

Overview

A trade war between the United States and China has accelerated in the last few months. Since the election of US President Donald Trump, Washington has become increasingly vocal in its protests over the US trade deficit with China. According to US data, the deficit amounted to US\$337bn in 2017. However, the President's rhetoric may be misleading. It is not the bilateral trade deficit but China's broader protectionist policies and forcible technological transfers that are the main driver of the trade war. While trade is the instrument that the Trump Administration is weaponizing, the 'Trade War' may be more accurately described as a 'Technology War'. This 'Technology War' has wide support in the US and in other developed states.

The first salvos in the trade war were fired on 6 July, with the US activating tariffs on US\$34bn worth of Chinese goods, which China reciprocated with tariffs in kind. Tariffs on a further US\$16bn worth of imports were imposed by both Beijing and Washington in August. On 17 September the US announced it will place tariffs on another US\$200bn of Chinese goods.

This report explains the drivers of the trade war. It argues that the fundamental tensions between the two countries are likely to persist well beyond President Trump's time in office. The implications of Trump's actions and the tensions that underlie them will be significant not just for China and the US, but for economies across the globe.

- What is driving the trade war?
- What is the short-term impact of tit-for-tat tariffs on the US and China?
- What is the short-term impact on emerging markets?
- What is the likely impact on commodity prices?
- What is the longer-term effect of the trade war?

For more information contact Harish.Natarajan@akegroup.com

Timeline

22 January 2018: The US imposes tariffs on solar panels and washing machines.

1 March: The US announces tariffs on US\$2.7bn worth of Chinese steel and aluminium imports as part of a Section 232 action on global steel and aluminium imports.

22 March: The US announces tariffs on US\$60bn of Chinese technology and telecommunications imports.

23 March: US tariffs on Chinese steel and aluminium become effective.

2 April: China imposes tariffs on US\$2.4bn worth of US aluminium waste and agricultural products.

3 April: The US unveils list of 1,300 Chinese products worth nearly US\$50bn that could be subject to 25 per cent tariffs.

4 April: China unveils list of 106 American products that could be subject to 25 per cent tariffs.

9 April: China files a complaint to WTO against US metal tariffs.

16 April: US Commerce Department bans companies from selling components to Chinese telecom company ZTE.

3-4 May: First round of trade negotiations.

14 May: US President Donald Trump reveals he and Chinese President Xi Jinping are in talks to save ZTE.

18-19 May: The US and China issue a joint statement on avoiding a trade war after a second round of negotiations.

About us

AKE has over 20 years of experience working with the insurance sector, providing clients with unrivalled political and economic risk consultancy. Our experienced team of analysts provides tailored analysis and strategic forecasting, allowing our clients to better assess risks in challenging environments.

29 May: The US threatens to impose tariffs on US\$50bln worth of Chinese imports

2-3 June: Third round of US-China trade negotiations. The US allows ZTE to resume some activities.

7 June: The US eases ban on ZTE by agreeing to lift sanctions in exchange for a US\$1bln fine.

15 June: The US announces 25 per cent tariff on US\$50bln of Chinese goods. China says it will retaliate with equivalent tariffs.

18 June: The US threatens to impose tariffs on additional US\$200bln worth of Chinese goods. The US Senate votes to block the 7 June deal with ZTE.

27 June: US President Donald Trump calls on Congress to tighten regulations around Chinese investment in US technology.

6 July: US activates 25 per cent tariffs on US\$34bln worth of Chinese goods. China responds with its own tariffs.

10 July: The US releases a list of Chinese goods to be targeted by a 10 per cent tariff, amounting to US\$200bln of imports in 2017.

13 July: The US lifts ban on ZTE

16 July: China files a complaint with the WTO over US President Donald Trump's 10 July tariffs threat. The US launches formal challenges at the WTO against China and other countries for retaliating against steel and aluminium tariffs.

20 July: US President Trump threatens tariffs on all US\$505bln of Chinese goods.

1 August: The US Trade Representative considers a 25 per cent tariff, instead of a 10 per cent rate, on US\$200bln in imports, per Trump's instructions.

