July 2018

QUEST Trade Policy Update

Ernst & Young LLP's Quantitative Economics and Statistics (QUEST) group's Trade Policy Brief summarizes the latest key events and potential trends on international trade and its domestic and global implications in a relatively concise, easy-to-read format.

QUEST Trade Policy Brief:

Additional tariffs imposed by the United States and China could disrupt US economy and hurt certain US industries

Introduction

New tariffs imposed by the Trump Administration on $34 billion of Chinese imports went into effect on July 6, 2018. Through these new tariffs, the Trump Administration has made clear that it views China as exercising a number of unfair trade practices that disadvantage the United States. Subsidies to state-owned enterprises, ineffective enforcement of intellectual property and World Trade Organization (WTO) regulations, alleged cyber economic espionage, and interventionist policies to undervalue China's currency are viewed as adversely affecting US companies and resulting in the loss of US jobs. The Administration also has expressed concerns that importation of relatively low-cost steel and aluminum, some of which comes from China, may pose a threat to national security.

In response to the new tariffs, China imposed tariffs, effective July 6, 2018, on $34 billion of US exported goods. The enactment of these additional tariffs could disrupt US economic growth. Specifically, US manufacturing industries and agriculture could be hurt by the tariffs.

This Trade Policy Brief summarizes the escalation to date of the trade dispute between the United States and China, puts into perspective merchandise trade flows between the two countries, and underscores potentially adverse consequences of a trade war for the US economy.[1] An appendix gives some additional information on US trade with China and the rest of the world.

Context

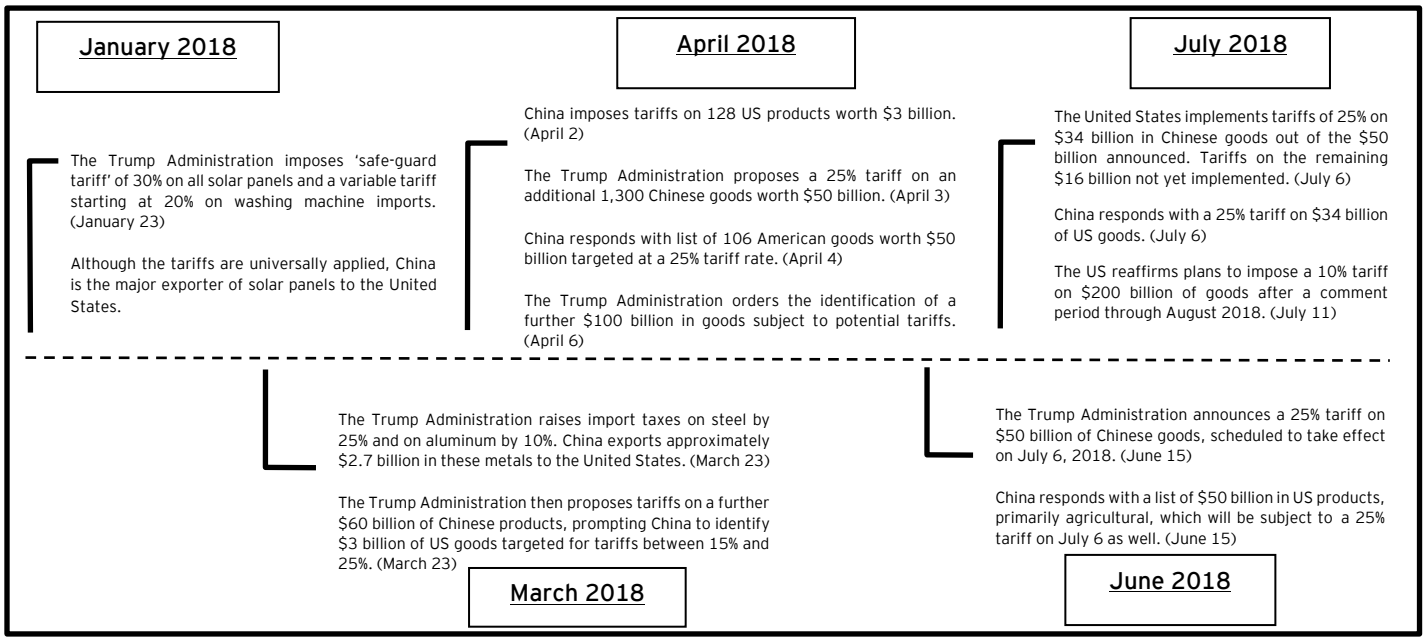
Since January 2018, trade relations between the United States and China have rapidly deteriorated. The Trump Administration's imposition of a general tariff of 30% on solar panels and 20% on washing machine imports marked the opening salvo of what is shaping up to be a trade war between the two countries. Although these tariffs were not targeted at any specific country, China is the largest exporter of solar panels to the United States and is a major exporter of washing machines as well.

