The US-China Economic Rivalry Is About To Heat Up

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Economic conflict between the US and China was the dog that didn't bark in 2017. This year it has begun to bark loudly and will soon bite deeply. The short-term macroeconomic consequences will be modest, beyond putting more downward pressure on the dollar. But the potential long-run impact on trade and investment flows, and on power relations in the Asia-Pacific, could be large.

Washington's announcement this week of 30% tariffs on solar panels and washing machines is just the opening shot of a broader offensive against China. This will not be limited to trade. The past month has seen the release of US strategy documents on national security, defense and trade, all of which for the first time define China purely as a strategic competitor and disavow the long-standing policy of constructive engagement.

Trump may announce a suite of measures directed against China in next week's State of the Union address

Moves likely in the next few weeks—some of which may be announced in President Donald Trump's State of the Union address on January 30—include: tariffs or import restrictions on steel and aluminum (on "national security" grounds); tariffs or other sanctions on Chinese technology goods (to retaliate against China's coercive technology-transfer policies); curbs on investments in the US by Chinese companies; limits on student and work visas for Chinese citizens in tech fields; and tighter restrictions on US technology exports and the ability of US citizens to work for Chinese companies.

Congress is likely to strengthen CFIUS

Further down the road, Congress will probably pass legislation beefing up the Committee on Foreign Investment in the United States, widening the definition of national security under which it can stop deals, and expanding its mandate beyond mergers and acquisitions to include greenfield transactions. Chinese investment in the US is already subject to tighter limits, via both CFIUS (which blocked Ant Financial's proposed takeover of Moneygram) and Congressional pressure (which forced AT&T to renege on a deal to market Huawei smartphones).

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
US new home sales fell -9.3% MoM to 625k in Dec, from 689k in Nov	Slightly lower than 675k expected	Small slowdown after a strong month; expect housing sector to stay strong despite rising rates
German IFO business climate survey rose to 117.6 in Jan, from 117.2 in Dec	Above 117.0 exp.; fwd looking GfK consumer confidence rose to 11.0 for Feb, from 10.8 for Jan	Business confidence at all time high; strong growth continues pointing to 1Q GDP of 2.8% YoY
Chinese industrial profits rose 10.8% YoY in Dec, down from 14.9% in Nov	Below 13% expected	Profit growth has slowed since Sep as the commodity price boost has faded
Japan CPI rose 1.0% YoY in Dec, up from 0.6% in Nov	Headline CPI below 1.1%ex-pected; CPI ex-food and energy unchanged at 0.3% YoY	Inflation continues to under-shoot BoJ target; expect policy to be on prolonged pause

The US remains worried about Chinese theft of intellectual property

The breadth of these measures, far beyond the usual trade-spat tariff hikes, reflects both practical and strategic concerns. On the practical side, the main economic worry is that China is trying to build up its technology industries by stealing American intellectual property and forcing US tech firms into unfavorable licensing agreements or joint ventures. These practices are hard to contain through tariffs, because China's tech-intensive firms mainly serve their huge internal market, and most Chinese tech exports to the US (think iPhones) are manufactured and shipped by foreign companies or their subcontractors, not Chinese companies.

The strategic factor is that US officials believe China is engaged in economic warfare with the aim of displacing the US as the world's preeminent technological and military power. Hence the response must go far beyond normal trade tools, and strike directly at China's technological ambitions.

Why has the US stance suddenly hardened, after a year in which Trump's trade talk seemed mostly empty bluff? The main reason is that trade policy in 2017 was subordinated to the goals of gaining Chinese help on North Korea, and passing a tax cut bill. With the tax bill done and the limits of Chinese action on Korea now well defined, the moment for an economic assault has arrived.

Trade hawk Lighthizer is in the driving seat

Another reason is that it was only in the second half of last year that US Trade Representative Robert Lighthizer (an old trade warrior who cut his teeth battling Japan in the 1980s) wrested trade policy from more accommodating figures like Commerce secretary Wilbur Ross and economic adviser Gary Cohn. The combative Lighthizer is now firmly in control of the international trade and economics agenda.

The coming battles between the US and China over trade, investment and technology will generate plenty of scary headlines, but the initial macroeconomic impacts will be small—which is why markets have so far ignored the storm-clouds. The US and Chinese economies are interdependent to an unusual degree, but they are also vast and complex systems with plenty of shock-absorbers. In both countries, domestic demand is strong and financial resources abundant.

Washington officials overestimate China's vulnerability to trade actions

US officials foolishly believe that China depends so much on foreign trade and investment, and has such a fragile financial system, that unilateral pressure from America will cause it to buckle. As with so much else in the America-first posture, this betrays a wild, outdated overestimation of the US's ability to single-handedly compel other countries to do its bidding.

Last year we estimated that a -10% fall in Chinese exports to the US would knock 0.3pp off Chinese GDP (see **Is China Ready For A Trade Shock From Trump?**). This is material, but can easily be offset by extra infrastructure spending. And China's technological ambitions will not easily be derailed by American investment restrictions. Its domestic innovation capacity has improved dramatically in recent years, and under the "Made In China 2025" industrial policy is backed by hundreds of billions of dollars in government venture-capital funds, which will probably be more effective than traditional subsidies.

Despite their complaints, multinationals remain fully committed to the China market

And despite their many complaints about onerous regulation and lack of market access, foreign companies continue to pour money into China: FDI inflows rose in 2017 (to US$131bn according to the Chinese government and US$144bn according to the UN). So long as China continues to be the world's fastest-growing big economy, the lure of its market will outweigh the fear of technological leakage for many multinational companies. MNCs think they can hedge the risk of IP loss by splitting up their technology, speeding up their innovation cycles, and relying more on processes and services that are tougher to copy than hardware. And they rightly fear that staying out of the world's most dynamic market will dull their competitive edge.

But a sustained US campaign of economic pressure against China does present two sets of risk. In the short run, it will bolster the view that the US is on a mercantilist campaign to reduce its trade deficit, and will push for a weaker dollar to achieve that aim. Treasury Secretary Steven Mnuchin stoked precisely those fears with his casual comments about the benefits of a weaker dollar this week. While other officials including Trump hastily reaffirmed their support for a strong dollar, currency traders should be skeptical. Deficit-reduction is a stated policy aim, and the Institute of International Finance reckons that cutting the current account deficit from 4% to 2-3% of US GDP will require a -10% depreciation of the real exchange rate.

Both the US and China appear set on onshoring globalized production chains...

In the longer term, both the US and China now seem set on re-onshoring the globalized production chains built over the past three decades—the US through inward-looking America-first policies, and China by a program of import substitution designed to minimize the foreign share of its industrial base. These efforts may well be in vain. Even partial success, though, would create two problems. First, the fragmentation of global supply chains is likely to be somewhat inflationary, just as the globalization of supply chains was deflationary.

...which may lower the cost barrier to future conflicts

The bigger worry is geopolitical. Trans-national production chains are a force for peace and stability because they raise the cost of armed conflict for everyone. Retreat into national production structures raises the odds that big countries will try to settle their differences by force. It is far too early to be seriously alarmed. But the direction is unsettling.