3 August: China warns it could add tariffs of 5 to 25 per cent on US\$60bln of US goods.

13 August: President Donald Trump signs the John S. McCain National Defense Authorization Act for Fiscal Year 2019 into law, which contains two key provisions on monitoring foreign investments in the United States (FIRRMA) and outbound transfers of technology (ECRA).

23 August: The Trump Administration imposes tariffs on US\$16bln of imports from China, with Beijing responding immediately.

12 September: US Treasury Secretary Steven Mnuchin pushes for a meeting with Liu He, China's top economic official, before the imposition of new tariffs on US\$200bln in Chinese imports.

17 September: President Trump announced that a 10 per cent tariff on US\$200bln in Chinese imports that will take effect on 24 September, with the rate set to rise to 25 per cent only 1 January 2019. The administration will also pursue tariffs on the remaining US\$267bln of imports.

18 September: Beijing imposed US\$60bln of new tariffs on American goods. The tariffs range from 5 to 10 per cent, lower than the 25 per cent Beijing originally threatened.

The US-China Dispute

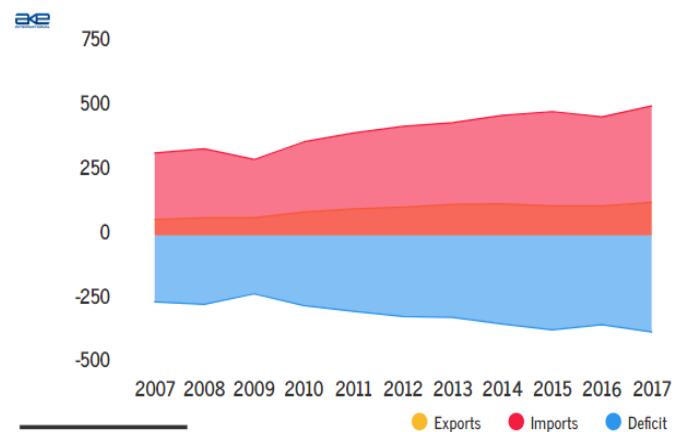
The Sino-US Trade War revolves around two areas of dispute. The first is the bilateral trade deficit, which is the smaller of the two areas of contention. There have been no tariffs specifically imposed by the Trump Administration on China alone due to the bilateral trade deficit. However, the larger dispute relates to accusations that Beijing has stolen technology from US companies. The Section 301 action was based on these claims and has justified tariffs on US\$250bln of US imports from China and could result with tariffs on all goods imported from China.

When viewed in a larger context, the trade war is also part of a wider US backlash against the rise of China. President Trump is imposing tariffs on China while also undermining the One China policy by signing the Taiwan Travel Act into law in February and challenging China's claims in the South China Sea by engaging in Freedom of Navigation Operations (FONOP). Washington has been very critical of China's Belt and Road initiative, and some in Congress have gone as far as to suggest that IMF support should not extend to countries that have accepted substantial Chinese financial aid. Tariffs on Chinese imports and efforts to counteract Beijing's tech aspirations go hand in hand with other US policies hedging a perceived threat from China's rise.

The Bilateral Trade Deficit

China has significantly liberalised economic regimes over the past three decades. However, Chinese state-directed policies appear to distort trade and investment flows.

Since US President Donald Trump assumed office in January 2017 there has been an emphasis on the US 'losing at trade'. One of Trump's first acts was to withdraw from the massive Trans-Pacific Partnership. He subsequently pushed for the renegotiation of NAFTA, with a rhetorical focus closing the bilateral trade deficit with Mexico.