[1] This brief draws from a previous May 2018 EY QUEST Trade Policy Brief titled, "Trade war with China could cost the US economy."

The Trump Administration then followed the initial tariff actions on solar panels and washing machines with new punitive tariffs on a wide range of steel and aluminum articles in March. These tariffs applied to all nations, although the Administration granted a temporary reprieve (now expired) to allies such as the EU.[2] These actions prompted China to propose 10% - 25% tariffs on an equal value of US imports (worth $3 billion), triggering the Trump Administration to respond with initial threats of tariffs on $60 billion of Chinese goods.

The first week of April contained a flurry of escalation, as China officially imposed the announced tariffs on US goods, countered by the Trump Administration's threat of additional US tariffs on $100 billion of imports from China. Following failed trade negotiations between the United States and China in May, the Office of the United States Trade Representative (USTR) announced in June that the United States would impose a duty of 25% on approximately $34 billion of Chinese imports effective July 6, with an additional $16 billion of Chinese imports under final review for duty imposition to follow. This represents a total of $50 billion of Chinese origin items targeted for punitive tariffs in response to the Trump Administration's earlier statements. China responded in kind, and on July 6, officially imposed 25% duties on $34 billion of US exported goods. On July 11, the Trump Administration proposed an additional 10% tariff on imports of Chinese goods worth $200 billion, anticipated to become effective in early fall 2018. Figure 1 provides a timeline of significant events.[3]

Figure 1: Timeline of US - China trade dispute



As both countries have taken turns in enacting and announcing additional new tariffs, there is a growing anxiety among businesses and consumers in both countries. This anxiety weakens prospects for bilateral trade growth and ensuing economic growth.

[2] Exemptions to steel tariffs also were granted to Australia, Argentina, and Brazil with quota limits on Argentina and Brazil. Also, South Korea agreed separately to a 30% reduction in 2017 steel exports to the United States as part of the renegotiated KORUS (US-Korea Free Trade Agreement) earlier in the year. On aluminum, permanent exemptions were given to Argentina (with quota limits) and Australia (no limits).

[3] An up-to-date and comprehensive timeline is available at: https://www.eyquestsurveys.com/Blog/bloghome

