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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:

Trade war with China could cost US economy

With the United States and China imposing import tariffs on certain goods, the United States faces a possible trade war with China, which could be costly to the US economy and potentially hurt US consumers. Although recent negotiations between China and the US have put the potential trade war "on hold," according to Treasury Secretary Steven Mnuchin, a re-escalation is possible, as is a negotiated solution that moves away from, rather than towards, expanded free trade between the countries.

Escalating US-China trade war

The Trump Administration views China as exercising unfair trade practices. 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.

As a result, the Trump Administration has imposed tariffs of 25% and 10%, respectively, on all US imports of steel and aluminum, two commodities for which China is the world's largest producer. Imports from some countries have since been exempted, but not those from China. The Administration also has published a proposed list of Chinese imports in manufacturing technology, transport, and medical products worth $50 billion as targets for an additional 25% tariff.

In response, China has imposed tariffs on $3 billion worth of US imports to counter the effects of US tariffs on Chinese steel and aluminum products. In addition, China has proposed a 25% tariff on $50 billion of US products (106 products in total) ranging from soybeans and beef to aircraft and automobiles in response to the US tariffs specifically directed at Chinese goods.

As both countries have taken turns in enacting and announcing additional new tariffs, in a tit-for-tat escalation of retaliatory measures, there is a growing anxiety among businesses in both countries. This anxiety weakens prospects for bilateral trade growth and ensuing economic growth as the world's two largest economies embark on what could be the beginning of a trade war.

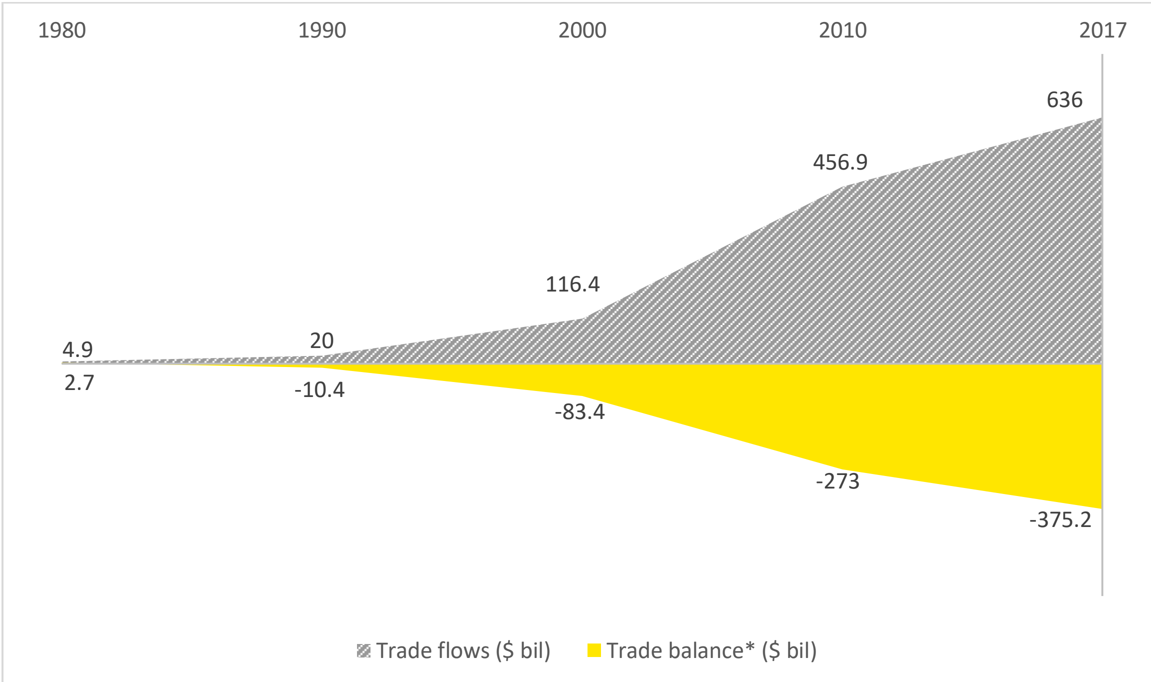
Recent negotiations between the US and China have led to a joint statement that there is "a consensus on taking effective measures to substantially reduce the United States trade deficit in goods with China" and that "China will significantly increase purchases of United States goods and services." No specifics were announced. It is unclear whether recently imposed tariffs have been suspended and whether these negotiations will ultimately succeed in resolving differences without harming trade between the countries.

China has become a dominant US partner for merchandise trade

In 1980, one year after the resumption of commercial relations between the United States and China through the signing of a bilateral trade agreement between the two countries, China ranked as the 24th largest trading partner of the US ($4.9 billion in US trade), the 16th largest US export market, and the 36th largest source of US imports.[1] By 2017, China had become the most important US trading partner, more important than even Canada and Mexico. Total US-China merchandise trade was $636 billion, 16.4% of total US trade, in 2017 (Figures 1 and 2).

