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RESEARCH ARTICLE

Why did Trump launch a trade war? A political economy explanation from the perspective of financial constraints

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ABSTRACT

The existing explanations for President Trump's decision to trigger a trade war with most of America's trading partners are not sufficient. The less explored motivation, we argue, is to raise income for the federal government through tariffs in order to balance the surging fiscal deficit caused by Trump's bold tax cut policy since December 2017. The repeated increase in interest rates by the Federal Reserve throughout 2018 is leading to sharp increase in the cost of servicing America's US$21 trillion and growing debt, which means that debt servicing would soon become the biggest outlay of the US government. This new explanation implies that the US will need additional sources of income like tariffs in order to balance its budget, and tariffs on Chinese products is viewed as a main source of such income. China should, therefore, rethink its strategy in seeking a resolution for the trade war.

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Why are not the existing explanations persuasive?

Since the beginning of 2018, the Trump administration has exerted economic and trade pressures on most of America's major trading partners, including its closest allies. This is not surprising, given that since the 1980s Trump has consistently criticised free trade, globalisation and the de-industrialisation of the US. What really surprised global observers were the method and timing he chose to launch the trade war against China. After all, in 2017, Presidents Trump and Xi held two very friendly and productive summits, and the relations seemed to be heading in the right direction. But since the beginning of 2018, the China-US relations have taken a sharp turn for the worse and are continuing to deteriorate.

On 18 August 2017, the US Trade Representative initiated an investigation under Section 301 of the Trade Act of 1974, which empowers the President to take trade actions against foreign practices which violate trade agreements or are otherwise unreasonable or discriminatory. Essentially as the opening shot of the trade war, on

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22 March 2018 the White House issued a Presidential Memorandum on the Actions by the US related to the Section 301 investigation. Tariffs on US$250 billion worth of Chinese goods were slapped in three installments, with additional ones planned should the two countries fail to reach an agreement. To accommodate the US president and his focus on improving the bilateral trade balance, the Chinese government was prepared to reduce the US trade deficit by as much as US$200 billion by ramping up the purchase of US energy and agricultural commodities. This intent was conveyed in at least four rounds of negotiations in the spring of 2017, summer of 2017, fall of 2017, and spring of 2018. However, Trump ultimately rejected China's offers. This humiliated the Chinese negotiators, headed by Vice Premier Liu He, and seriously undermined the mutual trust needed for serious future negotiations to take place. China's confidence in the possibility to reach a mutually acceptable trade deal, and even more so in Trump's ability to uphold such a deal, was shaken. As the adage says, 'once bitten, twice shy'. So why did the trade war break out?

Some experts view this trade war as yet another front in the global struggle between China, a rising power, and the US, the incumbent one. Ma believes that the nature of the Sino-US trade war is an inevitable result of the conflicts between the newly emerging power of China and the incumbent power of the US, with the latter employing the trade war to suppress the former. He points out: 'This is by no means a simple trade conflict or trade war, but an inevitable challenge facing the rising China' (Ma 2018, 10). Wang Yong (2018) focusses on future changes in international order, maintaining that the Sino-US trade war is rooted in the transition of the global power balance; China's rise will change international rules and systems, challenging the Western-led liberal international order. Chen (2018) too writes that, based on history, today's Sino-US trade war is actually rooted in a global strategic competition between the US and fast-growing socialist China. From a longer-term perspective, it is actually a competition for world economic dominance. Similarly, Xie and Zhang (2018) argue that the US-China trade war is a zero-sum game with the incumbent power fearing the new rising power. Apart from Chinese researchers, quite a few other scholars like Bergsten (2018) also view the Sino-US trade war as a manifestation of what is referred to as the 'Thucydides trap'. The US intends to maintain military, diplomatic and economic advantages over other countries, while China is not willing to remain in second place, hoping to gain equal status.

Although many regard the outbreak of the Sino-US trade war as a typical case of the Thucydides trap, this analysis is not sufficiently tenable. If President Trump was merely targeting the rise of China, he should have united his allies to restrain and suppress China. Instead, he did the exact opposite, rejecting the Trans-Pacific Partnership and alienating America's trading partners with tariffs and other economic penalties, including Japan and South Korea, its Pacific partners. Moreover, this view contradicts the US exit from international organisations and Trump's rejection of globalisation. Since Trump came into office, he has taken many measures that undermine the global economic system on which US hegemony is built, undoubtedly accelerating the decline of American influence. To reach a more tenable conclusion, researchers must differentiate between Trump's own policy intentions from those of the various political elites around him who are inherently adversarial toward China.

