USA and China: the new rules of the game

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Diario Expansión (Spain)

Tensions between the USA and China have been rising since Donald Trump was elected president in November of last year. During his election campaign, Trump accused China of manipulating its exchange rate, threatening to introduce trade tariffs of 45% on imports from Asian industrial power. In addition, Trump also hinted that his Administration would be willing to change the status quo that currently governs the relationship between China and theUS. It is not surprising therefore that the relations between China and theUS are not at their best. However, after a long telephone conversation with the Chinese president last week, Trump announced in a conciliatory tone that theUS is committed to maintaining the One China policy. This represents a complete U-turn from his prevailing discourse to date. Does this mean that Xi Jinping has inflicted a diplomatic defeat on Donald Trump, or that the latter is willing to subordinate his political messages to economic interests?

A more positive reading is that this shift reflects an Administration that is inexperienced but willing to learn from its mistakes. So far, Trump has opted for an approach of bilateral confrontation to correct the gap in the US trade balance. China is among the countries that have a trade surplus with the US,along with Japan, Germany, Canada and Mexico, so it is not wholly surprising that China has been criticised. However, the measures proposed by Trump would not achieve the desired effects for three reasons.

In the first of these, China intervenes in the currency market to prevent a steeper fall in its currency. Ironically, the lower the intervention, the greater the depreciation, which works against Trump's trade agenda. The proposal to introduce trade tariffs comes from Peter Navarro, who now leads the National Trade Council, and is based on a note by the Peterson Institute in 2010. However, the yuan has appreciated significantly in real terms since then, and although the valuation of a currency has high ranges of uncertainty, currently both the Peterson Institute and the IMF consider that the yuan is not undervalued.

Secondly, tariffs impede trade, entail negative consequences for growth and are subject to WTO scrutiny. The tariff data themselves suggest that tariff levels of 45%, not seen since the 1980s, would be unlikely, given that China could take the dispute to the WTO and win. Moreover, tariffs break the global value chains, which many of the US multinationals to which Trump is subject depend on. China could use them as an excuse to implement retaliatory measures, including on US companies operating in China. In addition, the Asian giant has made considerable progress with its economic restructuring, so that exports constitute only 20% of its current GDP, with investment and domestic consumption being much more significant. A decline in exports will therefore have less impact on the economy than it would have had a few years ago. According to our calculations, the isolated effect of tariffs on products where China has a trade deficit with the USwould only mean a drop in overall exports of around 5-10%. This excludes all the side effects, such as economic retaliation or the collapse of value chains, with the final bias being much greater. In other words, the trade tariffs hurt the US as much as China, which means they would be, from the economic rational point of view, absurd.

Lastly, the current legal framework allows the USto impose punitive measures, for example in the case of imports of Chinese steel. The most likely scenario is that Trump would introduce a border tax adjustment of 5%, while adopting parallel measures against individual sectors or Chinese companies under the pretext that there are unfair subsidies in place.

We are not therefore witnessing a trade war, but we will be seeing occasional increases in the friction between the two countries, which will nevertheless be manageable within a stable geopolitical framework.

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