Global Economy

What weapons does China have in the trade war?

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The trade war between China and the USA finally broke out on 6 July, when the US imposed 25% tariffs on US$34 billion worth of imports from China, to which China responded by applying the same tariff to the value of imports from the US. Subsequently, Trump threatened to apply additional tariffs to all imports from China, close to US$500 billion worth, to which China would not be able to respond, simply because its total imports from the US only amount to some US$150 billion. However, China may consider reprisals beyond imports, although some of the possible measures might have secondary effects on its own economy.

(i) Restrictions on US companies in China.

US companies' investment in China amounted to US$256 billion in 2017. The authorities could slow down the business activity of US companies simply by intensifying inspections, delaying licences, imposing fines or even restricting shareholdings in Chinese companies in global value chains. However, such measures could make China less attractive as a destination for foreign direct investment.

(ii) Restrictions on trade in services, such as education and tourism.

The US has a surplus of US$39 billion in services, more than half of which relates to spending by Chinese tourists and students in the US. China could impose more restrictions with a view to controlling the number of tourists visiting the US. However, the effect of this measure would be limited, since China's weight in the US tourist sector is not great.

(iii) Greater cooperation with other countries in the fields of international trade and investment.

China is actively pushing for the signing of free trade agreements (FTAs) and bilateral investment treaties (BITs) with the EU and Japan, as well as a Regional Comprehensive Economic Partnership (RCEP) with ASEAN (the Association of South-East Asian Nations), among others. These initiatives are aimed at offsetting the repercussions of the trade war, as well as offering a path for China to be able to strengthen its negotiating position.

(iv) Sale of US Treasury bonds

China is the US' biggest creditor, since it holds Treasury bonds for a total value of close to US$1.17 trillion. Although this measure seems a potent one at first sight, it might not prove so effective in practice, not least because of the resulting devaluation of the collateral in China's balance sheet. Moreover, in response, the Federal Reserve could announce a slowdown in its rate hikes, which would contribute to cushioning the impact of China's sell-off. Also, the US could even invoke its legislation on national security to freeze the holding of its Treasury bonds by China if it considered that China were seeking to disrupt the US financial market.

(v) Devaluation of the renminbi.

The recent devaluation of the renminbi leads the market to suspect that China could resort to this measure in retaliation against the US. This option does not seem practicable to us, because the collateral effects of such a strategy are absolutely unpredictable. As we saw in 2015-2016, a sharp currency depreciation can lead to large-scale capital flight and pose a serious threat to China's financial stability. Therefore, the People's Bank of China will take great care to avoid any risk of creating an adverse spiral between currency depreciation and capital flight.

In conclusion, having analysed the various instruments that China could use in its heated trade dispute with the US, we consider that its options for countering the US tariffs are limited. On the positive side, reality might lead China to actively seek a solution through bilateral negotiations instead of intensifying its confrontation with the US. We hope the two sides will soon resume negotiations after this initial phase of trade war.

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