Mapping the Unfolding US-China Trade War

JULY 12, 2018

RAMSEN BETFARHAD
BOB PRINCE
OLIVIA GONG
CONNOR O'STEEN

BRIDGEWATER

As various announcements and actions by the US and China pertaining to tariffs and trade come forth, they of course have direct implications, but to a significant extent each action is intended to achieve some higher-level purpose. In some cases the goal is more clearly evident, and in other cases it sits deeper in the background. In order to more clearly understand what is going on and to anticipate how things might play out, below we have mapped out what we see as each side's key overarching goals, connected the various actions taken to them, noted their interconnections, and recognized other factors at play.

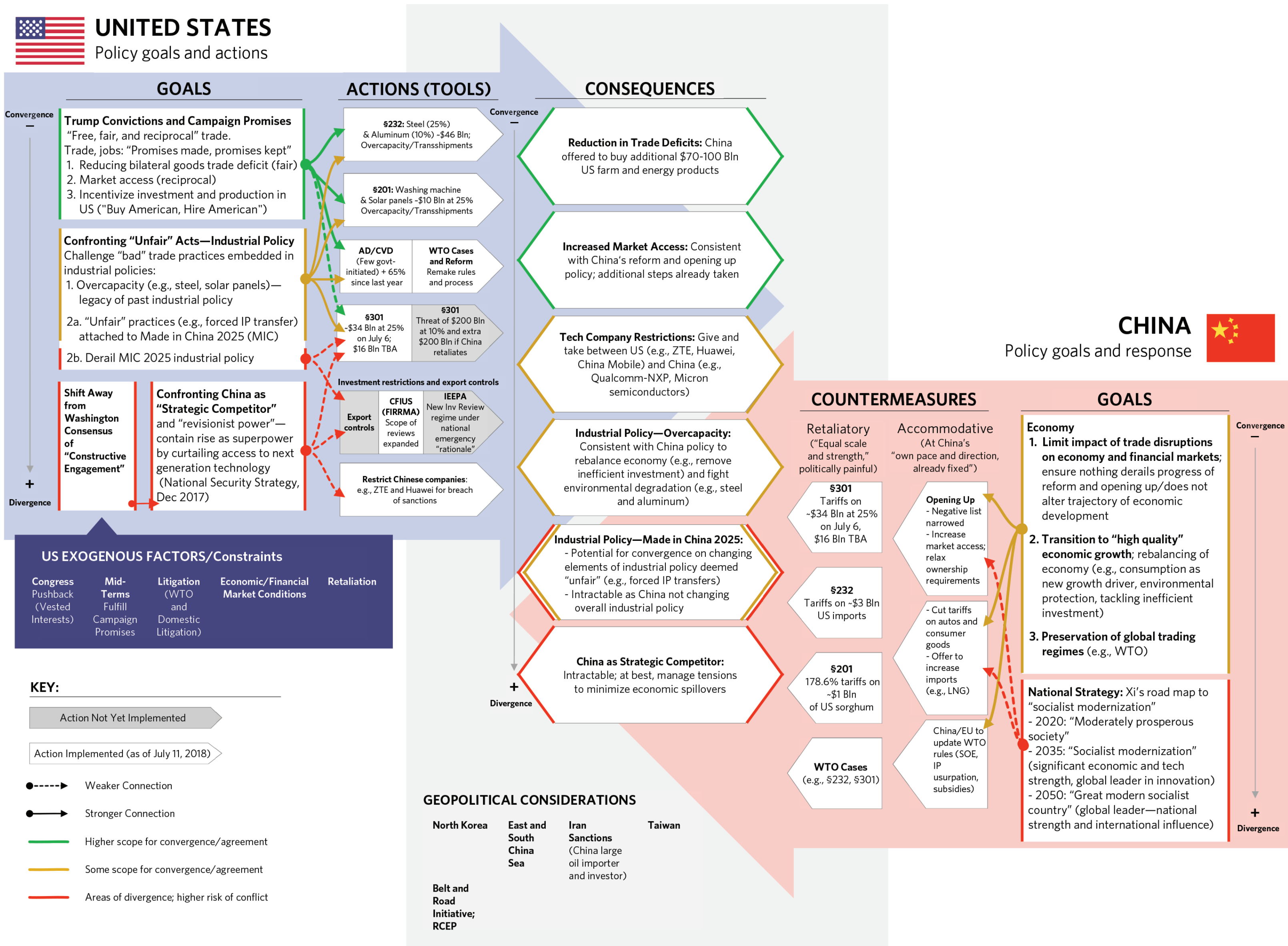
Where each side's goals overlap, favorable resolution is more likely. Where goals are at odds, escalating conflict is more likely. Overlaying the US goals onto the China goals, you see more pragmatic overlap in the near term and more strategic conflict farther out. We've also connected the actions to the consequences that they are likely to have. With respect to the markets, where bad outcomes are already discounted but the goals are aligned, odds are better that the discounting will reverse in time; where the goals are at odds, a worsening must be considered a likely outcome.