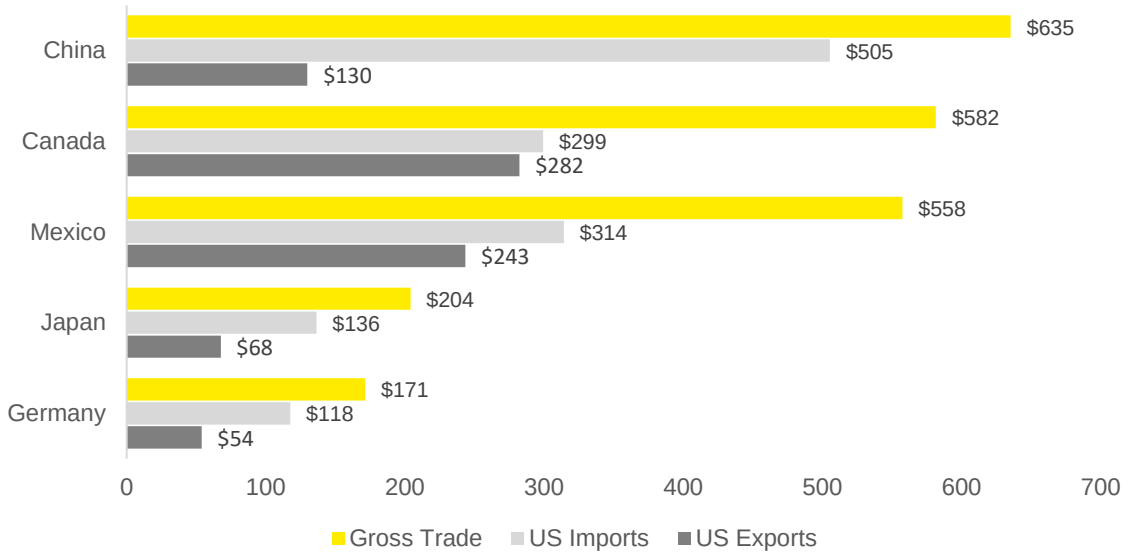
Trade flow analysis

China has become a dominant US partner for merchandise trade

In 2017, the United States had gross merchandise trade flows of $3,888 billion with $2,342 billion in imports and $1,546 billion in exports.[4] China is currently the most important US trading partner measured by gross trade, exceeding even NAFTA partners Canada and Mexico (Figure 2). In 2017, gross US-China merchandise trade was $635 billion, 16% of total US trade in 2017. China exports about $4 to the United States for every $1 the United States exports to China, leading to a significant net trade imbalance of $375 billion in 2017.

Despite the imbalance, US trade with China has become an important source of employment for both nations. According to a recent study by Oxford Economics, US trade with China supported more than 2 million US jobs, added 0.2% in national productivity, and boosted US GDP growth by 1.2% in 2015.[5] Nevertheless, China's dominance as the main trading partner of the United States is a major source of concern for policy makers and legislators on both sides of the aisle, especially since the US merchandise trade deficit with another country has never been so high.

Figure 2: Top 5 US partners in merchandise trade, 2017 ($ billions) [6]

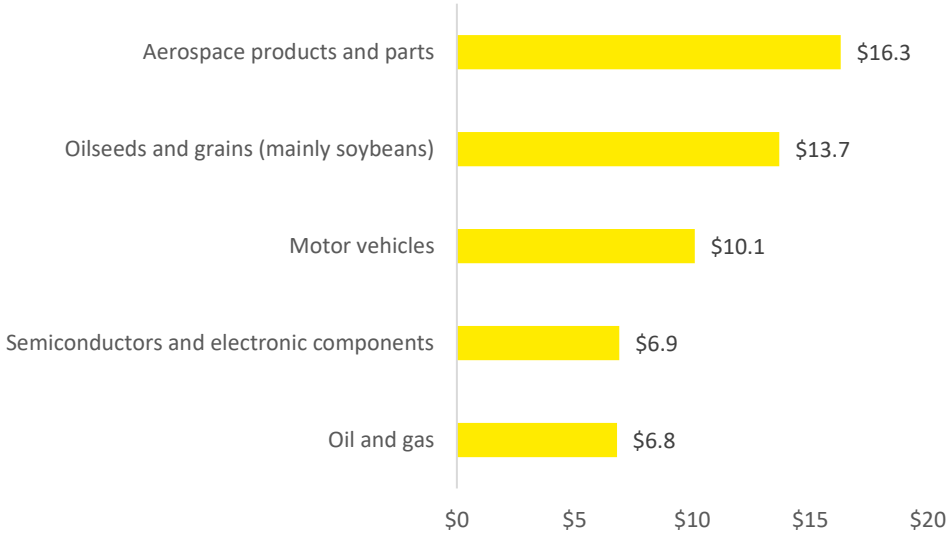


Top US exports to China

US merchandise exports to China totaled $130.4 billion (8% as a share of total US exports) in 2017. According to a recent study, China was the second-largest US agricultural export market ($19.6 billion) in 2017, and US exports to China grew faster than any of the other top 10 US export markets (491%) from 2002 to 2007.[7] The breakdown of the top five US merchandise exports to China by decreasing order of value is presented in Figure 3.

[4] Gross trade is calculated as the absolute sum of imports and exports between two nations.
[5] Oxford Economics. Understanding the US-China Trade Relationship. Report Prepared for the US-China Business Council. January 2017.
[6] Source: US Census Bureau, Accessed July 2018
[7] Morrison, Wayne M. April 2, 2018. China-U.S. Trade Issues. Report Number RL33536. Congressional Research Service.