Strange (1988) proposes that knowledge structure is one of the world's four main power structures. The competition between countries is becoming a struggle for leadership in the knowledge structure, with the US having dominance in all knowledge-structure sectors. Therefore, it is a possible motive for Trump to contain China's technological upgrades, derail the 'Made in China 2025' plan, and maintain US dominance in the high-tech field through the trade war. Li (2018) believes that a main reason for Trump to launch a trade war is to curb China's technological catch-up and by that to slow down China's economic rise. The initial lists of tariffs announced by the Trump administration are not on the low-end manufacturing industries in China, but the high-tech ones. Wang Yiwei (2018) believes that the purpose of the trade war is to reorganise the world industrial chain, locking China in the low end. Yang (2018) believes that the biggest worry of the US is not trade deficits, but China's ability to acquire industrial independence and economic dominance through technological development. This would undermine the US fundamental competitive advantage, namely, the knowledge-intensive industries and economic hegemony of the US. Some non-China's media has analysed the purpose of 'Made in China 2025', considering it a means for improving Chinese industry and long-term economic prosperity. In response and as a precautionary measure, Donald Trump announced a range of tariffs on Chinese goods (Victorino 2018). Lake and Weiss (2018) write that the real economic competition between the US and China is in industries of the future – robotics, artificial intelligence, biotech and more. The Trump administration appears to believe that the trade war will prompt Beijing to abandon the 'Made in China 2025' initiative. But this argument flies in the face of Trump's disinterest in science and some of his domestic policies which are friendlier to traditional industries, such as the energy and infrastructure industries. His claim that global warming is a hoax, the withdrawal from the Paris climate agreement and the snub of renewable energy are not conducive to the development of knowledge economy. Trump has done very little to promote and bolster America's scientific and innovation base and his relationship with Silicon Valley leadership is fraught with problems. Innovation and scientific superiority is something he may talk about but his actions do not match his talk.

Other scholars maintain that the trade war stems from Trump's desire to re-industrialise the US by repatriating manufacturing supply chains and creating manufacturing jobs, particularly in the US Midwest where his electoral support base is concentrated. This would please his constituents and help him gain political credit, thus providing the Republican with advantages in the elections. There are also observers who believe that Trump is embracing a trade war to endear himself to his nationalist base (Frum 2018). While some of his policies are in line with the demands of blue-collar workers, the current US economy and employment situation do not justify this interpretation. At present, the unemployment rate in the US is at the lowest level since 1969. The US economy is also in recovery, which has greatly benefited Trump supporters. The Trump administration did not face real pressure to maintain and create blue-collar employment. The hasty trade war is likely to be self-defeating. When it comes to repatriating supply chains, the Trump team surely understands that even if corporations left China, their destinations would be countries with lower labour costs such as Vietnam, Malaysia, Thailand and India, rather than the US where manufacturing costs are very high. According to Zhang, Xiong, and Ji (2018), only about 3% of the Chinese manufacturing sectors will be forced to move out, even if China's exports to the US fell to zero. China's exports to the US and their supporting industries account for only 5% of China's manufacturing industry. Creating jobs through trade wars is theoretically untenable. Furthermore, the trade war has hurt, more than anybody else, the farmers in the Midwest who are an important part of Trump's political base.

All of the above explanations may be valid, but not entirely satisfactory. This paper offers a fresh explanation for Trump's decision to launch the trade war in early 2018 and escalate it since. We suggest that the biggest economic constraint Trump faces today is fiscal imbalance. Trump's signature domestic achievement – the Tax Cuts and Jobs Acts of 2017 – has sent the US economy into a dangerous unfunded deficit, and Trump must find a substantial and sustainable source of revenue to balance the ballooning deficit he himself created. Failing to identify another source of income he concocted a national security-driven trade war with China and the rest of the world, under which he could justify the imposition of tariffs, which are essentially a new tax on the American people.

Although some scholars have mentioned the significance of trade war which can provide cash flow to balance tax cuts (Li 2018), this explanation lacks thorough investigation and demonstration. In the following section, we explain the indispensable costs of Trump's tax cuts. Then, we examine the limitations and dilemmas that Trump faces in implementing the tax cuts. In the final section we provide policy recommendations for how China should respond to this trade war.