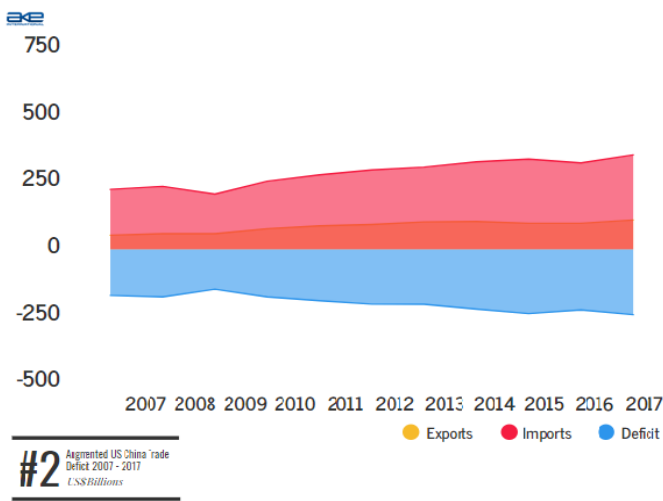


#1 US China Trade Deficit 2007 - 2017
US\$ Billions

The US' largest trade deficit is with China. Unsurprisingly Trump has regularly complained about this. In 2017, the headline trade deficit stood at US\$337bn (see figure 1). This is up from US\$258bn a decade earlier.

These trade figures are, however, misleading. There needs to be adjustment for the import content in US and Chinese exports. Around 85 per cent of the value of final US exports is US made content. The other 15 per cent is first imported. Only 70 per cent of the content of Chinese exports is Chinese-made, with the other 30 per cent imported.

Figure 2 corrects for import content in both US and Chinese imports. The correction reduces the 2017 deficit to US\$243.4bn.



The data can be further refined by including Hong Kong into the calculation. Hong Kong is a major market for American goods, and its good imports from the US are around a third of total US exports to the rest of China. Its good exports are fairly minor in comparison.

The two corrections between them reduce the trade deficit to around US\$200bn, which is around 1 per cent of US GDP. Adding the US surplus in service trade to China, the bilateral deficit falls to around US\$150bn. The final number thus remains high, but hardly as alarming as the headline figures that Trump quotes.

Why does this matter?

From an economic perspective, the trade deficit may not be concerning. The deficit with China partly reflects strong US consumption, and the relatively low US saving rate. While this is also driven by Chinese industrial and economic policy, overall increased trade with China has helped reduce the cost of goods in the United States, which on an aggregate basis has contributed the welfare of US citizens.

However, there are specific political-economic concerns related to the deficit. Increased exports from China has contributed to a decline in income and employment in segments of the US manufacturing sector. The losses from US industries that cannot compete with cheaper Chinese imports tend to be concentrated in certain states, while the benefits from cheaper Chinese imports is diffuse. Trump's 2016 Presidential Election victory was partly down to a promise to help areas that struggle to compete with Chinese imports – which has likely been a motivating factor in the decision to attempt to cut imports from China. When Trump speaks (or tweets) over the trade deficit, it is shorthand for the resultant displacement of American jobs.

The 'Technology' War

The Sino-US trade war is about more than just the US trade deficit with China; it is also a reaction to the belief that China's rise is a threat to US technological supremacy. US officials have long been suspicious of Chinese 'manufacturing superpower' ambitions and have repeatedly accused Beijing of stealing industry secrets from US firms.

President Donald Trump himself brought up the 'tremendous intellectual property theft situation' as he announced tariffs on Chinese imports. US Trade Representative Robert Lighthizer, in slightly less inflammatory language, accused China's industrial policy initiatives of seeking to acquire US technology and use it to dominate key industries.

US concerns over intellectual property theft and forced technology transfers are reflected in a Section 301 investigation of the Office of the United States Trade Representative (USTR). Section 301 is used to justify the majority of tariffs placed on China by the United States (see below).

The Section 301 Report

During negotiations, Washington rejected Beijing's offer to buy US\$70bn in additional US goods per annum to narrow the deficit. This is because it failed to address the core issues highlighted in the Section 301 investigation of the Office of the USTR. The USTR has accused Beijing of acquiring foreign technologies in support of the Made in China 2025 plan.

According to the report, China has done this in four ways:

- 1. Forced technology transfers:** Strict market access rules for foreign companies doing business in China require foreign companies to set up joint ventures between foreign and local firms. These partnerships mandate shared intellectual property and are effectively technology-transfer agreements. In 'forcing' foreign firms to transfer their technology to China as a condition for accessing its domestic market, China is violating the World Trade

Organization (WTO) guidelines on competition and multilateralism.