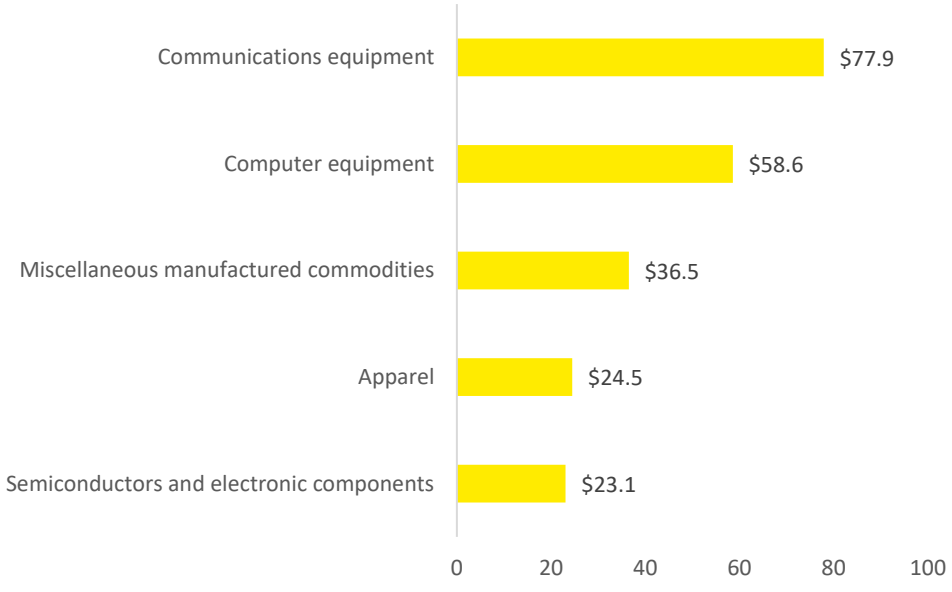
Figure 3: Top 5 US exports to China, 2017 ($ billions)



Top US imports from China

US imports from China amounted to $505 billion in 2017 (22% of total US imports), making China the single largest source of US merchandise imports. This is remarkable considering that China was ranked the eighth largest source of US imports in 1990, less than 30 years ago. The breakdown of the top five US imports from China by decreasing order of value is shown in Figure 4. Of note is the significant presence in high-value technology imports, which contrasts with the stereotype of cheap apparel and products.

Figure 4: Top 5 US imports from China, 2017 ($ billions)



Over the past several decades, China has become a major center for global supply chains for US manufactured goods. Rather than a supplier of low value-added and labor-intensive imports, China has become a source for technology-intensive imports. According to the US Census Bureau, US imports of “advanced technology products” (ATP) represented 39% of total US merchandise imports from China in 2017. This figure was just 14% in 2003.

China is also the major supplier of imports for US-manufactured products among Pacific Rim countries, supplanting traditional US partners in the region such as Japan, Taiwan and Hong Kong. It is the primary source of imported intermediate inputs for some industries, such as computer, electronic, optical and telecommunications equipment.

Implications

Bilateral trade with China is one of the most significant economic issues facing the US economy. China is a very important trading partner for the United States and, consequently, a potential trade war would be very disruptive and costly for the US economy.

Because of integrated world supply chains, US tariffs on imports from China would hurt some US manufacturing industries, even if China does not retaliate further. US industries, including agriculture, could be seriously damaged should China further retaliate. Regardless of which specific industries might be helped or harmed by US tariffs on imports from China and regardless of whether China retaliated, US consumers would end up losing. This is because tariffs would raise the prices for imported Chinese final consumption goods, for domestic goods manufactured in the United States using Chinese intermediate goods, as well US domestic goods that compete with (are similar to) imports from China. In addition, about 4% of the value of imports from China originates in the United States (see Appendix); to that extent, a tariff on imports from China directly acts as a tax on US products. Together, these adverse effects could work to temper US economic growth in the medium run or even revert the economic recovery of the past 110 months.

The United States has now imposed tariffs on 7% of Chinese imports and proposed to place future tariffs on a further 40% of imports. By contrast, China has already imposed tariffs on 28% of US imports and has proposed tariffs on a further 10% of imports from the United States.