The costs of tax cuts

The Tax Cuts and Jobs Act of 2017 was signed into law by Trump in December 2017, and has been implemented since January of the following year. It is Trump's biggest legislative achievement to date, and with Democrats now in control over the House of Representatives it may be his last. Unlike the bipartisan Tax Reform Act of 1986, which cleared the Senate with 97 votes, Trump's tax reform was passed without support of a single Democrat. This plan brought great expectations for economic revival, just as the Reagan and George W. Bush administrations did in the 1980s and 2000s. In addition to a 2–3% reduction in individual income tax, the tax reform included a cut in estate taxes and a one-time repatriation tax of overseas profits to allow US multinationals to move US$3 trillion held in subsidiaries and tax shelters overseas back to the US. The idea was that this money would spur investment, create short-term economic growth and bring about a historically low unemployment rate. But history has demonstrated that the trickledown effect of tax cuts falls short of expectations, leading instead to sharp rises in fiscal deficits. As of this writing, Trump's tax cuts seem to be no exception. The Joint Committee on Taxation estimated that the tax cuts would create a one trillion-dollar revenue hole which would significantly increase the US fiscal deficit over the 2018–2027 period, in addition to the US$10 trillion debt increase already projected by the Congressional Budget Office for the 2018–2027 period and approximate US$21 trillion in national debt that already exists. One year after Trump's tax reform implementation, it seems that the results are less promising than expected. In October 2018 the Trump administration announced that the federal budget deficit ballooned to US$779 billion, a 17% jump from the previous fiscal period, hitting a six-year high (*CBS News* 2018).

Furthermore, escalating trade deficits worsened the fiscal status of the Trump administration (Priest 2018). Federal revenues only increased slightly following the tax cuts and Trump has already instructed his cabinet members to prepare themselves for a 5% cut in discretionary spending in the fiscal year 2020, around a US$65 billion (0.3% of GDP) reduction. In other words, Trump's tax cuts have failed to deliver a balanced budget, and therefore, beg for a new source of federal income, or else borrowing costs would become prohibitive, financial markets could suffer a major blow and the government could experience frequent shutdowns. Before the mid-term elections, Trump was hoping for another tax cut in 2019, which would provide the economy with yet another boost. In September 2018, House Republicans rolled out 'Tax Reform 2.0', a set of new proposals to add on to the 2017 bill. Among other things, the proposals would make the individual tax cuts contained in last year's legislation permanent (they are currently scheduled to expire after 2025). Now with the Democrats in control, the second tax cut is effectively dead and there are no good solutions for how to pay for Trump's initial tax cuts.

The main reason why tax cuts have so much deepened the deficit lies in the collapse of the PAYGO rule. PAYGO was a restrictive clause of the US government budget, requiring that any new legislation affecting revenues and spending does not increase projected budget deficits. The original PAYGO was part of the Budget Enforcement Act of 1990 and worked well for the subsequent seven years (Tax Policy Centre 2016). During that time, President George H. W. Bush and Congressional leaders negotiated a large deficit reduction package which combined spending cuts and tax increases. This led to a near-elimination of the federal deficit during the presidency of Bill Clinton. But at the end of 2002, during the presidency of George W. Bush, PAYGO expired. The result, much attributed to the wars in Iraq and Afghanistan, was a massive increase of the US debt, to the tune of US$5.85 trillion, effectively doubling US total debt obligations. In 2010, during the Obama era, the latest version of PAYGO was introduced in order to put the fiscal house in order[1].

During conversations on Trump tax cuts, to keep the budget under control House Republican leaders pushed for a controversial provision called 'border adjustment tax' (BAT), which would tax all imports, regardless of the country of origin. This would be an important means of balancing tax cut expenditures. It was estimated that had the BAT been implemented, the Federal government would have been able to raise up to US$1 trillion, an amount crucial to cover the costs of the tax cut plan. However, there are two drawbacks to levying tax on all products. First, it would provoke retaliation from other trading partners, thus hurting exports. Second, it would lead to higher inflation, causing consumer dissatisfaction and tightened monetary policy by the Fed. As far as Trump was concerned, these two drawbacks seemed tolerable. The US external deficit is huge, and dependence of the trading partners on the US market is far greater than US dependence on them. He believed that his opponents would concede, and the US would win the trade war (prior to the imposition of tariffs on China, Trump's economic adviser Peter Navarro appeared on national TV and confidently stated that

China would not dare retaliate against US tariffs because it has more to lose). But the BAT faced very strong pushback by special interest groups as well as Senate Republicans. In July 2017, it was officially declared dead.

