# Q & A

WITH BAILARD'S SVP OF INTERNATIONAL EQUITIES

## U.S./China Trade: Tiff, Stand-off or War?

*Anthony Craddock, Senior Vice President, examines the state of trade relations between the U.S. and China.*

### *Where do the U.S. and China stand and how did we get here?*

Renegotiating trade deals and overhauling U.S. policy in order to protect American workers and industry was a central promise of Donald Trump's presidential campaign. In its first year, the Trump Administration was fairly quiet on this front before announcing tariffs early in the first quarter on imported solar panels, which mostly affects China. This was followed in March by hefty new tariffs on steel and aluminum imports, where temporary exemptions granted for most countries left the focus of this action also primarily on China. Early April brought a rapid acceleration of tensions, with competing announcements separated by hours rather than days. In response to the steel tariffs, China imposed tariffs on around $3 billion of U.S. imports, including pork and fruit products. The U.S. then targeted about $50 billion in Chinese electronics and machinery, a move designed to penalize China for its cavalier treatment of intellectual property. China immediately matched this with levies on roughly $50 billion of U.S. soybeans, autos and airplanes. The latest salvo was a presidential order to consider an additional $100 billion of Chinese products for possible tariffs.

### *So this is a trade war, right?*

Events have been moving quickly but, for now, there are reasons to hope that the escalating "tit-for-tat" tariff announcements will end up sounding like the opening fanfare for a round of bilateral trade negotiations. The $50 billion in tariffs proposed by the U.S. came with a comment period before they go into effect; statements from the U.S. Commerce Secretary and others have suggested the Trump Administration is willing to deal. China's selection of products—intentionally targeting soybeans and other goods from predominantly Republican states—may increase the momentum for negotiation, rather than war, in the run-up to U.S. midterm elections.

### *What's our problem with China anyway?*

The U.S. does have several legitimate grievances. American firms wanting to operate in China are often required to share proprietary technology with Chinese partners. The relatively lax enforcement of intellectual property rights law makes it easy for the technology to then be used or copied outside of the original partnership. China could also do more to lower its tariffs on imports from the U.S. and relax non-tariff barriers, including financial sector regulations that make it difficult for foreign banks and insurers to establish themselves in China. Additionally, the U.S. trade deficit with China is an eye-popping number: $375 billion in 2017, the highest level on record. Free trade skeptics in the Administration consider the large, persistent deficit to be clear evidence of unfair Chinese trade

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practices and an illustration of the damage done by globalization to American manufacturing prowess.

*What's wrong with fighting back then?*

Tariffs are the bluntest of blunt instruments when it comes to addressing a trade imbalance or "leveling the playing field." If tariffs succeed in causing a drop in imports from China, reciprocal tariffs will likely make U.S. exports to China fall as well. A series of tariff impositions can therefore leave the trade balance largely unaffected while managing only to reduce overall trade flows. Further, a reduction in imports from China would do collateral damage to other countries, such as Japan and Taiwan (not to mention the U.S.), that manufacture components for products ultimately assembled in China and exported from there.

Meanwhile, costlier imports reduce the purchasing power of American consumers and the profitability of businesses that use those products. Raising the price of imported solar panels might give relief to domestic manufacturers but it will also hurt the many American installers. The negative impact of one particular action may be considered minor in terms of incremental cost relative to GDP, but successive escalations create heightened uncertainty for business decision-making and add extra volatility to the financial markets.

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*But didn't I hear somewhere that trade wars are good and easy to win?*

We believe a full-blown trade war with China would impair growth in the world's two largest economies, disrupt global supply and distribution chains and raise prices for consumers worldwide. Tariffs declared in the midst of heated battle could influence investment and employment decisions, with impacts stretching over years and decades. It's true that the U.S. is more geared to domestic demand and less dependent on trade than many nations including China, so the Chinese could indeed have "more to lose" in a trade war than the U.S. On the other hand, the lack of any lines of accountability from the Chinese government to its people means that China can probably tolerate greater economic pain in the service of its strategic trade goals. Ultimately, the fact that "winning" a trade war means, at best, causing less harm to your own country than to another tells you that it's better not to fight in this way at all than to win.

*Stopping short of a war, how do we fix the trade deficit?*

First of all, it's unhelpful to view exporting more than you import as "winning" in trade and the reverse as "losing." Benefitting from trade is not really a matter of selling more to your trading partners than they sell to you. Rather, the gains from trade are the production efficiencies and lower prices that come from specialization. It is not mutually exclusive and both the net exporter and the net importer can be better off. Globally-competitive exports are nice to have, of course, but the production side is only one half of the economic story. A country in surplus—providing goods and services in high demand by other nations—might also be one whose citizens are too eager to save and too reluctant to spend, where domestic demand is insufficient to utilize the country's full productive capacity. A country in deficit, conversely, might be one where aggregate demand outstrips the country's capacity to efficiently supply it through domestic means alone, whose citizens are borrowing rather than saving, spending freely and enjoying well-priced, competitive goods from abroad.

*So, forget the trade deficit?*

There are good reasons to pursue a fresh set of trade negotiations with China (if that's what we're doing) as well as remedies through the World Trade Organization (which we are definitely doing), but to fixate on the trade deficit seems a bit masochistic. The U.S. has run a deficit with the rest of the world in every year since 1976, through expansions and recessions, through Democratic and Republican administrations, cumulatively totaling well over $10 trillion. If this is a chronic illness, it is taking a long time for the patient to die.

Balance of payments arithmetic ensures that the extra dollars sent abroad for all those imports eventually get recycled back into the U.S. as investments: in property, factories and financial assets including, crucially, Treasury bills. In the case of China, there is a fear that the country will someday decide to curtail its purchases of U.S. government debt. Since U.S. Treasuries represent both the safest possible investment vehicle for China's excess dollars and the mechanism by which China helps us finance the purchase of their exports in the first place, it's not clear what they would choose as a large-scale, long-term substitute. The past 30 years

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have seen the economic ties of the two countries evolve into a state of deep inter-dependency, which brings benefits to both and which will almost certainly outlast the current kerfuffle.

After all, trade may be managed but it is not coerced. Aggregate flows are the result of individual, self-interested buyers (more American than Chinese) and sellers (more Chinese than American) who have all spotted what they believe to be a good deal. America first, sure… but we're all in this together.

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Since 1978, we've held a weekly company-wide meeting during which we talk about the prior week's activities and those anticipated in the week to come. We refer to this meeting, which begins just after nine each Monday morning, as "the 9:05." Just as the 9:05 meeting enables us to share our knowledge and insights with each other, this newsletter provides us with a valuable means of communicating with our clients. Hence its title: *the 9:05*.

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