

# Causes and Consequences of the Escalating Trade War between the US and China

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*[Abstract: More than the US-China trade imbalance of \$375 billion, the US is more concerned with the Made in China 2025 programme of China, which is perceived to challenge the primacy of the US in the high technology domain. The US would wish China to dismantle MIC 2025 to which China is dismissive as it considers it a strategy to overcome its middle income trap. Further, it considers Made in China 2025 as a normal strategy which has been followed by countries like Japan and South Korea and even by the US during the early years of its development. Trump's tariffs have been designed to impact the MIC 2025 programme. Trump's strategy is unlikely to succeed, and may instead undermine US's manufacturing. China's exports to the US in 2017 were worth \$505 billion while imports were worth \$130. So it can retaliate against the US tariffs up to a point on dollar-for-dollar basis. If the tariffs are sought to be imposed beyond \$130 billion worth of exports, it will respond in quantitative and qualitative terms. It can consider certain other measures like selling its treasury bills, devaluing its currency to make life harder for the US companies, or isolating the US in international trade. China has targeted agricultural exports from the US which has led to a protest by farmers who are key part of Trump's rural political base. In case the China-US trade war persists, India will be impacted in trade, economy and geopolitical areas. There would be both threat and opportunity for India.]*

The current US-China trade conflict concerns two major sets of issues. The first is the US-China trade imbalance—a record \$375 billion US trade deficit in goods in 2017 which is perceived to be because of the lack of reciprocity in terms of tariffs, market access and investment. China has already offered some concessions in this area such as opening up particular service sectors, lowering investment restrictions, and offering to buy more American agricultural and energy products; and, such concessions can be made to align with China's overall economic reform agenda.<sup>1</sup>

The problem is that there is a second set of issues which concerns technology transfer and high-tech industrial policy, i.e. the Made in China (MIC) 2025 initiative.

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<sup>1</sup> Stewart, E. (2018), "Can the US-China Trade War be Stopped? 11 Experts Weigh in," *Vox*, July 08.

The US has demanded that the Chinese government abandon the plan altogether or face punitive tariffs. The US government believes that the state-led financing associated with MIC 2025 will enable Chinese companies to unfairly compete and dominate over strategic industries, especially food, fuel, medicine, and semiconductors (where US companies are presently global leaders). China, on the other side, views it as critical to its plan to transform the country into a high-tech power. On this second set of issues, there is no compromise in sight so far.<sup>2,3</sup>

Made in China 2025 is a strategy that aims to upgrade China's industrial sector by shifting the country's economy to higher value-added manufacturing sectors such as robotics, aerospace, and energy-saving vehicles. The stated objective of this programme, released in 2015, is for China to become a major competitor in advanced manufacturing, a sector dominated by high-income, developed countries such as the US. Until now China has relied on manufacturing and exporting basic consumer goods like clothing, shoes and consumer electronics to drive the country's growth. In these lower-value, low-wage sectors, China mainly competes with other developing countries like Mexico, Brazil, South Africa, India, Vietnam and Taiwan. But to escape the middle-income trap, China will have to move towards high-tech industries and that is where the MIC strategy comes in. This programme involves government subsidies, heavy investments in research and innovation, and targets for local manufacturing content. It also builds on earlier government policies that encouraged or required foreign companies seeking access to the Chinese market to enter into joint ventures with, and transfer technology to, domestic firms. Trump argues that MIC 2025, with the support of state funding, puts the US companies at an unfair disadvantage. However, these policies are not unique to China—these are standard tools for developing countries wishing to catch up with the richer, industrialised West. Japan, South Korea, Taiwan, Hong Kong, and Singapore used similar policies to foster economic growth and raise incomes. From the Chinese perspective, the proposition is straightforward. If foreign multinationals are going to reap profits from producing and

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<sup>2</sup> Institute for Security & Development Policy (2018), *Made in China 2025 – Backgrounder*, June.

