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China Economic Watch

What will be China's weapons in the trade war arsenal?

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Trade war between China and the US escalated recently

The trade war of China and the US finally exploded on July 6th when the US imposed 25% tariff on China's imports with the total target of USD 34 billion and China retaliated back with the same tariff rate on the same amount of the US imports.

Right after Chinese announcement, Trump threatened to impose another 10% on China's USD 200 billion goods immediately, which marks the escalation of the trade war between China and the US. Apparently, it has made it impossible for China to implement a similar retaliatory tariff measure since China's total exports to the US only amounted to USD 150 billion last year. To a certain extent, the Trump's move is drawing a new deadline for China and the US to reach an agreement in the near future.

How will China fight back in the trade war?

Except for the retaliatory tariff measure, China actually has many other weapons in the arsenal to fight back. Below we list a number of policy options for China to fight back the US tariff measures. We then assess their feasibility as well as pros-and-cons to Chinese economy.

(i) Retaliatory tariff measures

This "mirror" retaliatory tariff strategy has its natural limitation since US imports much more from China than its exports to China. In 2017 the US imported Chinese goods of USD 500 billion while only exported USD155 billion of US goods to China. As Trump decided to expand its punitive tariff to USD 200 billion of Chinese exports as he threatened, it is impossible for China to find the same amount of US imports for retaliatory tariff. (Chart 1)

(ii) Restrictions on US business in China

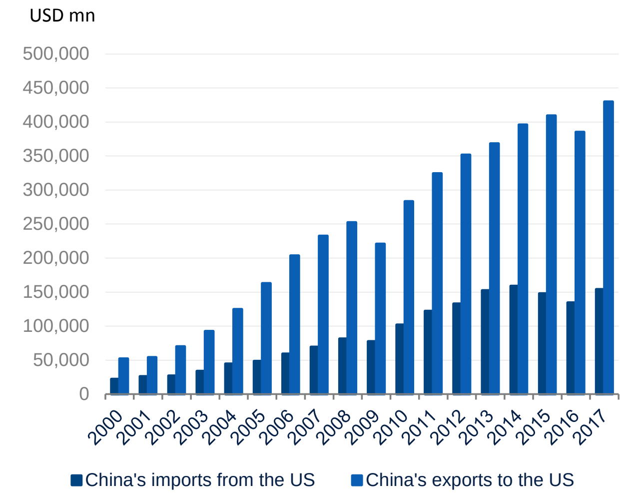
China could use some non-tariff measures to retaliate as well. Some people suggest that China could limit investment or market access of US firms in China. Indeed, US firms have a large presence in China. Some estimates show that the stock of US investment in China amounted to USD 256 billion as of 2017. (Chart 2) China could seek to punish these US firms in China for retaliation.

In this respect, the retaliatory measures could include: (i) to conduct more inspections on the US firms in China; (ii) to put restrictions on Chinese firms which are on the supply chain of these US firms; (iii) to increase penalties for US firms in China and delay their licensing approvals. Actually, China used these measures in the past when its territorial dispute with South Korea and Japan became acute.

However, these measures also have strong side effects on Chinese economy. First of all, one important goal of Trump's administration is to move US companies overseas back to the US. Therefore, by harassing US firms

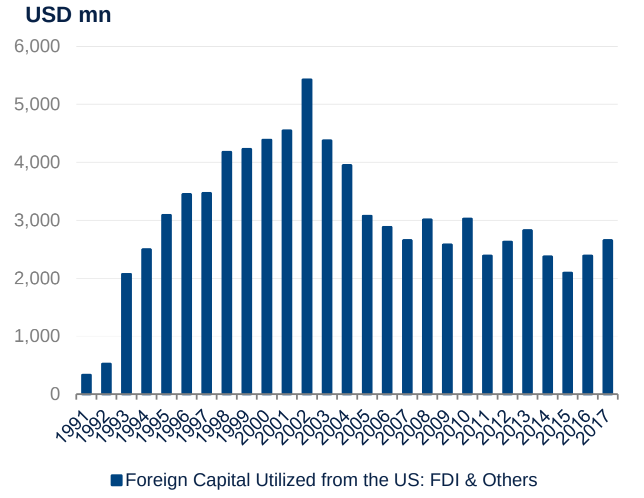
China's authorities are indeed doing a favor to the Trump administration to expedite the departure of these US firms. Second, these retaliatory measures could create a bad impression for investors from other countries and reduce the attractiveness of China as a FDI destination.

Chart 1 China's exports to the US have been higher than the imports from the US in the past decades



Source: BBVA Research and CEIC

Chart 2 The volume of US FDI in China is large



Source: BBVA Research and CEIC

(iii) "Anyone but the US"

Recently, China's National Development and Reform Commission (NDRC) announced the 2018 "negative list" for foreign investment. Compared to its 2017 version, the new negative list features a significant reduction in the restrictions of foreign investment. In particular, China's authorities dropped many restrictions of foreign investment in a number of sectors including finance, automotive and aviation etc.

