China's supply chains

Collateral damage

In a trade war, Asia's small open economies would be caught in the crossfire

CHINA is the stated adversary in Donald Trump's incipient trade war. But 30% of the value of the goods China exports to America is added elsewhere. If the row escalates, countries entwined in Chinese supply chains will suffer.

In absolute terms, Japanese suppliers will fare worst. Japan is the country that exports most to firms in China that export onwards to America. But relative to economic size, such suppliers are a bigger part of several small, open Asian economies (see chart). Between 1% and 2% of some countries' total output is shipped first to China and then on to America. If Chinese exports to America were to fall by 10%—an extreme but not impossible scenario—it could knock 0.1-0.2 percentage points off their economic growth.

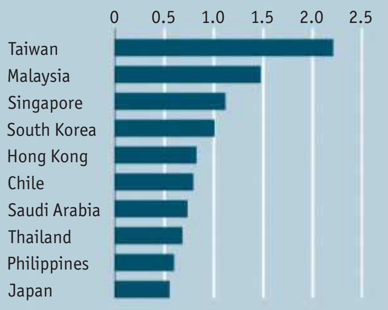
China's competitors in industries that have been threatened with tariffs, namely aerospace, machinery and IT, however, would benefit. There are many of these in Mexico, Germany and Japan. Tariffs also encourage companies to switch their investment plans. When Ronald Reagan forced Japan to restrict its car exports to America in 1981 he (unintentionally) boosted Japanese investment in Thailand's fledgling car industry. Manufacturing has already started to shift from China to other, cheaper countries in the region. Tariffs on goods made in China would speed this up.

If the Chinese retaliate, an early target will be America's farm exports. Brazil, the world's second-largest producer of soyabeans behind America, would be happy to pick up the extra business. But America's and China's competitors should not cheer from the sidelines. A trade war would damage the world's two largest economies and hit global growth. That would be bad for everyone.

Supply-chain pain

Value added to Chinese exports to United States

As % of GDP, 2017 estimate



Source: OECD

ment's plan to achieve global dominance in industries it regards as strategic.

Two clocks have thus been set ticking. The full list of proposed tariffs will be published by April 6th, after which it will remain open for public comment for 30 days. Stephen Mnuchin, Mr Trump's treasury secretary, has until May 21st to come up with proposals for restrictions on investment. It seems possible that neither will actually go into effect. Even as Mr Trump talked tough on March 22nd, he also spoke of a big, ongoing negotiation with the Chinese government. He has asked it to reduce America's bilateral trade deficit by $100bn. He seems to be presenting China with a choice: a grand bargain or a trade war.

Fighting on many fronts

The first part of the plan seems sensible enough. WTO procedures are designed to reduce the risk that a trade dispute escalates, by giving countries a chance to vent their frustrations in a controlled setting and by setting out the consequences if the rules are broken. America could find support for its case from Japan and the EU, both of which share America's concerns over China's technology-licensing practices. Using the WTO to resolve this trade tussle could be taken as a vote of confidence in the multilateral trade system.

A grand bargain, too, might contain some useful additional measures. The Trump administration is reportedly demanding that China lower its tariffs on imported American cars, liberalise its rules governing financial services and, perhaps, cut subsidies for state-owned enterprises. Similarly, more systematic scrutiny of incoming Chinese investment could be prudent, rather than nakedly protectionist.

But given the Trump team's attitude towards the rules-based multilateral trade system, such hopes seem fleeting. Mr Trump often blasts the WTO for being biased (there is no evidence that it is). That weakens its ability to resolve disputes. For the system to work, WTO members must support it and think that others will, too. If China thinks America may ignore a ruling against its interests, why should it play along? Meanwhile, the Trump administration is undermining the WTO by blocking the appointment of judges to its court of appeals. If America ends up wanting to appeal against a ruling in favour of China, this will become self-defeating.

As for Chinese investment in America, the CFIUS committee was already toughening its oversight. According to Rhodium Group, a research firm, this was part of the reason Chinese investment in America fell by 35% from 2016 to 2017 (a Chinese clampdown on outbound capital was the main factor). New rules that give wide discretion to the president, or block investment on economic rather than national-security grounds, could easily be abused.

In the short term, bullying could get results. Mr Lighthizer is not the only person in Washington frustrated by the limited results of years of talks with China about its economic strategy. The threat of stiff tariffs on South Korean steel imports and of withdrawal from KORUS, a trade deal between America and South Korea that came into force in 2012, speedily secured changes to that deal desired by the Trump administration and announced by South Korea's government on March 26th.

But browbeating tactics also weaken the rules-based trading system. They do this, in part, by encouraging managed trade. In the 1980s America could be bought off by other countries that promised "voluntary" restraints on their exports. But this made a mockery of the idea that markets, rather than bureaucrats, should determine trade flows. The revamped KORUS includes a cap on South Korean steel exports to America of 70% of the average between 2015 and 2017. (This arrangement would appear to flout the WTO's rules, though other members may choose not to challenge it.) China is reportedly offering to buy more American semiconductors to stave off tariffs. Wilbur Ross, the commerce secretary, recently suggested that China could buy more natural gas from America.

As the Chinese representative complained during a heated WTO committee meeting on March 26th, Article 23 of the WTO's rules includes a pledge not to claim violations of the trade rules unilaterally, but to use the WTO's dispute-settlement process. Article 23 refers only to commitments specified within the WTO. The Americans say that where such commitments have been broken, they have duly filed a WTO dispute. What they do regarding other misdemeanours, they argue, is their own business. But since America is threatening China in ways that would contravene its own WTO commitments not to break agreed tariff limits, the distinction is not so clear. And once WTO members start writing and enforcing their own rules, the existing rules could lose their force.

There is more potential for trouble if America's unilateral actions do not have their desired effect—especially if the multilateral system weakens. So far China has been keen to be seen to follow the WTO's rule book. On March 23rd it responded to steel and aluminium tariffs by announcing