2. **Discriminatory licensing requirements:** Chinese business legislation is accused of systematic discrimination against foreign licensing technology to domestic companies. After ten years of paying for licensing, a Chinese firm can keep on using the technology indefinitely and beyond the contract expiry date.
3. **Overseas acquisitions and subsidies:** In this 90-page long section of the report, the Chinese government is accused of sponsoring the acquisition of US technology in strategic sectors such as integrated circuits, robotics, aviation and biotechnology. Beijing has used the ‘Made in China 2025’ initiative to subsidise tech and Artificial Intelligence (AI) companies, essentially overriding market forces in giving Chinese firms the financial edge at bidding stages.
4. **Illegal commercial hacking:** The final section of the report reflects longstanding accusations of cyber espionage. Unauthorised intrusions into US commercial computer networks and cyber-enabled intellectual property theft continue to occur on a regular basis and are harming US firms.

What China says: The government has denied the report’s accusations against ‘Made in China 2025’. Vice Minister of Commerce Wang Shouwen stated that the initiative is fully in line with WTO practices. Vice Finance Minister Zhu Guangyao said that China has focused on talent and innovation to make significant progress in the field of intellectual property, and its achievements will only serve to boost the global industry.

As for China’s strict market rules, Beijing has released a list of long-anticipated relaxations on foreign investment which points to a gradual opening-up of the business environment and financial sector reform. On 10 July, Tesla announced it would build a wholly owned auto plant in Shanghai and the municipality is accelerating efforts to remove restrictions on investment in the auto manufacturing sector.



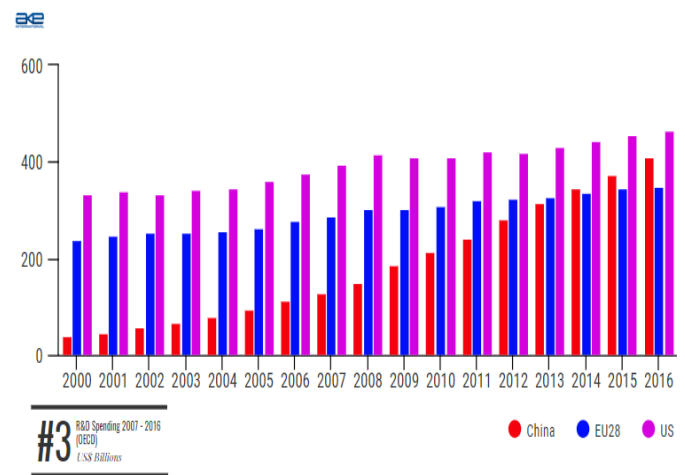
Made in China 2025

‘Made in China 2025’ is a strategic plan announced by Premier Li Keqiang in May 2015 aimed at bolstering Chinese hi-tech industries and moving the country’s manufacturing goods up the value chain. Beijing is seeking to raise the domestic content of core components and material to 40 per cent by 2020 and 70 per cent by 2025.

Ten industries are being targeted:

- Advanced information technology, including AI and quantum computing
- Automated machine tools and robotics
- Modern rail transport equipment
- Aerospace and aeronautical equipment
- Maritime equipment and high-tech shipping
- Self-driving vehicles and electric-vehicles
- Power equipment
- Agricultural equipment
- Biopharma and advanced medical products
- New materials

To achieve the goals set out, the government is increasing investment in high-tech sectors currently dominated by the US and Europe. Figure 3 shows the substantial increase in Chinese Research and Development Spending since 2000. In 2016, the last year that the OECD has published data for, China spent US\$410bn in R&D – only behind the US’ US\$464bn, and more than the entire EU28.



R&D is only part of the ‘Made in China 2025’. In addition, Chinese companies are massively increasing acquisition of technology. This has come both from Chinese companies investing abroad and from forming joint ventures with foreign companies investing in China.

Leading the way in foreign investment are Chinese tech giants Baidu, Alibaba and Tencent (BAT), who together account for more than half of China’s total US\$44bn investment in the US tech industry over the past five years.



Baidu: Baidu is focusing on AI and self-driving cars to become a global technology leader. In 2017 Baidu bought Seattle-based start-up Kitt.ai invested about US\$40m in US machine learning and data firms.