The goals of the Trump administration, as the provocateur, anchor the framework. China's responses are similarly connected to its stated policy goals. The juxtaposition of the two countries' respective goals and motivations, in turn, elicits a better assessment of areas of convergence (lower risk of confrontation) and divergence (higher risk of confrontation), and the space in between.

We also note other "exogenous" factors that color the bilateral trade relation, to varying degrees, for a fuller understanding of the dynamics at play. The goals are susceptible to the push and pull of these exogenous factors—increasing or decreasing the conviction toward the goal. For example, the coming US midterm elections may have enhanced the rigidity of the US stance, while over time, countervailing tariffs and other measures pressuring US industry—key among them agriculture and energy, which have a disproportionate presence in states that supported President Trump—may enhance flexibility. Geostrategic considerations, in turn, are a reminder that US-China bilateral relations are not unidimensional and that trade relations may be colored by other considerations.

The diagram on the following page provides this mapping to date, and will evolve over time. It includes, for example, the just-published United States Trade Representative (USTR) list of an additional $200 billion in imports from China to potentially be made subject to 10% tariffs. We also go into more detail on those potential new tariffs in the appendix.

US-China Trade Tensions



Juxtaposing Goals and Motivations

The Trump administration's goals are aggregated in three sets. The sets, in turn, fall on a continuum starting from where the US and China tend to converge, creating scope for an agreement and progressing to where their goals diverge. These more intractable issues, to the extent that they become the focus of the bilateral relations, increase the risk of protracted tensions and conflict.

First Set of Goals

At one end of the continuum there is a set of goals informed by President Trump's long-standing, strongly held views on trade—summed up in the often repeated mantra of "free, fair, reciprocal" trade. These views comprise the core of his campaign promises on trade, which he has pledged to uphold coming into the midterm elections ("Promises Made, Promises Kept"). President Trump has long held the view that deficits in goods trade are "bad," indicative of "unfair" trade practices. A standout "unfair" trade practice for the president is unequal market access or no "reciprocity."

There is scope for agreement on reducing the bilateral trade deficit and increasing market access, as both measures dovetail with China's goals. The first few rounds of US-China negotiations yielded tentative commitments by China to significantly increase imports from the US, in particular agricultural and LNG imports. This commitment is consistent with China's policy priorities of increasing imports while maintaining current export levels, mitigating environmental degradation (LNG), and pursuing "quality growth" by rebalancing the economy toward consumption. To this end, China recently cut tariffs on a number of consumer products.

China has also undertaken a number of recent market-opening measures. They include relaxing ownership requirements in some industries (e.g., autos, mining, shipping); narrowing the "negative list" (sectors subject to investment restrictions); and continued, pronounced financial services "opening up"—in line with long-standing financial reform objectives. These measures are both consistent with its policy goals and responsive to US concerns. In late June, President Xi reaffirmed that "the great door of China's opening will not close, it will only get bigger and more open." China sees further reform as necessary to accomplish its economic rebalancing and attain the next stage of development.

Second Set of Goals

The second set of Trump administration goals falls in between the ends of the continuum. These goals target China's industrial policies, which the administration sees as comprising a number of "unfair" trade practices. The administration has targeted overcapacity, e.g., in steel and solar cells and panels, as a legacy of past industrial policies. Chinese overcapacity, the administration asserts, distorted global prices and enabled dumping (including bypassing US and EU anti-dumping and countervailing duties via transshipments) to the detriment of US industry and labor.