China is limited in its ability to respond directly to additional US tariffs, as it imported $130 billion in goods from the United States in 2017 as is illustrated in Table 1. As a result, it cannot impose equal tariffs on imports from the United States that would match the initial $50 billion ($34 billion July 6 duties and an anticipated $16 billion in a second round of US duties), along with the additional $200 billion in Chinese imports subject to proposed US tariffs, although it could consider a higher tariff rate than the United States applies. China could further consider retaliation measures beyond tariffs, including:

1. Raising non-tariff barriers to trade, increasing the direct cost of doing business in China for American companies
2. Restricting Chinese investment (FDI) in the United States
3. Imposing restrictions on Chinese travel to the United States
4. Flooding the foreign exchange market with US dollars
5. Flooding the international debt market with discounted US treasuries
6. Obstructing US policy outside the area of trade, e.g., in the US negotiations with North Korea over nuclear weapons

The June 27 QUEST Trade Policy Brief provides further analysis on several of these scenarios.[8]

[8] https://www.eyquestsurveys.com/Blog/PDFs/Possible%20Chinese%20Response%20June%202018.pdf

Table 1: Proposed and imposed tariffs

	Imports from partner in 2017	Total value for proposed tariffs	% of imports facing proposed tariffs	Actual tariffs implemented	% of imports tariffed
China	$130 billion	$50 billion	38%	$37 billion	28%
US	$505 billion	$250 billion*	50%	$37 billion**	7%

* Official statements by the US government suggest $250 billion of tariffs, while statements by President Trump sum to $360 billion.
** This figure includes both the $34 billion of Section 301, and $2.7 billion in tariffs specifically referencing Chinese origin steel.

The trade war between the US and China has already affected each nation's domestic markets, reflected in declining market indices and falling business investment and business confidence.[9] The Chinese Renminbi has fallen by 5% against the dollar since mid-June, ironically making Chinese imports more attractive and US exports less attractive.[10] It is unclear if this is a result of market conditions due to the emerging trade war, or if the Chinese central bank is intervening in the currency markets to offset the costs of tariffs on Chinese imports. Sources are currently conflicted on the nature of the depreciation, but regardless, its end result is to stymie the effect of the US tariffs.[11]

For a detailed discussion of the products subject to duties on July 6, 2018 and filing requirements as well as China's retaliation and US response, see Tax Alert 2018-1386.

[9] Ben St. Clair, "Fresh Trade Threat Drags on Global Stocks," *WSJ*, July 11, 2018, https://www.wsj.com/articles/fresh-trade-threat-drags-on-global-stocks-1531294908?mod=hp_lead_pos1.
[10] Michael Hunter, "Trade War Escalation Rattles Global Stocks and China's Currency," *Financial Times*, July 11, 2018, https://www.ft.com/content/4c52b9ae-84d0-11e8-96dd-fa565ec55929.
[11] Edward White, "Analysts React as Renminbi Resumes Slide," *Financial Times*, July 2, 2018, https://www.ft.com/content/dbbafe0a-7db2-11e8-bc55-50daf11b720d.

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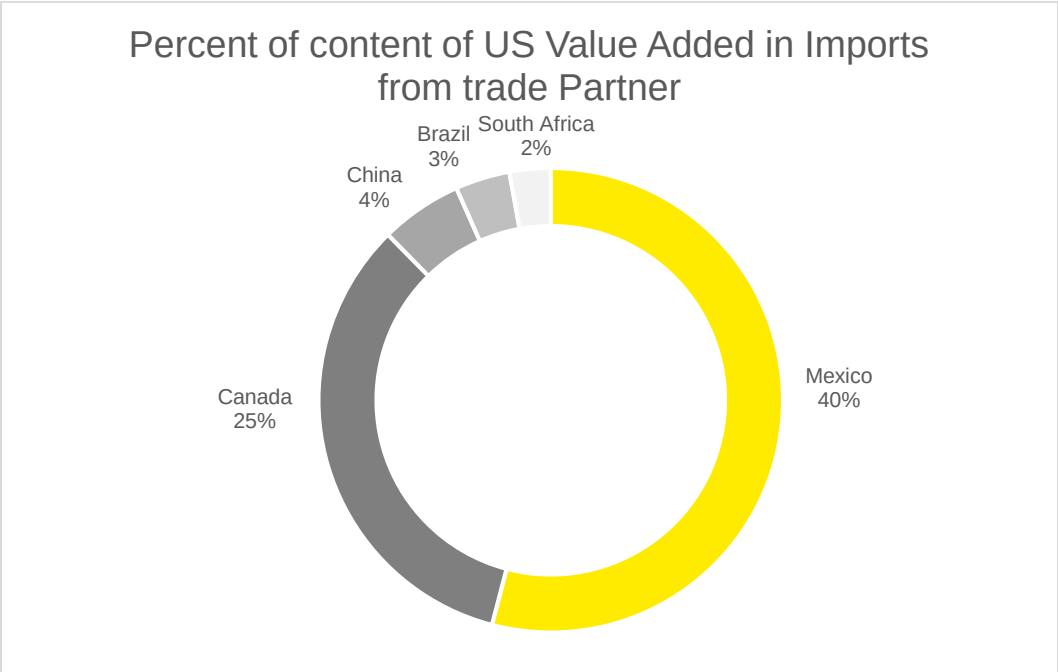
Appendix 1

