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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:

Possible Chinese responses to escalating trade war with United States could hurt US economy

Introduction

On June 19, 2018, President Donald Trump ordered his Administration to draft plans for an additional $200 billion in potential tariffs on Chinese imports, the latest escalation in the emerging trade war between the United States and China. The Administration previously published a list of Chinese imports worth $50 billion as targets for an additional 25% tariff. These imports are in manufacturing and technology, areas that contribute to China's "Made in China 2025" industrial policy. China has retaliated by proposing a 25% tariff on $50 billion of US products. Both countries have announced actual tariffs on $34 billion (out of the $50 billion proposed) that go into effect on July 6, 2018.

Considering that the United States exported $130 billion in goods to China in 2017, the Trump Administration's proposed additional $200 billion in tariffs far exceeds the value of goods imported by China from the United States.[1] This suggests that China is limited in direct reprisals to match the US tariffs. Therefore, any additional tariff measures considered by China could not be imposed on a wider range of US exports. Instead, China would need to increase the tariff rate above the US proposal of 25% to achieve an equal value with the United States. This action could lead to spiraling tariff rates and become counterproductive for the Chinese economy. The Chinese may, however, consider measures beyond tariffs in the trade war.

[1] Exports to China of $130 billion, in context of $506 billion in imports and a net deficit of $376 billion. US Census.

This Policy Brief explores five options available to the Chinese Government outside of direct tariff imposition that could adversely affect the US economy and assesses their likelihood of occurring.

Scenario 1: Raise non-tariff barriers to trade and increase the direct cost of doing business in China for American companies

This scenario could involve either raising non-tariff barriers to trade and/or increasing the direct cost of doing business in China for American companies and subsidiaries.

Potential actions include:

- Increasing technical standards and rules of origin for imports into China from abroad
- Increasing performance and local content requirements
- Further restricting or increasing the cost of US ownership in Chinese-based companies
- Enforcing labor laws and regulations more rigorously
- Delaying the approval of permits and licenses required for operation
- Boycotting products made by US companies

Currently, China's business climate is ranked the 78th best out of 190 countries, according to the World Bank's *Doing Business 2017* indicators. China is far below the United States (ranked 6th) and Hong Kong (ranked 5th). While there is a lot of room for Chinese improvement, there is also a lot of room for things to get worse, in the event of a trade war.

*Who would be affected***?**

Raising non-tariff barriers and increasing the cost of doing business would increase the marginal costs of American companies operating in China, which would raise the prices of goods produced. This in turn would subject American goods to: 1) more intense price competition in the Chinese market from foreign imports and comparable Chinese goods, and 2) more intense price competition from foreign producers in foreign markets. The overall effect would be to reduce US companies' market share in China and to squeeze profit margins earned by these companies.

This scenario could particularly affect US technology companies and automakers. In 2015, US multinational subsidiaries in China made more than $220 billion in sales to Chinese consumers. US technology companies had more than $40 billion in sales, and US car makers sold more vehicles in China than in the United States. These earnings would be at risk if indirect production costs were to increase.

One drawback to this scenario for China is the potential reduction of demand for Chinese workers. US companies and subsidiaries in China represent a significant source of jobs (more than 1.5 million in 2015) and have driven up Chinese wages generally. Eventually, the US business community may respond to such policy induced cost pressures by reducing its presence within China.

Likelihood of scenario happening

This scenario is very likely, though American companies could challenge some of China's non-tariff barrier measures at the World Trade Organization. It is unclear whether these companies would have any legal recourse for barriers that more indirectly raise the cost of doing business in China.

Scenario 2: Limit Chinese investment in the United States

Under this scenario, China would limit outbound capital flows to the United States, essentially limiting its foreign direct investment (FDI) and portfolio investment in the United States.

Who would be affected?

This scenario would affect various sectors of the US economy. Businesses in California, New York, and Massachusetts would likely be affected most as those states are the top three destinations for Chinese FDI. Affected sectors could include information and communications technologies, health and biotech, agriculture and food, and entertainment in California; real estate, transport and infrastructure in New York; and financial and business services in Massachusetts.[2]

Likelihood of scenario happening

This scenario is likely, as Chinese investment in the United States has already decreased. According to a recent report, Chinese direct investments in the United States decreased by 35% in 2017 from $46 billion to $29 billion and the value of newly announced Chinese acquisitions in the US dropped by 90% in 2017 compared to 2016. The decline in Chinese investment was partly due to China's regulatory restrictions on outbound capital flows imposed as a crackdown on leveraged private investors, and partly due to greater US regulatory pushback on the basis of national security concerns.[3]

Capital flows between the two countries remained uneven in 2017, with US FDI in China ($14 billion) being half the level of Chinese FDI in the United States ($29 billion). Considering these past regulatory restrictions, China could resort to similar capital controls in the future.

Scenario 3: Imposing restrictions on travel to the United States

In this scenario, the Chinese Government could hurt the US domestic economy by restricting travel for Chinese tourists and/or restricting the number of Chinese students permitted to study in the United States.

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[2] National Committee on US-China Relations and Rhodium Group. April 2018. New Neighbors: 2018 Update. Chinese Investment in the United States by Congressional District.
[3] Thilo Hanemann and Daniel H. Rosen, "Chinese FDI in the US in 2017: A Double Policy Punch" (Rhodium Group, January 17, 2018), https://rhg.com/research/chinese-fdi-us-2017-double-policy-punch/.

In 2017, China sent more than 3 million travelers to the United States, who spent more than $33 billion on restaurants, hotels, retail, and entertainment.[4] This represents 30% of total tourism expenditure across America in 2017.