<sup>3</sup> Hopewell, K. (2018), "What is 'Made in China 2025' – And Why Is It a Threat to Trump's Trade Goals?" *The Washington Post*, May 03.

selling goods in the large Chinese market, it should be able to take advantage of such investment to aid its own development. Even advanced industrialised states, including the US, relied on state intervention and protectionist policies during their own stages of economic development.

Though China has now become a major economic power, it continues to be a developing nation with a per capita income of just \$8000 compared to \$56000 of the US. Though China has achieved success in fostering economic development and reducing poverty, it faces challenges in boosting incomes to anywhere close to the level of advanced economies. China's continued economic development will bring it increasingly into direct competition with the United States, which is why Trump has explicitly stated that the proposed US tariffs are designed to impede the MIC 2025 programme. However, this strategy is unlikely to be effective; rather, it may undermine US manufacturing instead of boosting it. Currently, the US imports only limited high-tech products from China; however, over half of its imports are intermediates that are used to manufacture high-tech goods in the US which are then exported to China and other countries. The 25 per cent tariff on "high-tech" imports from China will harm the competitiveness of US's high-end manufacturers across various sectors. Retaliatory tariffs imposed by China on American goods would expose them to the double-whammy of increased costs alongside reduced access to the Chinese market—the largest market for many of US's exports.

Tariffs are unlikely to significantly disrupt China's industrial development and/or its MIC 2025 programme as China is not critically dependent on the US market, which accounts for just 18 per cent of China's exports. High-tech products developed through the MIC 2025 initiative will rely in the first instance on sales to the country's enormous domestic market and much later seek to compete in advanced economies. Thus, even if access to the US market is cut off, it would not hamper the development of China's advanced industries. Trump's tariffs may not be able to achieve their stated

goals; however, the trade war between the two countries has the potential of damaging the global economy.<sup>4</sup>

The total value of goods imported from China into the US in 2017 was \$505 billion and goods exported to China from the US were worth \$130 billion. On June 15, 2018, when the US announced that it was to impose tariff on US \$50 billion worth of Chinese products, China immediately issued a statement announcing its retaliatory measures, with a detailed list of US products that Beijing would target for additional import duties. When Trump announced tariffs on another US\$200 billion of goods, Beijing responded that it would adopt quantitative and qualitative countermeasures without providing specifics.

As China only imports \$130 billion worth of US goods, there is no way it can match the US's tariff threat of dollar-for-dollar. On July 20, 2018, in an interview Trump announced that he was ready to take a more aggressive approach by imposing tariffs on the entire import of goods from China. China chose not to respond immediately.<sup>5</sup>

If China cannot do tit-for-tat tariffs any more, there are four possible ways to hit back at the US.

1. **Stop buying US Treasury:** China is one of the largest holders of US Treasury, owning about \$1 trillion bonds in 2017. It could decide to sell off its holding or stop buying new US bonds, thus impacting the US economy. China, however, would not choose this option as it would make its own holdings lose value.
2. **Devaluing the Yuan:** Devaluing the Yuan is the most effective way to offset the impact of tariffs.
3. **Make life harder for American companies:** The Chinese government has a lot of sway over its people, who may be encouraged not to travel to the US for tourism purposes and also to quit buying American goods. Further, the

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<sup>4</sup> Leng, S. (2018), "Why is Beijing Unusually Muted since Donald Trump's Latest US\$500 Billion Trade War Threat?" *South China Morning Post*, July 22.

<sup>5</sup> Borzykowski, B. (2018), "4 Powerful Weapons China has in its Arsenal to Win the US-China Trade War," *Yahoo Finance*, July 20.

processes can be towards slowing down cash transfers and increase the regulatory burden on American Companies.