Alibaba: Jack Ma Yun's Alibaba has also embarked on an ambitious US tech investment spree. The e-commerce giant co-invested US\$1.3bln in two deals in 2016 and 2017 in order to buy artificial reality start-up Magic Leap. However, like other Chinese tech companies, Alibaba is facing increasing resistance abroad. In January, the US blocked a US\$1.2bln deal for Alibaba's Ant Financial to buy MoneyGram amid concerns about the Chinese government accessing the personal data of US citizens.

Tencent: Social messaging and gaming firm Tencent is the largest Chinese investor in the US, signing 12 deals in the US worth US\$11.5bln in 2017. Several of these deals were with biotech, medical AI, and disease detection start-ups. Tencent also purchased a 5 per cent stake in Tesla for US\$1.78bln in March 2017 and even ventured into the realm of robotics with a US\$41m deal in educational robotics.

Concerns with 'Made in China 2025'

'Made in China 2025' has triggered alarm bells among existing high-tech economies such as the US, Germany, South Korea, and Japan. They see China as attempting to replace their share in high-tech manufacturing rather than join their ranks. This is what China did in the late 1990s with the low-cost manufacturing industry.

Chinese technological advancement also has the potential to threaten US security. In June 2017, China conducted a flight and operation test for 119 drones, demonstrating a technological capability that outstrips that of the United States. There are concerns within the US Department of Defense that if China can deploy Artificial Intelligence-powered drones and unmanned submarines it could become harder for US aircraft carriers and vessels to operate easily in Asia.

What China says: China has recently sought to tone down its enthusiasm for new industrial policies to alleviate fears over its ambitions. However, Beijing is unlikely to back down on 'Made in China 2025'. The initiative is seen as part of the national interest, an essential blueprint to high income status

and for China to escape the so-called 'middle-income trap' that has affected other developing countries. On 11 July, a spokesperson for China's Ministry of Commerce said China will be forced to take countermeasures against US sanctions to ensure the survival of Made in China 2025.

ZTE

China's second-largest telecommunications company ZTE has played a central role in the Sino-US trade war saga, particularly once the tech war parallel is taken into account. Most of the essential components of ZTE products, such as smartphone chips and semiconductors, are purchased from US companies – Qualcomm, Intel, Lumentum Holdings, and Acacia Communications being some of most prominent in the field. About 20 per cent of ZTE components are reportedly produced in the US.

In 2016 ZTE was accused of breaching US sanctions on selling goods containing American components to Iran. On 7 March the US Commerce Department ordered the company to pay US\$1.19bln in fines and to penalise the employees involved, in what was the Justice Department's largest ever settlement in a criminal sanctions case. On 17 April ZTE was banned from purchasing US products for seven years after it was revealed that the telecommunications giant had failed to enforce some of the US' non-financial demands and made false compliance statements.

This had a devastating impact on ZTE. On 10 May the company was forced to cease major operating activities.

In a surprising turn of events, President Trump then moved to try and keep ZTE afloat, striking a deal with Xi to end sanctions. In this way, ZTE became a central pawn of trade talks and lifting the sales ban was a key demand from China.



Trump was likely tempted to give reprieve to the embattled telecommunications firm in order to gain concessions in trade talks. Indeed, on 20 May US Treasury Secretary Steven Mnuchin said the trade war was 'on hold' and on 5 June China promised to buy more goods to reduce the US trade deficit.

However, on 18 June the Senate voted to block the Commerce Department's deal with ZTE. After trade tariffs on Chinese

products were activated on 6 July, the US Commerce Department lifted its trade sanctions against ZTE and a subsequent deal between the Congress and Trump Administration allowed most restrictions to be lifted. There remains a risk Congress will seek to re-impose the ban, however.

Tariffs and Trump

The Trump Administration’s response to unfair Chinese trade and investment has involved the imposition of tariffs and quotas. The use of tariffs targeting Chinese imports is not new. When Trump became president in January 2017, around 9 per cent of US imports from China were already tariffed.

