Economic War with no End in Sight*

C.P. Chandrasekhar

The tariff war with China unleashed more than a year back by the Trump administration threatens to turn into full-fledged economic war. The US claims that China is engaging in unfair trade practices and adopting coercive measures against US firms, undermining US economic interests. China not only denies US allegations, but in a White Paper released early June dismisses US claims that it reneged on agreements arrived at in the negotiations to end the war. In the press conference held to release the paper, Vice-Minister of Commerce Wang Shouwen noted that it is not uncommon for both sides to propose changes to the text of an agreement in the course of consultations. “Nothing is agreed until everything is agreed,” he reportedly said.

It is now increasingly clear that while the initial tariff spat was clothed by the US in the rhetoric of generalised protectionism, which included a rewrite of NAFTA and exit from the Trans-Pacific Partnership, the war with China is special. It is aimed at forcing China to step back in its drive to become another economic superpower. The rhetoric against China is not just that it runs large trade and current account surpluses with the US or that it is stealing technological secrets to bolster its competitiveness, but that the activities of its firms pose a national security threat to America. The issues go beyond the purely economic.

The real agenda of the Trump administration comes through from the way its economic war with China has evolved, in contrast with its measures against countries like Canada, Korea, Mexico and Germany. Initial US action against China, which started early 2018, was similar to that adopted vis-a-vis other countries that were deriving asymmetrical benefits from their trade with the US. In January 2018 the US imposed quotas and tariffs on solar panel and washing machine imports, ostensibly to benefit US manufacturing. This was followed in March 2018 with tariffs of 25 per cent on steel and 10 per cent on aluminium, which too were imposed on imports from countries other than China as well. Interestingly, while the tariffs on solar panels and washing machines were imposed on the ground that imports were causing injury to US industry, steel and aluminium were targeted on “national security” considerations, marking a transition in the justification provided for the new protectionism. These tariffs were not targeted solely at Chinese imports, and even when countries such as Argentina, Brazil or South Korea were granted exemptions, import quotas were specified. But the focus was China, especially on the ground of threat to national security..

That became clear when the US administration proposed tariffs on products worth $100 billion imported from China. In a first step to implement that proposal, tariffs of 25 per cent were imposed on $34 billion worth of imports from China in July 2018. This largely covered agricultural products. Then, in September, similar 25 per cent tariffs were imposed in $16 billion of imports from China consisting of products such as semiconductors, chemical and motorcycles. And in October tariffs on $200 billion worth of Chinese imports, which had been announced in July were imposed.

Initially China’s response to this US trade war was muted. It imposed duties on a set of US exports to it (such as aluminium waste, pork and fruits and nuts) of a value of just around $3 billion. But soon, China decided that it needed to show it is not afraid of retaliating. When faced with the July action of the US, China's response was more aggressive, with 25 per cent tariffs on $50 billion worth of imports from the US, also imposed in two stages in tandem with US actions. Finally, when in October, the US imposed tariffs on another $200 billion worth of Chinese imports, China responded with retaliatory tariffs of either 5 or 10 per cent on $60 billion of its imports from the US.

It was at this point that in December 2018, the Presidents of the two countries decided to call a truce, start negotiations and not escalate the trade war in the near future. But with a rider from the US that if an agreement is not arrived at by March it would consider raising the 10 per cent duty imposed on a range of Chinese imports to 25 per cent. Initially it appeared that talks were going well, but in a sudden turn after 7 rounds the US alleged that the Chinese had gone back on their promises. This has triggered the current aggressive second phase of the economic war that has gone far beyond tariffs. On May 10, 2019, the US administration did raise the 10 per cent tariff on $200 billion worth of imports from China to 25 per cent. With this the US had imposed tariffs on imports worth $250 billion exclusively from China, whereas the tariffs on imports exclusively from the US imposed by China covered products worth $113 billion.