Common ground may be found here as well, since tackling overcapacity, in particular in old economy, "dirty" industries (i.e., steel and aluminum) is part of China's goal of transitioning from a phase of rapid growth to a stage of "high-quality development." This requires economic growth to be "more efficient, equitable, and sustainable" in order to address imbalances and insufficiencies in the economy. In particular, tackling overcapacity is deemed necessary to improve the environment and to address market inefficiencies (e.g., overinvestment).

Importantly, and further along on the continuum, the Trump administration is targeting China's keystone industrial policy: advancing 10 high-tech, high-value-add sectors that China deems necessary for the achievement of its next stage of economic development—becoming a great, modern socialist country by 2050. It is unlikely that China will forgo any industrial policy it deems necessary for future economic prosperity. This policy is best encapsulated by the Made in China 2025 plan (MIC; launched in 2015). Under MIC 2025, the government orchestrates the development of these 10 sectors (including AI, aerospace, robotics, biomedicine, new materials, green technology, and semiconductors), populated with world-class China-based firms. While President Xi has stressed China's need to become more self-sufficient in innovation and "core technologies" and holds as a goal "building a global technological superpower," he has also noted "indigenous innovation is innovation that takes place in the context of an open environment...[We] absolutely cannot shut the door...[We] must deepen our international scientific exchanges and cooperation."

For the Trump administration, MIC 2025 exemplifies the Chinese government's concerted efforts to favor its homegrown firms in high-tech, high-value-add sectors via "unfair" trade practices, including the forced transfer of US firms' IP. For example, MIC 2025 calls for 40% of essential spare parts and key materials for the designated 10 sectors to have domestic sources by 2020. By 2025, 70% will have domestic sourcing. Significantly, the administration finds these sectors key to both future US economic and national security. The Trump administration is specifically confronting MIC 2025 through Section 301 tariffs, an enhanced foreign investment review regime (review of sectors touching "sensitive" technologies), and export control measures (covering "emerging" and "foundational" technologies). These remedial actions are deemed necessary to confront China's "unfair" trade practices.

That said, there may still be some scope for an agreement. China could choose to revisit elements of its industrial policy found to be "unfair" not only by the US, but also by the EU. The EU is another major trading partner with grievances about China's "unfair" trading practices not dissimilar to those raised by the US. However, both the EU and China reject the US's unilateral trade actions and have reaffirmed their support for international trading rules and institutions. This means that any agreement is likely to advance through a multilateral process and institution, such as the WTO. For example, China and the EU recently agreed to form a working group on the modernization of WTO rules and processes to take account of technology policies (forced IP transfers, IP protection), the role of SOEs, and state subsidies.