4. **Isolate the US:** Already, China is courting Europe and there are talks between Canada and China. China could work out arrangements with countries of the Trans-Pacific and reduce or eliminate tariffs among them.<sup>6</sup>

In fact there are indications that the trade war that the US started will profoundly reshape the global economy. Impetus is being built up for the EU and Asia to speed up the opening of their markets to forge closer economic ties as it would lead to even faster growth than in the last decade in trade between the EU and Asia, accompanied by rising investment. Outside the US, a new sense of urgency is afoot to fast-track regional free trade agreements. As soon as Trump pulled out of the Trans-Pacific Partnership, a fresh agreement was signed by countries on both sides of the Pacific. Within Asia, China and Japan are seeking to mend fences. A direct consequence of the Trump trade war thus is a faster and wider economic integration outside of the US, accelerating the shift of global economic centre of gravity toward Asia. As Europe and Asia forge closer economic ties, their tariffs against each other's export will come down and business operations in these countries would become more efficient, innovative and dynamic. The network of global supply chains that has revolutionised the nature of trade and investment since the 1980s will expand and become more productive and more densely intertwined across Europe and Asia while withering in the US. While 326 million American consumers are increasingly 'protected' by Trump's tariff wall, over four billion consumers in Europe and Asia will thrive and enjoy more, better and cheaper products and services provided by competitive and creating businesses.<sup>7</sup>

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<sup>6</sup> Hedrick-Wong, Y. (2018), "How the U.S.-China Trade War will Transform the Global Economy," *Forbes*, July 13.

<sup>7</sup> Partington, R. (2018), "IMF Warns Trump Trade War Could Cost Global Economy \$430 Billion," *The Guardian*, July 16.

The IMF, in its *World Economic Outlook* report of July 2018, warned that the Trump trade war could cost the global economy \$430 billion and that the US could be ‘focus of global retaliation’ in tariff dispute. The current threats made by the US and its trading partners risked lowering global growth by as much as 0.5% by 2020, or about \$430 billion in lost GDP worldwide.<sup>8</sup>

The Chinese have been clever in targeting products such as soybean that impact American farmers, thereby adversely affecting Trump’s base in the US heartland. Similarly, Trump’s tariffs have carefully refrained from impacting US consumer goods (at least until July 6, 2018) to minimise the impact on the public. It would be a bigger problem for the US if the impact is perceptible as it would play out in full public view, unlike China who can tightly control the discourse. For example, a study of the US tariffs on imports that came into effect in January 2018 (washing machines and solar panels) and March–June 2018 (steel and aluminium) show that 16 US jobs will be lost for every steel or aluminum producing job gained, totaling over 400,000 net lost jobs. The consequence has been that there is split between US companies and workers in two camps: those who make the metals and gain tariff protection, and those who must buy the metals and pay higher prices.<sup>9</sup>

In case of persistent and long drawn trade war between the US and China, India will be impacted in three areas: trade, economy and geopolitics.

**Trade:** In the short to medium term, there are opportunities for India. India will benefit as levies are slapped by China on products like soybean originating from the US while these have been brought down to zero per cent for import from India, South Korea, Bangladesh, Laos, and Sri Lanka. China sourced as high as 36,148,312 tons of soybean in 2016–17 from the US, which has now dropped to almost zero. This presents a huge opportunity for India. Similarly, if Chinese

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<sup>8</sup> Behsudi, A. (2018), “Farm Groups Go On Anti-tariff Blitz after Trump Offers Trade Aid,” *Politico*, July 26.

<sup>9</sup> Talukdar, S. (2018), “US-China Trade War: India May Make Geopolitical Realignments, But Economy May Suffer Hammer Blow,” *Firstpost*, July 06.

exports to the US slow down, India may gain some traction in the supply of garments, and gems and jewellery.

**Economy:** Within the US domestic economy, higher tariffs on a range of imported products escalate the threat of higher consumer prices; this could force the Federal Reserve to increase the interest rates faster than it would have done otherwise. In that case, the Rupee, which is already under strain, may come under further stress and some even estimate that it may touch as low as Rs 72–80 to a dollar within 2019.

**Geopolitics:** China will seek alliance with India as the US-China trade war escalates. Likewise, India may also be willing as it is also on the wrong end of Trump's stick in trade deals. Further, India may seek to reduce its own imbalance in trade vis-à-vis China. There have already been some reconciliatory moves from China on the Indo-China trade front. India has also reciprocated.<sup>10</sup>

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<sup>10</sup> *Ibid.*