early enough in 2020 for the White House to claim a victory going into the November elections.

The remainder of this paper sums up and analyses the implications of tit-for-tat trade volleys between Washington, DC and Beijing over the last week.

CHINA'S PROMISED RETALIATION

Beijing's Ministry of Finance indicated on August 23 that its retaliation to Trump's early-August tariff threat would be rolled out in two parts:

1. **Restoration of the import tariffs on US auto parts and components** that have been stayed since December 2018; and

2. **New proposed additional tariffs on what are likely to be about USD 75 bn worth of goods imports from the US in 2019.** These additional tariffs would be implemented in two tranches as outlined in table 1:

    a. **Tranche 1 would take effect on September 1** and would add tariffs of 5% on soya beans and petroleum oil products, with tariffs of 10% on fish, fruit, meat, and some electrical goods; and

    b. **Tranche 2 would follow on December 15** with 5% tariffs on optical instruments and some machinery, while 10% tariffs on cereal grains and US vehicles would be imposed.

The weighted average of these new tariffs would be around 6.4%, which would raise the effective Chinese tariffs rate on US imports by 2.4 percentage points (ppts) to over 20%—well over the 16.2% that prevailed prior to China's WTO accession in 2001. The increase in tariffs on US goods would raise the overall effective Chinese tariff rate on global imports by about 1.1 ppts even as Beijing is lowering the effective tariff rates on imports from nearly all of its other large trading partners.

Beijing's announcement remains in line with China's previous responses to Pres. Trump's exceptional tariffs on imports from China in that it is relatively more modest in both absolute and proportional terms:

- The proposed weighted average 6.4% increase in Chinese tariffs comes in well below the 10% tariffs threatened by Pres. Trump on August 1;

- The total value of goods affected, at about USD 75 bn, is substantially lower than the USD 300 bn set to be hit by Trump's August tariff announcement owing to the fact that China imports from the US (around USD 120 bn) only about a fifth as much by value as the US imports from China (about USD 558 bn);

- Trump's August threat and China's retaliation affect nearly equal shares of their total imports from the other. The August Trump tariff threat would apply to about half of US imports from China, while Beijing's retaliation would similarly hit about half of China's imports from the US;

- This round of tit-for-tat, however, affects a substantially smaller of share (around 4%) of total Chinese goods imports from world than the share (about 12%) of US global goods imports set to be hit by Trump's August tariff threat.

Since the benefits from trade come from importing, China is shooting itself in the foot with a smaller bullet than the one Pres. Trump is inflicting on the US. Moreover, Pres. Trump is disrupting US's major trading relationship that, dollar for dollar, returns the biggest direct beneffit5s to the US. As chart 1 notes, the San Francisco Fed finds that over half of the value of every US dollar spent on imports from China stays in the US through, amongst other things, payments to retailers, distribution channels, and the owners of intellectual property.

TRUMP'S PANIC POINTS TO AN ALL-OUT BILATERAL BATTLE WITH CHINA

After Beijing's announcement, Pres. Trump upped the ante again on the afternoon of August 23 by first ordering via Twitter that American companies "immediately start looking for an alternative to China", a command for which the office of the President clearly lacks authority. That said, he could, under specific circumstances related to national security, attempt to block investment flows to China.

Pres. Trump announced through a series of tweets that even more tariffs would be imposed on US imports from China:

- The roughly USD 250 bn of US imports from China that have between June 2018 and May 2019 progressively had additional 25% tariffs imposed on them "will be taxed at 30%" from October 1, the 70th anniversary of the founding of the People's Republic of China; and
- The roughly USD 120 bn (i.e., 40% of USD 300 bn) of goods that were set to get tariffs of 10% from September 1 "will now be taxed at 15%". The roughly USD 180 bn in consumer goods that received a Christmas-shopping-season reprieve from these tariffs (grey areas in chart 2) will also get hit with a 15% tax from the previously delayed December 15 start date.

Once again, with this new announcement, Pres. Trump continues to flout US trade law that requires his office to provide a considered economic rationale, backed by evidence, for the scale and scope of tariffs he intends to apply.