Despite being unable to find new sources of income[2] to fund tax cuts, and despite his grand and expensive plans to build a wall, increase military spending, create a Space Force and revitalise national infrastructure, Trump and the Congressional Republicans decided to move forward with the reform, hoping that the tax cuts would pay for themselves through growth. This was wishful thinking which ignored the warnings of many economists. This leads us to the conclusion that Trump's global trade war should be viewed not only as a punishment toward China, but as an important means of supporting his Tax Cuts and Jobs Act policy and providing a considerable and sustainable source of income to the Federal government. In essence, the tariffs are an elegant and more politically digestible version of the BAT. If a BAT of 10% was directly imposed on about US$2.7 trillion worth of goods imported, regardless of their origin, the US Treasury would be able to gain roughly US$250 billion annually, more than enough to pay for the tax cuts. Instead, if a 25% tariff is eventually imposed on all goods coming from China, government revenue could increase by more than US$120 billion a year. Tariffs are *de facto* a new tax on ordinary households. While Americans are strongly averse to new taxes, they are willing to accept costs associated with national security. This is exactly why China is such an easy scapegoat. By setting off a trade war, targeting China under the slogan 'unfair trade plundering US's money and jobs', Trump succeeded in portraying himself as a national hero defending the US economy from foreign predators, bringing the middle and lower classes together.

The debt time bomb

In 2017, the initial Trump administration plan was to control the debt growth by keeping interest rates low. The cost of servicing debt was the only major expenditure of the federal government that could be easily reduced and save hundreds of billions of dollars per year (Di 2017).

As shown in Table 1, the US debt today stands around US$20 trillion. Since the financial crisis of 2008, the US federal debt mounted from 60% of GDP to over 100% (see Figure 1), while China was expected to invest a growing part of its vast foreign exchange assets in US Treasury bonds. Since 2001, China's share of foreign held treasuries has grown from 6% to more than 20% today. Over the same period, interest rates on the debt were sliced by 2/3. Today, China is still called to buy more debt. It already owns nearly US$1.4 trillion in total (including custodian accounts and agency holdings). For some time buying US debt suited China, but slower Chinese growth and increasing tension with the US have triggered new thinking regarding the sustainability of this arrangement. Under the baseline scenario of the Congressional Budget Office, the US debt will rise from US$21 trillion in 2018 to over US$27 trillion in 2025. This means that, all being equal, China will be expected to buy more and more US debt. If China continues to hold the same ratio of US foreign debt, it will be expected to increase US debt holding by an extra US$80-100 billion a year for the foreseeable

Table 1. US historical debt outstanding, interest paid and interest rates during 2000–2017.

Fiscal Year	Historical debt outstanding, $billions, US	Interest paid $billions, US	Interest rate
2017	20,244	458.5	2.26%
2016	19,573	432.6	2.21%
2015	18,150	402.4	2.22%
2014	17,824	430.8	2.42%
2013	16,738	415.7	2.48%
2012	16,066	359.8	2.24%
2011	14,790	454.4	3.07%
2010	13,562	414.0	3.05%
2009	11,910	383.1	3.22%
2008	10,025	451.2	4.50%
2007	9,008	430.0	4.77%
2006	8,507	405.9	4.77%
2005	7,933	352.4	4.44%
2004	7,379	321.6	4.36%
2003	6,783	318.1	4.69%
2002	6,228	332.5	5.34%
2001	5,807	359.5	6.19%
2000	5,674	362.0	6.38%