This opening-up measure can also create certain policy room for China to retaliate the US tariff measures. For example, China's authorities can intentionally prolong the approval process of US enterprises' applications to enter these newly opened industries while give certain fast track to firms from other trade partners. This method will give certain disadvantage to the US firms but won't hurt them immediately.

(iv)Targeting service trade such as education and tourism

It is noted that the US has a surplus of USD 39 billion against China under the service trade, more than half of which comes from spending by Chinese tourists and Chinese students attending American schools and colleges. (Chart 3 and 4)

China could target this service trade deficit and put more restrictions to control the number of Chinese tourists to the US. Indeed China has a recent track record of using it as an economic weapon. For instance, China's authorities forbid domestic travel agencies to organize tourist groups to the South Korea in 2017 when the two countries' relation turned sour.

However, we expect the impact of this measure could be limited since the US tourism industry is not that susceptible to Chinese tourists as the South Korea. Moreover, now the Trump administration deliberately tightens the visa issuance to Chinese students and researchers for so-called national security reason. It is hard to tell to what extent these measures could hurt the US.

Chart 3 China's service trade balance has been deficit over time

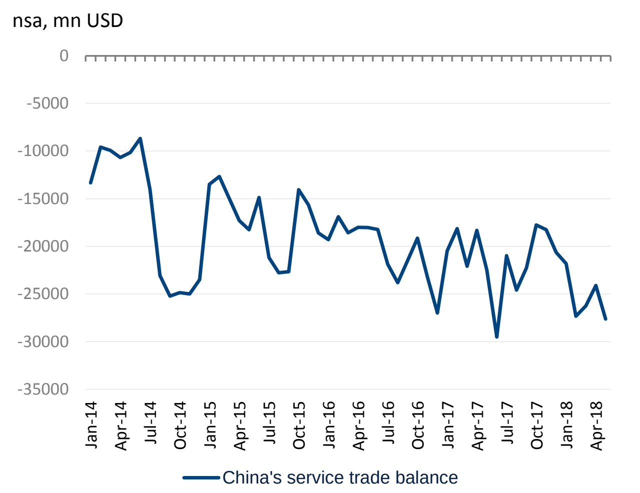


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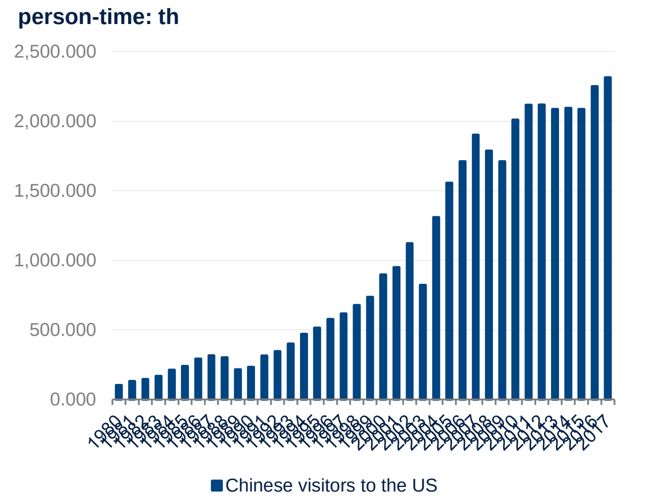
Chart 4 Chinese visitors to the US has been increasing over time



Source: BBVA Research and CEIC

(v) Cooperating with other countries in trade and international investment

Now China is trying to ally with the EU and Japan to fight against the US. Unfortunately, the EU seems to be not interested in it. As some EU officials revealed, they have rejected China's demand to publish an anti-US joint statement in the forthcoming Sino-European Summit. According to the media report, the EU is sharing almost every US concern with China although they don't agree to US practice of unilaterally imposing tariff.

At the same time, China actively pushes for the signing of free trade agreement (FTA) and bilateral investment treaty (BIT) with EU and Japan. It is also pushing for the signing of Regional Comprehensive Economic Partnership (ASEAN 10+ China, Japan, South Korea, India, Australian, New Zealand). These initiatives are aimed to offset the shock from the trade war. From our perspective, they also provide China a way to end this trade war with the US gracefully.