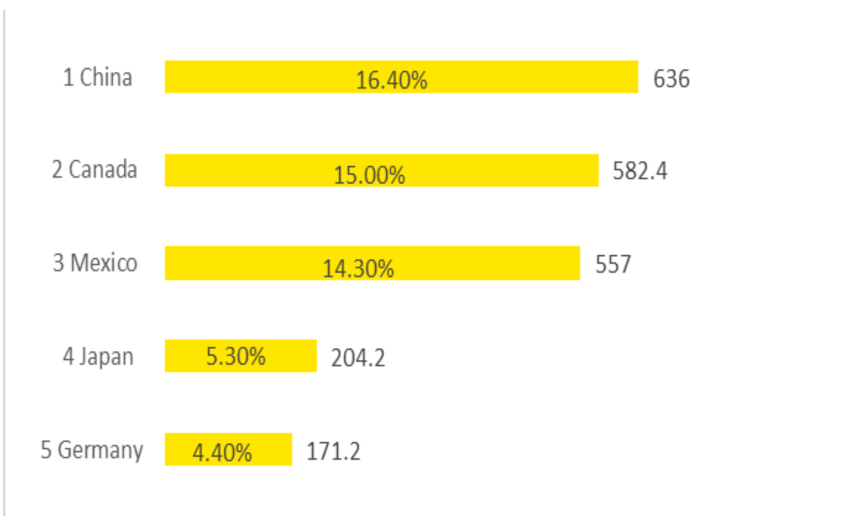
America's trade with China has become an important source of employment. According to a recent study by Oxford Economics, US trade with China generated over two million US jobs, added 0.2% in productivity, and boosted US GDP growth by 1.2% in 2015.[2] Nevertheless, China's dominance as the main trading partner of the US 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 ($375.2 billion in 2017).

Figure 1. US merchandise trade with China



Source: US Census Bureau.

Figure 2. Top five US partners in merchandise trade in 2017 ($ billions)



Source: US Census Bureau.

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[1] In 1979, US-China merchandise trade flows were $2.3 billion (0.6% of total US trade).

[2] Oxford Economics. Understanding the US-China Trade Relationship. Report Prepared for the US-China Business Council. January 2017.

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.[3] China is also the second-largest market for US motor vehicle exports, after Canada.[4] The breakdown of the top five US merchandise exports to China by order of decreasing importance is given in Table 1.

Table 1. Top five US merchandise exports to China in 2017

Rank	Products	$ Billion
1	Aerospace products and parts	16.3
2	Oilseeds and grains (mainly soybeans)	13.7
3	Motor vehicles	10.1
4	Semiconductors and electronic components	6.9
5	Oil and gas	6.8

Source: US Census Bureau.

Top US imports from China

US imports from China amounted to $505.6 billion in 2017 (21.6% as a share of total US imports), making China the single largest source of US merchandise imports. This is remarkable considering that less than 30 years ago in 1990, China was ranked the 8th largest source of US imports. The breakdown of the top five US imports from China by decreasing order of importance is given in Table 2.

[3] Morrison, Wayne M. April 2, 2018. China-U.S. Trade Issues. Report Number RL33536. Congressional Research Service.
[4] Ibid.

Table 2. Top five US imports from China in 2017

Rank	Products	$ Billion
1	Communications equipment	77.9
2	Computer equipment	58.6
3	Miscellaneous manufactured commodities	36.5
4	Apparel	24.5
5	Semiconductors and other electronic components	23.1

Source: U.S. Census Bureau.

Imports from China are important to many US industries

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% ($17.1 billion) of total US merchandise imports from China in 2017. This figure was 14.1% 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.

Figure 3 shows the relative importance of Chinese imports across a range of US industries. China is the primary source of imported inputs for some industries, such as computer, electronic, optical and telecommunications equipment.

With the integration of global supply chains, it is increasingly difficult to distinguish a domestic good from a foreign good because a larger share of a final good reflects fabrication in multi-staged production systems spanning across several countries. A recent study reported that accounting for production sharing and domestic value added in foreign imports would have reduced the US trade deficit with China by 30-40% ($35-50 billion) in 2004.[5]

[5] Johnson, Robert C. and Guillermo Noguera. 2012. Accounting for Intermediates: Production Sharing and Trade in Value Added. *Journal of International Economics*. Volume 86, pp. 224-236.

Figure 3. Importance of Chinese imports in US industries in 2011

Industry	Chinese imports as share of total imports
Computer, Electronic and optical equipment	40%
Post and telecommunications	39%
Computer and related activities	28%
Manufacturing nec; recycling	24%
Other transport equipment	24%
Pulp, paper, paper products, printing and publishing	22%
Wood and products of wood and cork	22%
Construction	21%
Electrical machinery and apparatus, nec	20%
R&D and other business activities	20%
Machinery and equipment, nec	20%
Wholesale and retail trade; repairs	19%
Other community, social and personal services	18%
Education	17%
Rubber and plastics products	17%
Health and social work	17%
Hotels and restaurants	16%
Public admin. and defence; compulsory social securit	15%
Motor vehicles, trailers and semi-trailers	15%
Renting of machinery and equipment	13%
Other non-metallic mineral products	13%
Fabricated metal products	12%
Food products, beverages and tobacco	11%
Chemicals and chemical products	10%
Real estate activities	9%
Agriculture, hunting, forestry and fishing	7%
Basic metals	7%
Transport and storage	6%
Mining and quarrying	6%
Financial intermediation	5%
Textiles, textile products, leather and footwear	4%
Electricity, gas and water supply	2%
Coke, refined petroleum products and nuclear fuel	0%
Private households with employed persons	0%

Source: OECD World Input-Output Table 2015.

Implications of US-China trade war

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 US, 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. US industries, including agriculture, could be seriously damaged should China retaliate. Regardless of which specific industries might be helped or harmed by US tariffs on imports from China and regardless of whether China retaliates, US consumers would end up losing. This is because tariffs would raise the prices for imported Chinese final consumption goods and for domestic goods manufactured in the US using Chinese intermediate goods. Together, these adverse effects could work to temper US economic growth in the medium run or even revert the economic recovery of the past 91 months.

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