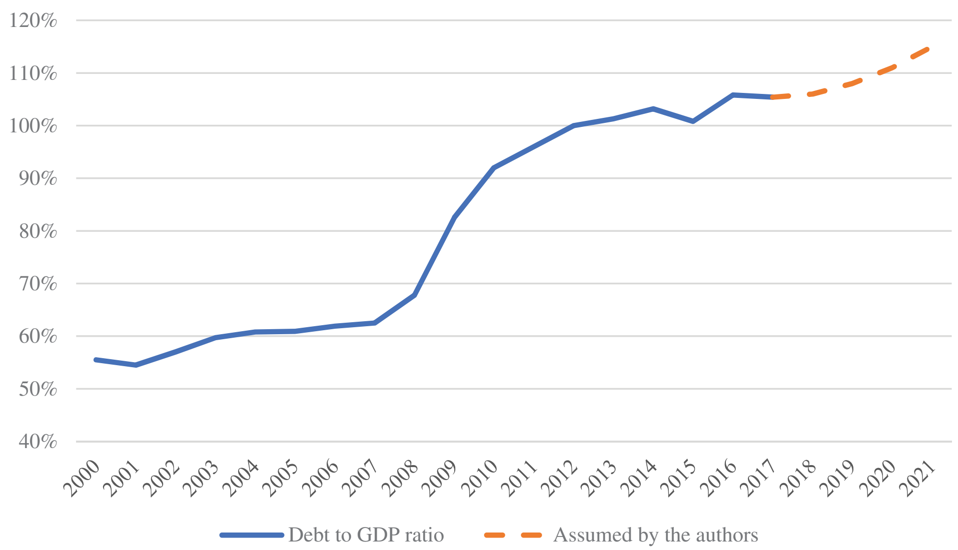

Figure 1. US gross federal debt to GDP.
Data source: Tradingeconomics.com.

future. Essentially, this means that China would be called to almost double its US debt holding within a decade in order for the US economy to stay afloat.

The US government can roll over debts by borrowing new ones, but interest constitutes an important part of government spending. Considering that most US government spending is determined by the Congress, the President has little wiggle room when it comes to reducing the cost of debt servicing. For example, in 2017, the Department of Treasury returned relatively expensive long-term government bonds, while borrowing relatively cheap short-term bonds to lower payments. By shifting from long-term to short-term, the Trump administration can save money and drive down the dollar index. However, because foreign governments are typically willing to buy long-term government bonds rather than depositing reserves into short-term bonds,

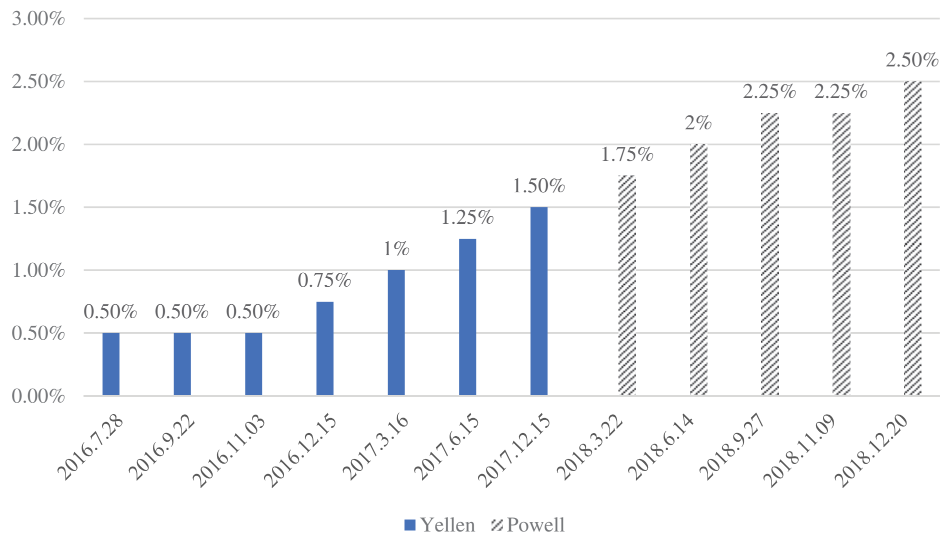

Figure 2. Interest rate hike comparison between Yellen and Powell.
Note: In January 2017, Trump went into office; in February 2018, Powell went into office.

the Trump administration's reduction in the long-term bond supply can force the transfer of a portion of official foreign exchange reserve funds out of the US dollar, thereby shorting the dollar.

The first two decades of the 21st century have witnessed a quadruple increase of historical debt outstanding, with only a 27% rise of interest payments. This is due to the continuous Federal slashing of the interest rates and the decade of low interest rates following the financial crisis. But this is now changing. During the 2016 campaign, Trump accused then Fed Chairwoman Janet Yellen of keeping interest rates too low. However, since December 2016, the Fed has continuously raised interest rates, beginning to shrink the balance sheet (see Figure 2). Trump was not happy. He publicly claimed that the US needs low interest rates and weak dollar. He tried to convince Yellen to support his low interest rate policy, but to no avail. Interest rates began to move up. This partially led Trump to replace Yellen with Jerome Powell, a lawyer rather than an orthodox economist, whom he believed would back his low interest policy. But, adhering to the principle of independence of the Fed, Powell implemented an even more aggressive rate hike policy. Powell raised interest rates four times in 2018 and already announced two hikes in 2019. Trump did not hide his disappointment and resentment. In December 2018 he even threatened to fire Powell.