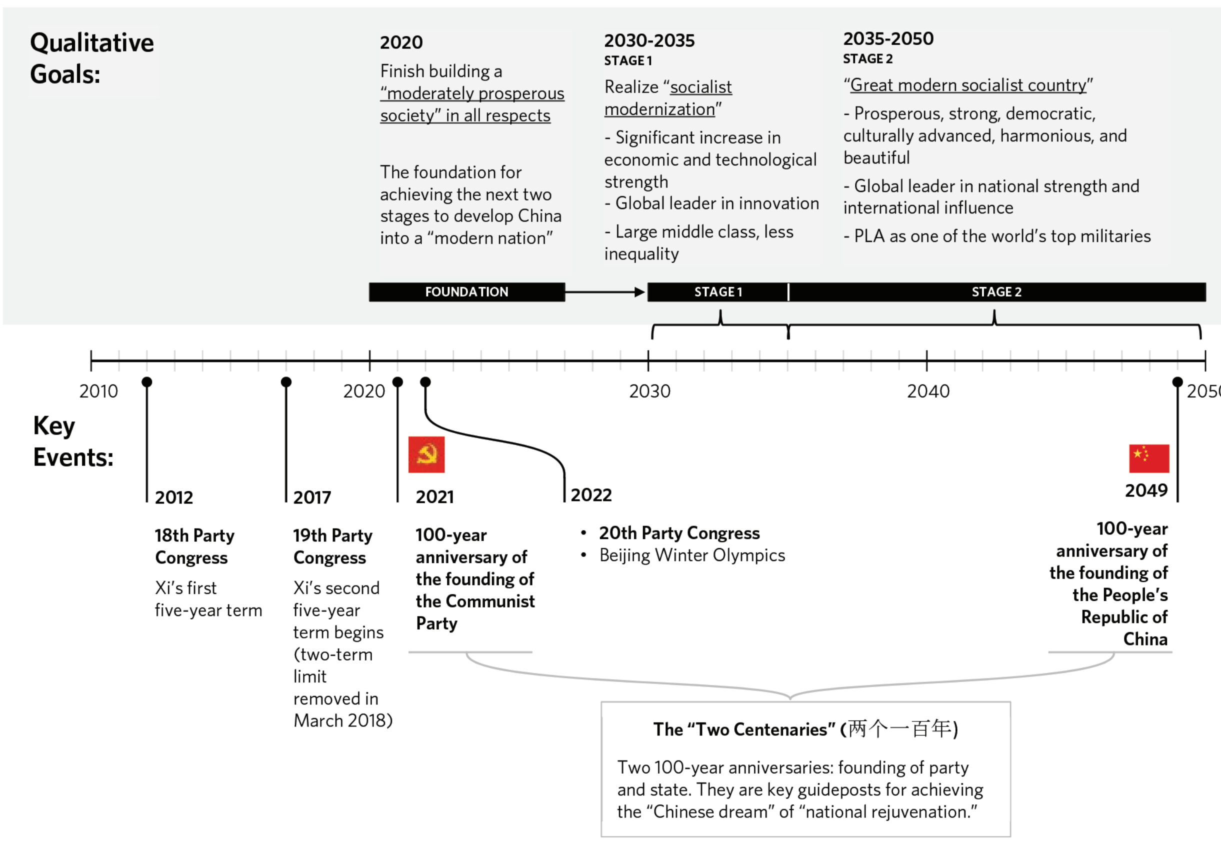
Third Set of Goals

The third set of goals and motivations that may be informing the Trump administration's trade actions revolves around a view of China as a strategic competitor, implying the need for containment efforts. This view presents the most complex (and maybe intractable) issues with the highest risk of conflict. A concerted and protracted effort to redefine China as a "strategic competitor" will bring about a structural shift in the bilateral relations, away from the long-standing Washington consensus of "constructive engagement," which has led to the progressively deeper integration of China into the global trading and financial systems. The Trump administration has helped accelerate a shift away from the Washington consensus. To what extent President Trump will press this shift is not clear for now.

This new view is best articulated in President Trump's first National Security Strategy address (NSS; December 2017). The strategy identifies China as a "revisionist power" that "[has] expanded its power at the expense of the sovereignty of others" and as a "strategic competitor." The NSS finds China's rise as a superpower contingent on access to next-generation technology and states that "part of China's...economic expansion is due to its access to the US innovation economy."

The view of China as a "strategic competitor" when juxtaposed with President Xi's "Chinese Dream of National Rejuvenation" points to potential intractable tensions that could play out over years, with at best the hope of managing relations. At the 19th Party Congress, President Xi laid out a long-term, ambitious roadmap for China to become a leading global power by 2050—a "great modern socialist country" that is "prosperous, strong, democratic, culturally advanced, harmonious, and beautiful." He declared that China is well on its way to achieving a "moderately prosperous society in all respects" by 2020. Yet, he stressed that China must fight the remaining "three tough battles" of de-risking, pollution control, and poverty alleviation. President Xi then called for China to build on the foundation created by the moderately prosperous society to become a leading innovative nation by 2035. After realizing "socialist modernization" from 2035 to 2050, he stated that China should evolve into a "great modern socialist country" that is a global leader with international influence, along with a world-class military.

Xi's Strategic Road Map to "Socialist Modernization"



Appendix

Three US measures are explained below. While one measure, §301 tariffs, applies only to China, the other two, §232 and §201 tariffs, are ultimately aimed at China's overcapacity in targeted sectors. The §301 tariffs, in turn, are best understood as one element of a compendium of actions, including enhanced foreign investment reviews and export control measures, mainly directed at China's "unfair" trade practices entailed in the Made in China 2025 industrial plan.

Thus far, China has responded with targeted retaliatory measures of equal intensity and scale, while making clear it will "follow suit to the end and at any cost" with both quantitative and qualitative measures. Reportedly, China will pick its battles carefully to ensure no distraction from policies of reform and opening up and no altering of its economic development path.