But now, tariffs were soon accompanied by US sanctions of various kinds. To start with the US decided to impose a ban on use of Chinese telecom major Huawei's technology in the roll-out of 5G within the US, claiming that this would be used for espionage purposes. In mid-May 2019, the US government issued an executive order legalising this threat to bar US companies from using telecommunications equipment manufactured by Chinese companies such as Huawei and ZTE. Thus, imports from Huawei of 5G technology have been banned, on the grounds that the company is linked to the Chinese state. The US has also been pressuring other nations to refrain from purchasing 5G equipment from Huawei, ostensibly on security considerations. Some like Australia and Japan have complied. Others like Denmark, Sweden and the UK, besides many emerging markets are undecided or against the ban.

The US government also placed Huawei on the 'Entity List', which means that US companies wanting to transact business with the Chinese firm would have to obtain a licence. Intel, Qualcomm, Xilinx, Broadcom, Google, and others, have already announced that they will stop selling hardware, such as chips, and offering software services to Huawei. Firms outside the US, threatened with loss of business connections with that country, are also cutting links with Huawei. For example, chip designer ARM has announced its decision to break ties with Huawei, citing its dependence on "US origin technology" that makes it subject to the Trump ban. In the event, Huawei would be hard put to produce its own chips that are heavily dependent on ARM technology. In addition, with Chinese semiconductor production being a fraction of global supply, a major like Huawei is bound to be affected by the US effort at targeted sanctions. According to reports, in 2017, Huawei bought as much as $11 billion worth of components, especially computer chips, from US firms.

But this is not the only hit Huawei has taken. With Google having withdrawn Huawei's Android license, Huawei phone users have been shut out from updates of their operating system and the benefits of Google Play, ensuring that demand for Huawei phones from new buyers would shrink hugely. More than one mobile company has announced ending its tie up with Huawei. So besides being hurt by loss of potential markets for its 5G technology, Huawei seem to be shut out of the mobile phone business from both the production and demand sides.

It not just Chinese firms that are hurt. The US actions can hit the profits of US firms exporting to China and producing in China. Moreover, the fallout of the trade war would lead to loss of US jobs. So, the stakes here are not purely economic, but strategic. Matters would get worse as the US actions increase the pressure on China to retaliate, not least in order to bolster its image at home.

While the Trump administration has relied on the threat to national security angle to justify its hit on Chinese firms, especially Huawei, many see in it a direct effort to reign in growing Chinese superiority in a range of hitech areas, that would challenge US supremacy. Recognising this, China too has decided to go beyond tariffs and trade. It has announced that it plans to prepare a list of foreign companies that work against the "legitimate rights and interests" of Chinese firms and corporate groups. A Commerce Ministry spokesperson declared that "Some foreign entities violate market norms, break the spirit of business contracts, block Chinese enterprises and use discriminatory measures for non-commercial purposes." They are also seen as adversely affecting China's national security. So a "non-reliable entity" list is being prepared to rein in such firms. The language indicates that this is retaliatory action. So, the war is poised to intensify. The message is that China does not want war, but is not afraid of responding if dragged to war. The Chinese Ministry of Commerce has cautioned the US that the standoff can become "the largest trade war in economic history to date".

In principle, there are multiple ways in which China can retaliate to US action in future. First, it could intensify its tariff response expanding the range of commodities on which higher tariffs are imposed. That would reduce American exports to China. Second, it could increase restrictions on US firms operating in China and catering to the Chinese market. That would hurt these firms, some of which are also likely to be adversely affected by US tariffs, to the extent that they export output from Chinese facilities to the US. Finally, China can consider using its holding of US Treasuries to punish the US. China currently holds 7 per cent of all outstanding US Treasuries, and accounts for 17 per cent of foreign holdings of those instruments. That China is reducing its holdings comes through from evidence that in March 2019 alone China sold $20 billion worth of securities out of the more than $1.2 trillion it held, even though its reserves were stable. If that is a first sign of China's inclination to dump the instrument, it could lead to depressed bond prices and higher interest rates, undermining the heavily used low-interest rate monetary policy used by the US to spur its recovery. It will also raise the cost of borrowing for the US government and restrain the US government's plans to hike expenditures on infrastructure to spur growth.

In sum, China can hurt the US as well. There is no economic gain to be derived by either side from this war. But the US is pushing ahead because the political stakes are too high.

*** This article was originally published in the Frontline Print edition: June 21, 2019.**