Powell's betrayal limited Trump's ability to govern the economic agenda of the country. Trump had hoped he could encourage economic growth by cutting taxes and save money by keeping interest rates low. Instead, he has dug the US economy into a fiscal hole while the 'insubordinate' Fed opts for higher interest rates and hence higher debt servicing costs. According to the Congressional Budget Office, the cost of interest is on track to hit US$390 billion in 2019, nearly 50% more than in 2017. This projected annual growth rate of this amount is expected to surpass US$900 billion within a decade. This means that the Federal government is on track to pay more debt interest than it spends on the military, Medicaid or children's programmes.

In summary, the beginning and evolution of Trump's trade war seem to maintain a certain degree of consistency with the primary measure of making up for tax cuts through low interest rate. According to Table 2, Trump's remarks during the Fed's interest rate hike are also in line with his situation: before coming into power, he attacked the Democratic Party and Yellen's low-rate policy; after he took office, instead, he hoped that Yellen would continue her low interest. When Trump finally replaced Yellen with Powell, and then perceived Powell's betrayal intentions, the trade war set off – just one month after Powell's nomination. During Powell's constant rate hikes, Trump continuously deepened and exacerbated the trade war, while criticising Powell and the Federal Reserve.

The forecast in Figure 3 reveals a threat of the US economy sinking under a huge financial burden, which forces the US government to raise taxes and cut spending. Because raising taxes is not politically acceptable, Trump and future presidents are likely to continue to find innovative ways to tax the American people under the guise of various national security imperatives. After tearing up China's large trade concession agreement, Trump repeatedly said that China's concessions were not enough, therefore, beginning the tax increase process (Behsudi 2018). He also tweeted that tariffs will make the US richer and stronger: no matter the opponents choose to negotiate with the US or not, the US can earn a large sum of money. And indeed the US Treasury is already earning billions from the trade war. Figure 4 demonstrates the surge of customs duties and the monthly assessed revenue (*Economist* 2018).

Recommendations and the future of the trade war

It is our conclusion that Trump's trade war is, to a large extent, a mechanism to raise funds to cover tax cuts and improve America's fiscal situation. While this may not be his only motivation and while he may eventually agree to make a deal, the thirst for new outside revenue streams will always be part of his calculus. Many Chinese negotiators ignore this point, making trade negotiations with the US less effective. In its 2017–2018 rounds of trade negotiations, China tried to reduce its trade deficit with the US by purchasing a large amount of US goods, but as mentioned before Trump was not interested. We are not suggesting that revenues were the only motivating factor. To be sure, the US concerns about intellectual property protection, cyber intrusions and discriminatory policies against US firms operating in China have played a big role in shaping the US administrative positions toward China, and no peace deal is likely to emerge without an acceptable solution to these problems. Instead, we are suggesting that the need for revenues incentivises Trump to prolong – rather than shorten – the trade war, and to adopt hardline positions and raise the price of a peace deal with China. In other words, a trade agreement would deny the federal government a steady and much needed source of income. Based on this conclusion, we offer the following recommendations.

First, the Chinese government should assume that as long as the US Treasury is starved for cash, Trump will have an incentive to maintain tariffs on goods exported by major world economies to the US – China as the first among them. Beijing should abandon the expectation that the era of low-tariffs can somehow be restored. Chinese

Table 2. Fed's interest rate change and Trump's remarks.