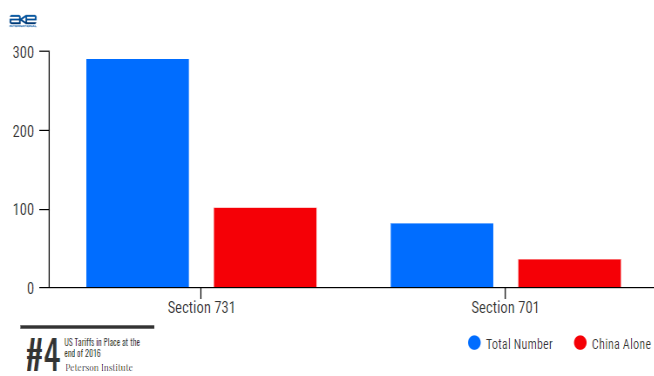
The Trump Administration’s approach is different to past administrations in three ways:

1. A rhetorical focus on the bilateral trade deficit (see above)
2. A more extensive use of tariffs and quotas
3. The use of unconventional legal measures to justify the imposition of tariffs

Legal Mechanisms

Between 1980-2016 the vast majority of US international trade law cases were either Section 731 or Section 701 of the Tariff Act of 1930. Section 731 is antidumping legislation – with tariffs imposed to protect US firms from unfairly under-priced goods from abroad. Section 701 allows the imposition of countervailing duties – tariffs on competitors to US firms that receive illegal government subsidies.

At the end of 2016 the US had 292 antidumping orders in place, with 102 targeting China. Antidumping duties are in place for five years, and then subject to review. There were 82 countervailing tariffs in place, with 37 imposed on imports on China.



The Trump Administration has used unconventional legal arguments that differ from those predominantly used by previous governments. The Administration’s choice of instrumental highlights that it is willing to circumvent World

Trade Organisation (WTO) processes. It also shows that most tariffs are technology-related, rather than disputes over the trade deficit.

Section 201

Section 201 of the 1974 of the Trade Act of 1974 allows the US International Trade Commission to investigate whether an increase in imports is causing injury to import-competing US industry. Section 201 is used temporarily to support domestic industry. The so called ‘safeguard’ measure requires no allegation of unfair trade, unlike antidumping and countervailing duty laws. Following an investigation, the decision to impose safeguards are decided by the President alone. Importantly, the imposition of barriers is not specified to any single trade partner.

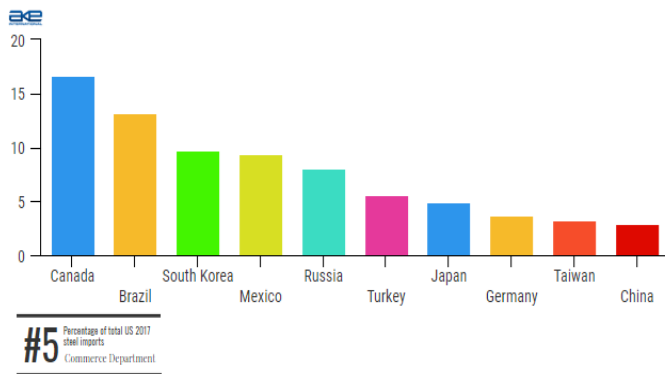
On 22 January 2018 the Trump Administration used Section 201 to impose global safeguard tariffs on US\$8.5bln in imports of solar panels and US\$1.8bln of washing machines. These tariffs were imposed on all countries, not just on China. In apparent retaliation, Beijing originally imposed a preliminary antidumping duty of 178.6 per cent on imports of sorghum from the US, although they would later scrap those tariffs in an olive branch to Washington. Both China and South Korea have challenged the US’ tariffs in the WTO. However, the direct fallout from the Section 201 tariff imposition has been minor.

Section 232

Section 232 has been one of the least utilised of US trade law. Section 232 of the 1962 the Trade Expansion Act allows the Department of Commerce to investigate whether imports ‘threaten to impair’ national security. The General Agreement on Tariffs and Trade (GATT), which took effect in 1948, gives country’s considerable latitude when deciding on when to apply national security measures. This makes the measures difficult to challenge in the WTO. There were only 14 Section 232 investigations between 1980 and 2016, of which only two resulted in trade restrictions. The last time Section 232 was used was under President George W. Bush in 2001 in regard to iron ore and semi-finished steel products.