US Trade Actions Implemented

Confronting Overcapacity: Section 232 and 201 Tariffs

The §232 tariffs on steel and aluminum imports (25% on ~$46 billion in imports) and §201 tariffs on solar cells and panels and washing machines (25% on ~$10 billion in imports) are best understood as leverage against countries of exporters, many US allies, to persuade them to join the US in confronting the ills of China's overcapacity (lower global prices, dumping detrimentally impacting non-Chinese firms and workers). China is the largest producer of all four products but not a major exporter to the US. The Trump administration asserts that China has successfully circumvented the US and EU anti-dumping and countervailing duties (imposed on steel products and solar panels, for example) through transshipments, e.g., Vietnam for steel and Malaysia for solar panels. Secondarily, these measures help with the goals of reducing deficits in goods trade and fulfilling campaign promises to important Trump constituencies.

A special G20 forum was established late last year to address global steel overcapacity, but has yet to yield meaningful results. After the imposition of §232 tariffs, while Canada (the largest exporter of steel and aluminum to the US) and the EU have retaliated by imposing commensurate tariffs on US exports, they have also initiated investigations into the transshipments of steel (e.g., via Turkey, as it is a member of the EU customs union). In addition, South Korea, Australia, and others have agreed to steel and aluminum export quotas in lieu of tariffs. South Korea agreed to an outright cut in exports as well. The importance of North Korean denuclearization and NAFTA negotiations with Canada's and South Korea's responses to the §232 and §201 tariffs cannot be overstated.

Confronting Made in China 2025: Section 301 Tariffs, Enhanced Investment Restrictions, and Export Controls

The Trump administration is directing §301 tariffs, enhanced foreign investment review (CFIUS, as amended by FIRRMA), and export control measures at China's "unfair" trade practices, i.e., China "coerc[ing] American companies into transferring their technology and intellectual property to Chinese enterprises." These measures are more broadly directed at China's Made in China 2025 (MIC 2025) industrial policy—the unfair practices "bolster China's stated intention of seizing economic leadership in advanced technology as set forth in its industrial plans."

The Trump administration has imposed 25% tariffs on $34 billion of imports from China under §301 of the Trade Act of 1974. A second tranche of tariffs on an additional $16 billion in imports is to be imposed at a later date. China responded in kind, consistent with its policy of retaliating with countermeasures of equal intensity and scale. <u>On July 10, the US Trade Representative (USTR) published a list of an additional $200 billion in imports from China, encompassing many consumer products, to be made subject to a 10% tariff as early as September. Earlier, President Trump had warned that if China refused to change its "unfair" practices and retaliated, such tariffs will be imposed.</u>

The first set of §301 tariffs ($34 billion imposed and $16 billion pending) were calculated to be commensurate with injuries suffered by US firms due to loss of IP, and were mostly imposed on products associated with MIC 2025's 10 high-tech, high-value-add sectors (e.g., aerospace, transport, medical equipment). Notably, the initial list of 1,333 products subject to tariffs (later narrowed to 818 products) included 550 product categories for which either there were no imports from China or they were minimal. These tariffs were in part prospective, designed to increase the cost of imports expected to benefit from MIC 2025. The second set of tariffs, an additional $200 billion of imports, falls within the administration's estimated range of damages incurred by US firms due to loss of IP. However, this set encompasses many consumer products and is far less targeted at MIC 2025.

In addition to the §301 tariffs, the Trump administration measures include the strengthening of foreign investment and export control restrictions. Congress is about to enact the Foreign Investment Risk Review Modernization Act of 2017 (FIRRMA), increasing the scope of the foreign investments reviewed by the Committee on Foreign Investment in the United States (CFIUS). The scope is expanded beyond national security considerations to include transactions touching key technologies and intellectual property. FIRRMA also tightens foreign investment screening by expanding the scope of the vetting procedures (imposing mandatory filing requirements) for transactions that directly or indirectly result in a foreign government (including state-owned enterprises) acquiring a "substantial interest" in "US critical infrastructure or critical technology companies." Moreover, it establishes a higher scrutiny for investments coming from "countries of concern."

Finally, the Department of Commerce is to review current export controls and make "any modifications that may be needed to strengthen them to defend our national security and technological leadership." FIRRMA establishes a new export control process, to be managed by the Department of Commerce, that covers "emerging" and "foundational" technologies (separate from critical technologies) in transactions involving foreign persons.

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