MAKING AMERICA A PLANNED ECONOMY (AGAIN)

Altogether, Pres. Trump is imposing an enormous burden on US businesses and households that will take the American economy close to the all-out bilateral fight with China that we recently analyzed in line with earlier scenarios run with our colleagues on the Scotiabank Global Macroeconomic Model (SGMM). Under an all-out bilateral US-China trade fight, 25% US tariffs on all goods imports from China would directly weaken US GDP growth by a cumulative 0.5 ppts over 2019–20 and prompt an additional 25 bps cut by the Fed in 2020 compared with our prior baseline projection of 3 x 25 bps in cuts during 2019. While the US economy doesn't go into technical recession, growth is brought down to around 1.2% in 2020 and the chances of a technical recession increase. Pres. Trump's current tariff threats portend a future close to this scenario: his most recent tweets imply a weighted average tariff of 20% on all US imports from China from the beginning of 2020.

As we've previously noted, additional indirect effects from Pres. Trump's tariffs likely imply a more negative outcome than these scenarios project. The erratic and unpredictable nature of trade policy by tweet is and will continue to weigh on business activity by inhibiting major investments, purchases, and hiring. Moreover, the administrative burden inflicted on the thousands of companies still seeking exemptions from US steel and aluminum tariffs—in addition to the tariffs themselves—is also dampening growth as nearly all assessments of these metals tariffs imply that their deadweight costs far outweigh the value of any jobs they maintain or temporarily create.

WORSE BEFORE IT GETS BETTER

Given Pres. Trump's singular focus on the performance of US equities markets as the benchmark by which he judge's his administration's economic success, investors still have some room to influence his quixotic and self-defeating trade battle before it advances much further. Major US equity indices remain close to the levels in early-2018 when the White House launched its tariff plan. But market pressure can't undo the damage already inflicted on the US and global economy, and on international norms of conduct between national governments.

Proponents of the notion that Pres. Trump is deploying an elaborate "3-D strategy" with China may take heart from the fact that he was willing to declare as historic victories even mild revisions of US trade agreements with Korea, Mexico, and Canada. Perhaps Pres. Trump will find a similar excuse to declare victory in the coming months and walk back his tariffs on China, but he hasn't left himself much rhetorical room to do so, and he hasn't given himself enough time for the US economy to repair the damage he's inflicted ahead of the November 2020 elections.

For now, we expect Pres. Trump's dangerous trade obsession, and its effects on the US and global economies, to get worse before it gets better.

Table 1

China's Proposed Retaliation to Pres. Trump's August 1, 2019 Tariff Threat

Major Goods Classification	2018 Imports from US, USD bn	US Share in China Imports, % total	Proposed Additional Tariffs, %
Tranche 1: Tariffs that Take Effect on September 1, 2019			
Fish, fruits, and meat, etc.	2.4	11	10
Electrical machinery and equipment, meat, essential oils, etc.	1.6	5	10
Soya bean and dairy products, etc.	7.1	18	5
Petroleum oil, plastics, essential oils, chemicals, etc.	13.3	4	5
Total	**24.4**	**6**	**…**
Weighted Average of Proposed Additional Tariff Rates, %	**…**	**…**	**5.8**
Marginal Impact on Effective Tariff Rate on US & Global Imports, ppts	**0.79**	**0.35**	**…**
Tranche 2: Tariffs that Take Effect on December 15, 2019			
Major Goods Classification	**2018 Imports from US, USD bn**	**US Share in China Imports, % total**	**Proposed Additional Tariffs, %**
Cereals, plastics, etc.	3.5	4	10
Vehicles, optical & precision instruments, etc.	10.7	20	10
Optical & precision instruments, machinery, cotton, etc.	9.1	20	5
Optical & precision instrumenst, machinery, pulp, electrical equipment, etc.	18.5	10	5
Total	**41.8**	**11**	**…**
Weighted Average of Proposed Additional Tariff Rates, %	**…**	**…**	**6.7**
Marginal Impact on Effective Tariff Rate on US, Global Imports, ppts	**1.56**	**0.74**	**…**

Sources: Scotiabank Economics, Chinese Customs Service, Ministry of Finance.