The Fed's interest rate policy	Trump's remarks
20 December 2018 2.25–2.5%	22 December 2018 Trump discussed about firing the Fed chair Powell. 23 December 2018 Mulvaney said that Trump 'now' realised he cannot fire Fed chair Powell. 24 December 2018 Trump claimed on his Twitter that 'The only problem our economy has is the Fed. They don't have a feel for the Market, they don't understand necessary Trade Wars or Strong Dollars or even Democrat Shut downs over Borders'. 25 December 2018 'They're (The Fed) raising interest rates too fast because they think the economy is so good. But I think that they will get it pretty soon', Trump told reporters in the Oval Office, referring to the US central bank.
9 November 2018 2.25–2.25%	21 November 2018 Trump once again opened fire on the Fed, hoping that the Fed would lower interest rates, saying that the Fed was the biggest present problem. 26 November 2018 Trump told *The Wall Street Journal* that he thought the Fed was a much bigger problem than China, and he hated the things the Fed did about the interest rate. 27 November 2018 'I'm not even a little bit happy with my selection of Jay (Powell)'. 11 December 2018 Trump told Reuters that the interest rate hike was stupid. He needed the quantitative easing, but Powell's was too radical.
27 September 2018 2–2.25%	27 September 2018 Trump convened a press conference to criticise the Fed just a few hours after it raised interest rates. 11 October 2018 In an interview with the Fox TV, Trump said that 'because of the Fed I am paying high interests. They are making a big mistake.' The day prior, he said 'the Fed is crazy'. 12 October 2018 Trump said that the Fed had lost control. 16 October 2018 Trump called the Fed his biggest threat. 23 October 2018 In an interview with the *Washington Post*, Trump said that every time he did something good, Powell undermined US economic growth and appeared happy with his high interest rates. He admitted that there might be some regrets in appointing Powell. 30 October 2018 On Twitter, Trump announced the hawkish style of the Fed as being responsible for the stock market.
14 June 2018 1.75–2%	20 July 2018 Trump claimed that the constant rate hikes had caused the loss of US competitive advantage, which was seen as a signal for the president to intervene the Fed's decision. August 2018, Trump again criticised the Fed's interest rate hike policy in an interview with Reuters.
22 March 2018 1.5–1.75%	9 May 2018 Trump again mentioned his preference for low interest rates in his White House speech. Allegedly, he was trying to interfere with the Fed's decision.
15 December 2017 1.25–1.5% 15 June 2017 1–1.25%	4 December 2017 Trump's tax cuts and job acts plan was passed. 13 June 2017 Trump said he believed that Federal Reserve Chairman Yellen was also a low interest rate supporter, just as him. 19 October 2017 Trump changed his tone and said that he 'likes and respects Yellen'.
16 March 2017 0.75–1%	April 2017 Trump accepted an interview with the *Wall Street Journal* and said he preferred low interest rates.
15 December 2016 0.5–0.75%	Trump was about to take office, and the Republican Party believed that the interest rate hike 'intensifies the difficulties'.
22 September 2016 0.5%	26 September 2016 Trump claimed that the Fed's practice of maintaining low interest rates was a pure political behaviour in a TV speech.
2011 0.5%, a very low interest rate since 2008	Trump said on his Twitter that 'the Fed's reckless monetary policy will cause troubles'.

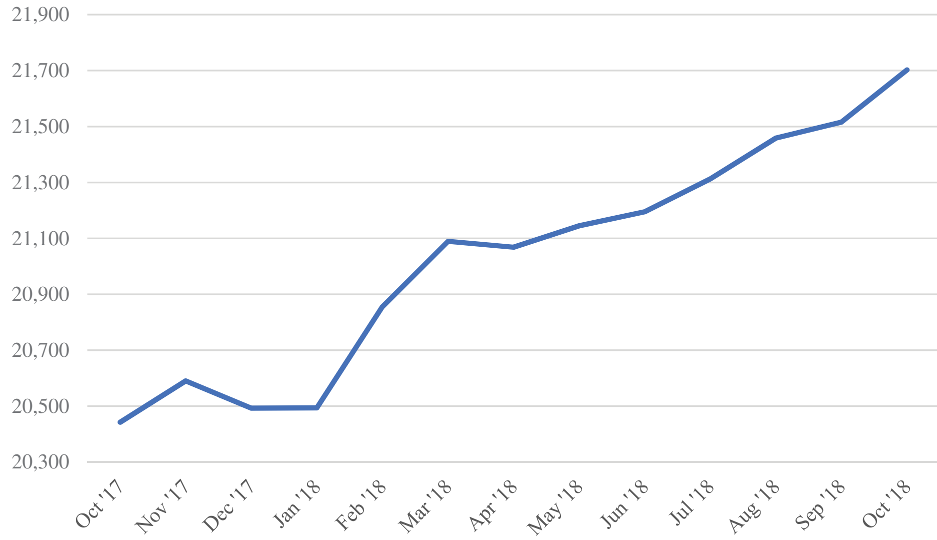

Figure 3. The US public debt from October 2017 to October 2018, by month (in billion US dollars). Data source: US Department of the Treasury.