The Trump Administration self-initiated two investigations under Section 232. The first was whether steel imports threatened national security, and the second on aluminium imports. The Commerce Department found that imports of both threatened national security. On 1 March 2018 Trump announced a global 25 per cent tariff of steel and a 10 per cent tariff aluminium. The measures covered US\$48bln of imports, with the majority from Canada, the EU, Mexico and South Korea. The White House exempted Argentina, Australia, Brazil, and South Korea from the tariff and imposed quotas instead.

China only made up 6 per cent of all US imports of steel and aluminium in 2017, although the number is significantly higher once re-exports are included. Figure 5 shows the percentage of steel imports in 2017 broken down by source.



The European Union announced that it would retaliate with its own restrictions through the imposition of 25 per cent tariffs on US\$3.4bn on US exports. The EU's retaliatory list included cranberries, Harley Davidson motorcycles, blue jeans, and bourbon. In April Beijing imposed retaliatory tariffs on aluminium waste and scrap, pork, fruits and nuts, and other US products, worth US\$2.4bn in export value in 2017. This compares to the US steel and aluminium tariffs covering Chinese exports worth US\$2.8bn in 2017. The largest retaliatory measures came from Canada. Ottawa imposed tariffs on US imports worth US\$12.8bn in 2017. The rest of the retaliatory tariffs covered agricultural and food products. Overall, retaliatory measures covered US exports worth US\$24bn.

The national security justification is weak given that most of the US' major suppliers are traditional allies. The steel and aluminium tariffs appear largely to be a measure to protect domestic US producers.

In May 2018 the Commerce Department initiated another Section 232 investigation over the import of automobile and auto parts. Trump is reportedly considering tariffs of up to 25 per cent. The impact of Section 232 tariffs on automobiles would be many times the size of the steel and aluminium tariffs. Assuming no exceptions, it would affect US\$208bn in imports, mainly from US allies.

Section 301

Section 301 of the U.S. Trade Act of 1974 allows the President to take all appropriate action to remove any act, policy, or practice of a foreign government that violates an international trade agreement or is unjustified, unreasonable, or discriminatory, and that burdens or restricts US commerce. This means that President can unilaterally impose tariffs on another company. Section 301 was enacted by Congress as a war to help US exporters open foreign markets.

As indicated in the section above, the Section 301 investigation reported four main problems with Chinese economic policy. The problems the report found relate to Chinese acquisition of

US technology. They do not relate to Chinese trade policy more narrowly, nor do they directly concern the bilateral trade deficit. Under the Section 301 action, the Administration proposed to:

1. Implement ad valorem tariffs on Chinese imports
2. Initiate a WTO dispute settlement case against China's 'discriminatory' technology licensing
3. Introduce new investment restrictions on Chinese efforts to acquire sensitive U.S. technology.

The majority of US actions against China are Section 301 actions. The Trump Administration has used Section 301 to place tariffs of up to 25 per cent on US\$50bn of imports from China and imposed 10 per cent tariffs on US\$250bn. Trump has indicated that he could use Section 301 as a justification 'to go to 500,' an apparent reference to the US\$504bn total of US goods imported from China in 2017, claiming that 'you know the expression 'We're playing with the bank's money.'

In response, China has imposed 25 per cent tariffs on US\$50bn of US exports and 5-10 per cent on another US\$60bn following Washington raising tariffs rates on US\$200bn of Chinese goods.

Committee on Foreign Investment in the United States (CFIUS)

On 22 May the US Senate and House of Representatives voted to approve bills aimed at strengthening the Committee on Foreign Investment in the United States (CFIUS), which regulates foreign investments in the country. CFIUS will be required to review joint deals that could involve technology transfers. This would delay ventures between US and foreign companies. In August, Trump signed the John S. McCain National Defense Authorization Act For Fiscal Year 2019. The law contains two key provisions as pertains to CFIUS. These are the Foreign Investment Risk Review Modernization Act of 2018 (FIRMA) and the Export Control Reform Act of 2018 (ECRA) for exports and outbound transfers of technology.