Large numbers of Chinese students are enrolled in American schools, with more than 350,000 university students in the 2016 school year and an indeterminate number of students attending private US high schools.[5] Chinese university students represent only 2% of the 20.2 million enrolled tertiary students, but pay the full out-of-state tuition on which universities have come to rely. On average, full tuition is $10,000 more expensive than in-state tuition per academic year, meaning that the total potential value of Chinese students registered in four-year programs is at least $14 billion.[6]

Who would be affected?

This scenario would affect many sectors of the US economy, including:

1) The tourist sector (hotels, restaurants, airlines and other modes of transportation), as Chinese tourists are among the largest groups of foreign visitors to the United States each year

2) All sectors dependent on tourism either through forward or backward linkages, including retail and wholesale trade, construction, entertainment, recreation, etc.

3) US colleges and universities, as Chinese students are among the largest contingent of foreign students in the United States

For many small towns across the American heartland, universities provide the lifeblood to local retailers, city and state tax revenue, and small businesses. Reducing revenue to these schools means reduced budgets, fewer available jobs and fewer students spending money in local businesses.

Likelihood of scenario happening

This scenario is possible. The Chinese Government is one of the few today that requires citizens to obtain a visa in order to travel abroad (an exit permit). Further, the Chinese Government has limited the amount of currency Chinese citizens can withdraw abroad to US$50,000 and will suspend oversea transactions if exceeded.[7] The infrastructure for further restrictions already exists if the Government chooses this course of action.

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[4] ITA National Travel & Tourism Office, "International Visitation in the United States," March 2018, https://travel.trade.gov/outreachpages/inbound.general_information.inbound_overview.asp.
[5] Institute of International Education, "International Students Enrollment Trends," 2017, https://www.iie.org/Research-and-Insights/Open-Doors/Data/International-Students/Enrollment.
[6] Health Resource Center at the National Youth Transitions Center, "In-State vs. Out-of-State Tuition," March 2013, https://www.heath.gwu.edu/state-vs-out-state-tuition. Calculation: 10,000 * 4 years * 350,000 students
[7] Charles Clover and Tom Mitchell, "China Steps up Capital Controls with Overseas Withdrawal Cap," *Financial Times*, December 31, 2017, https://www.ft.com/content/b69166fa-ee01-11e7-b220-857e26d1aca4.

Scenario 4: Flood the foreign exchange market with US dollars

In this scenario, the Chinese Government could sell a sizable portion of its net international reserves held in US dollars in the foreign exchange market, which would immediately depreciate the US dollar relative to other major currencies, including the euro and Renminbi yuan.

As of May 2018, China held $3.1 trillion in total foreign exchange reserves.[8] The exact composition of the Chinese reserves is unknown, but the US dollar represents approximately 65% of global currency reserves.[9] This suggests that China holds at least $2.0 trillion in US dollars that it could sell on the global market for euro, Renminbi yuan, and other currencies.

While the foreign exchange currency market is huge (e.g., it trades between $5 trillion and $7 trillion in currency per day), relatively small transactions can have devastating effects. For example, in 1992, George Soros famously crashed the British Pound by taking a $10 billion position against the currency and causing a sell off, which forced the British government to raise interest rates 50%. Thus, China potentially could disrupt trading in the dollar by selling off only a fraction of its dollar holdings.

Who would be affected?

A Chinese sell-off could be devastating to multinational corporations that rely on stability, as well as nations that denominate their sovereign debt in US dollars. It would also drive up the cost of imports for US consumers and could lead to a watershed moment in which the US dollar is no longer the reserve currency of the world.

In the medium-term, US exporters could actually benefit from the Chinese intervention through more competitive global prices. This could also result in a more favorable effective rate of repatriation on profit margin earned within China, assuming a real appreciation of the yuan relative to the dollar.

Likelihood of scenario happening

While possible, this scenario is unlikely since it could hurt the Chinese economy (e.g., appreciation of the yuan would raise the price of Chinese exports).

Scenario 5: Flood the debt market with discounted US treasuries

China currently owns $1.18 trillion of US debt and is therefore the main foreign US creditor. In this scenario, China could reduce its US treasury holdings by selling a sizable portion of US bonds on the secondary market. This would not be the first time that China has sold its US treasury holdings. Since 2013, the Chinese Government has reduced its purchase of US Government debt by 10.2%.

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[8] FRED Economic Data, “Total Reserves Excluding Gold for China,” March 2018, https://fred.stlouisfed.org/series/TRESEGCNM052N.

[9] Salvatore Babones, “Fears That China Will Abandon The Dollar Are Greatly Exaggerated,” *Forbes*, January 11, 2018, https://www.forbes.com/sites/salvatorebabones/2018/01/11/fears-that-china-will-abandon-the-dollar-are-greatly-exaggerated-as-usual/#6794102161b9.

Who would be affected?

This scenario would affect the US Government (public investment and spending in particular) and the US economy by extension. In the event that pension funds, insurance companies, private investors, and other foreign governments do not subsequently purchase this US debt, China's move could limit the US Government's ability to raise capital in international markets and would amount to a contractionary fiscal policy with ensuing adverse consequences for the US economy.

Likelihood of scenario happening

Though possible, this scenario is unlikely since US bonds remain by far one of the safest investments in the world.

Conclusion

It is unclear at this point which measures beyond tariffs the Chinese Government may implement in the trade war with the United States. Whatever measure is adopted, it is likely to adversely affect US businesses and the US economy. Consequently, options to mitigate these adverse effects should be carefully considered. Options available to businesses may include purchasing insurance, accelerating transactions, modifying the terms of transactions and repricing the risks of projects still in the works.

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