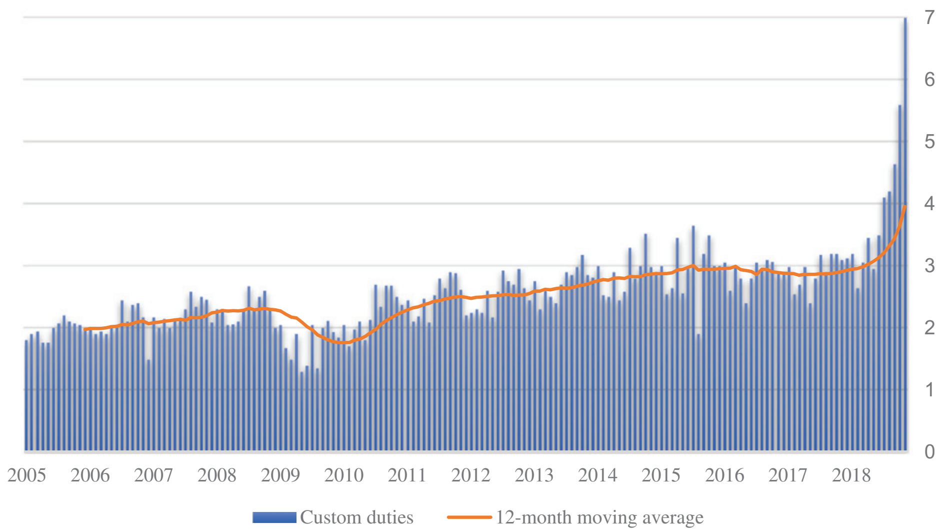

Figure 4. Custom duties, monthly from January 2005 to 28 November 2018 (in billion US dollars). Data sources: Department of the Treasury; Customs and Borders Protection; *Economist*.

reforms, pledges or abandonments of industrial policies would have to be deep and meaningful in order to be enough for Trump to relinquish his newfound source of income. If anything, it is more likely that the tariffs will increase over time, unless the US government faces a very strong pushback from its own citizens who are hurt by the trade war. China should, therefore, focus on adapting itself to the new reality and find creative ways to overcome and even benefit from it.

Second, given Trump's penchant for unorthodox deal-making, China could consider unconventional offers that would reduce the US debt to China in exchange for favourable political conditions that would be unimaginable under normal circumstances. For example, China can propose to use debt forgiveness to buy the US's share in some international organisations (such as the IMF and World Bank). In this way China can gain greater influence in multinational organisations while providing the US with debt relief.

Third, China could seek to embark on frank and serious conversations with the US on the status, scope and direction of foreign debt increases. Withdrawing from debt buying would lead to an increase in US financing costs, worsening the federal financial situation, but this would hurt China no less. On the other hand, a business-as-usual approach in which China is called to buy more and more US debt without any sign on the horizon of debt shrinkage is equally untenable. China could therefore signal to Washington that it can no longer take China's debt buying for granted. The two countries should elevate the matter in their bilateral dialogues and draw a long-term plan which balances the US needs with China's will and capabilities.

Finally, China could be aware that the trade war is directed against all of America's major trading partners – not exclusively against China. Should the US and China be able to reach a trade deal after all, Trump could still find other countries to target with tariffs. For example, since March 2018 Trump has been threatening to impose tariffs on the EU automotive industry. This urge for revenues should guide Chinese diplomacy in the coming years. China could work with other major economies in an effort to reach a zero tariff trade system and recruit as many countries as possible to endorse this vision. Then, and only then, Washington may be persuaded to abandon the trade war path.

Disclosure statement

No potential conflict of interest was reported by the authors.

Notes

1. The Obama administration re-introduced PAYGO and imposed restrictions on the size of government's fiscal deficit. One way for Trump's tax cuts to be exempt from PAYGO's terms is that the Congress votes to shelve it, which would not be easy for the current Republican Party. The new Speaker of the House Nancy Pelosi also expressed her willingness to launch the PAYGO clause and limit the current huge government deficits. If the PAYGO clauses take effects during the tax cut implementation, Trump will have to reduce spending or implement a corresponding tax increase. If the counter measure is to increase taxes, Trump's tax cuts are likely to have little or no success.
2. Trump has also taken other measures to make up for the fiscal deficits, but they are very limited. The first is to reduce US participation in international affairs and reduce spending on global public goods. The withdrawal of the US from multilateral international organisations and the collection of protection fees from allies and geopolitically protected countries has become convenient ways to raise money, but its scale is far from enough. Second, the tax cuts bill reduced the tax rate on US companies' overseas profits to 10%, which has caused part of the US$2.6 trillion that have been stored overseas to repatriate to the US. However, incremental taxation (according to the Bureau of Economic Analysis, US$305.6 billion profits have been repatriated to the US) is not sufficient to cover the financial losses caused by tax cuts, and it is a one-time income.

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