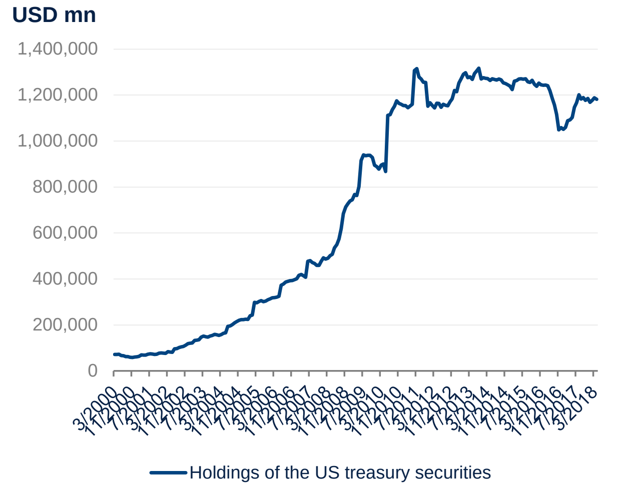
Indeed, US major complaints against China in essence are the market-access issues. For example, the US claimed "forced technique transfer" usually happened in the joint venture between China's local companies and multinational companies. The root reason is that China's government didn't fully open some sectors to foreign investors but only permit joint-ventures with local companies. As such, many local companies ask for technique transfer as one of premises to cooperate with foreign investors. Such a problem can easily be solved when China directly open these sectors to foreign investors and permit them to establish branches or control the major stake in the joint venture.

That being said, if China can manage to sign FTAs and BITs with the EU and Japan, the market-access issues between China and the US will become much easier to solve, which can also lay a good ground for solving other differences between them. Thus, this should be the right way to end this trade war with the least cost.

(vi) Dumping US treasury bonds

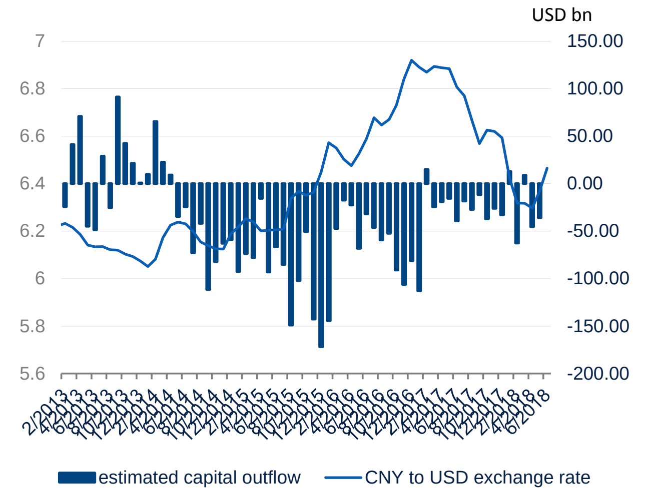
China is the biggest creditor of the United States: It owns more US government bonds than any other country, with the total amount around US 1.17 trillion as disclosed by US department of the treasury. We believe that the real figure could be higher than it as China's government also holds US treasury bonds through certain special purpose vehicles (SPVs). (Chart 5)

Chart 5 China holds a large amount of US treasury securities



Source: BBVA Research and CEIC

Chart 6 Significant RMB to USD depreciation in the recent months, leading to capital outflows



Source: BBVA Research and CEIC

Investors worry that if China could dump its holding of US treasury bonds to retaliate for US tariff measures against China. Although this action looks very powerful at the first glance, it might be not effective in practice.

As a response the Federal Reserve can signal a slowdown of rate hikes and change its pace of balance sheet reduction, which can help to cushion the shocks from China's short selling. Moreover, the US government could even cite national security laws to freeze China's holding of US treasury bonds if they believe that China's dumping behaviors aim to disrupt US financial market.

All in all, we believe that Chinese authorities will take a cool-headed approach and are unlikely to take extreme steps such as dumping US Treasury bonds.

(vii) Guiding RMB depreciation

The recent sharp depreciation of the RMB makes the market suspect whether China will use the RMB depreciation to retaliate the US. (Chart 6) We cannot agree to this point because the side effect of this currency weapon is too unpredictable.

As we witnessed in 2015-2016, a sharp currency depreciation could lead to large-scale capital outflows and pose material threats to the financial stability. There is no point for the authorities to risk financial stability in hitting back US tariff measures.

Indeed, the PBoC's intervention into the FX market early this week has confirmed our prediction. Although the authorities are willing to allow the market to play an important role in pricing the currency, they will be very cautious to avert any risk of creating an adverse spiral between currency depreciation and capital flight. That being said, although the RMB exchange rate is expected to maintain a weak trend in the coming months due to the trade war, the authorities will ensure that the pace of depreciate is not too steep.

Conclusion

After reviewing a number of methods which China could use in the escalating trade dispute with the US, we find that China's policy options to counter the US tariff measures are actually limited. We expect that the authorities will implement the methods from (i) to (v) but are unlikely to resort to method (vi) and (vii), namely dumping US treasury bonds and guiding currency depreciation.

More importantly, with time going, these retaliatory measures tend to have increasingly negative impact on China itself. For the positive side, the reality could make China actively seek for a solution through bilateral negotiation rather than escalating confrontation with the US. We expect that the two sides will restart the negotiation soon after the initial stage of the trade-war.

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