Table A1. US trade volume with world regions in 2017 ($ billion)

	Exports	Imports	Total	Percentage
Asia	486.6	1,058.2	1,544.8	39.7
North America	525.4	614.0	1,139.4	29.3
Europe	332.9	506.6	839.4	21.6
European Union	283.5	434.9	718.5	18.5
South and Central America	150.2	116.0	266.2	6.8
Africa	22.0	33.4	55.4	1.4
Australia and Oceania	29.6	14.7	44.3	1.1
World	1,546.7	2,342.9	3,889.6	100.0

Source: US Census Bureau.

Figure A1. Share in US imports of domestic value added processed overseas



Source: Robert Koopman, William Powers, Zhi Wang and Shang-Jin Wei, *Give Credit Where Credit is Due: Tracing Value Added In Global Production Chains*, National Bureau of Economic Research Working Paper No. 16426, Cambridge, Massachusetts: September 2010, revised March 2011, (appendix, p.8).

Table A2. US States in which China is ranked in the top three as a source of imports in 2017

China's ranking as a source of US imports	Number of states concerned	State abbreviation
1	23	**AR, CA, FL, GA, ID, IN, KS, KY, MN, MS, MO, NE, NV, NJ, NM, NY, NC, OH, PA, TN, VA, WA, WI**
2	16	**AZ, CO, DC, IA, IL, MA, ME, NH, OK, OR, SC, SD, TX, UT, VT, WY**
3	7	**AK, CT, HI, MD, MI, RI, WV**

Source: US Census Bureau.

Table A3. US States in which China is ranked in the top three as an export destination in 2017

China's ranking as a destination for US exports	Number of states concerned	State abbreviation
1	5	**AK, LA, OR, SC, WA**
2	5	**AL, HI, ME, NM, VA**
3	22	**AZ, CA, CO, DE, GA, IL, IN, MD, MA, MI, MN, MO, MT, NH, NC, OH, PA, TN, TX, VT, WV, WI**

Source: US Census Bureau.

Table A4. Contribution of China to US employment and GDP growth

Value of China-US relationship to the US, 2015

	Gains to employment Thousands of Jobs	**Boost to US GDP** Percentage
Direct exports to China	1,467	0.7
Indirect exports to China *	296	0.2
Income from outward FDI	688	0.3
Inward FDI from China	104	0.1
Total	2,555	1.2
US Productivity boost from increased integration with China	0.2 percent gain in productivity	

*Indirect exports are defined as exports from the United States to other Asian countries that are re-re-exported to China.
Source: Oxford Economics. Understanding the US-China Trade Relationship. Report Prepared for the US-China Business Council. January 2017.

Table A5. Growth in US sectors benefiting from Chinese imports growth

Growth in US Value added and growth in US imports from China (CAGR 2000-2014-15)

	Real imports from China Percentage	**US value added** Percentage
Computer and electronic product manufacturing	23.8	6.7
Transportation equipment manufacturing	16.0	2.5
Chemical manufacturing	16.3	0.8
Machinery manufacturing	15.4	1.0
Food manufacturing	11.0	1.5
Primary metal manufacturing	8.8	0.9

Note: CAGR: compound annual growth rate.
Source: Oxford Economics. Understanding the US-China Trade Relationship. Report Prepared for the US-China Business Council. January 2017.