The second provision means that more investments are now subject to review by CFIUS – particularly foreign investments in critical technology and infrastructure sectors or those involving controlling sensitive data on US citizens. The law allows review even if foreign investors would not own a controlling interest of the business.

On 12 March President Trump signed an order to halt Singapore-based Broadcom's US\$142bn bid to acquire US chip company Qualcomm over concerns that it would allow China to gain access to US technology using third party arrangements. The move to block a deal from a non-Chinese company due to national security concerns about China highlights the extent to which the US government will go to push out any China-sensitive investment.

What China says: Decision-makers in Beijing are increasingly seeing this as an ‘economic cold war’ and China is branding itself as a champion of free trade against the backdrop of President Trump’s protectionist ‘America first’ policies. Beijing has emphasised that it remains ‘open for business’ and strongly supports globalisation.

World Trade Organization

China’s trade and technology conduct is in breach of its WTO obligations. The Trump Administration has launched cases against Beijing in the WTO, although this is only a minor part of its strategy.

As shown above, Washington’s tariffs on China and other countries is an attempt to sidestep WTO regulations.

The reticence to use the WTO and a willingness to disregard the rules-based trade order are likely a product of two factors:

1. The WTO appears to be ill-suited to combat Chinese trade practices. When China entered the WTO in 2001, it agreed that foreign firms would not be pressured by government entities to transfer technology. However, the WTO has not significantly constrained China’s industrial policies thus far. This is in part due to the difficulty in translating WTO rules to a semi-market economy. For instance, it is a live question as to whether de facto subsidies from state-owned companies or banks is the same as the subsidy from the state.
2. Washington is generally suspicious of the WTO Dispute Resolution Body. The WTO’s Appellate system has ruled against the US several times in the recent past, particularly over the practice of ‘zeroing’.

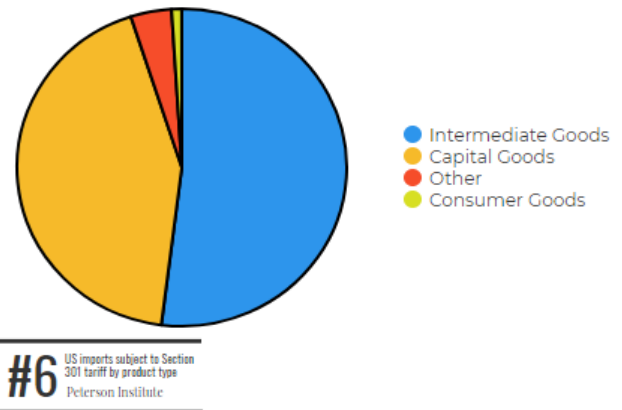
Short-term impacts

China

The 25 per cent tariffs on the initial US\$34bn worth of Chinese goods imposed on 6 July was mostly intermediate goods. The set of goods with tariffs thus will affect US based companies that are dependent on imports from China and could disrupt the supply chains for US producers.

The products affected by the original tariffs as shown in Figure 6 is unusual. A large portion of companies affected are foreign investors in China, rather than Chinese companies. It is unclear why the Administration originally focused on these imports, although it certainly appears deliberate.

Another US\$16bn worth of Chinese consumer goods came into effect in August. On 10 July the US Trade Representative (USTR) published a list of additional tariffs on Chinese products amounting to roughly US\$200bn and targeting agricultural products, seafood, fruits and a wide range of consumer goods.



Growth

In the short term the tariffs do not appear to have had a huge impact of Chinese trade. Data from China’s General Administration of Customs revealed that China’s trade surplus with the US widened by 10 per cent in August to a record US\$31bn. The increased deficit is mainly attributed to a stronger dollar, an expanding economy, and US importers front-loading orders to counter worse disruptions at the next round of tariffs. However, in the medium term there will almost certainly be a negative affect on China’s trade surplus and growth.

Beijing is partly responding to the expected decline in growth by ramping up infrastructure spending, funded by both state-owned banks and local governments. The increase in investment cuts against China’s medium-term ambition to reduce the economy’s reliance on investment growth and leverage – but at least over the short term, combatting the effect of trade tensions with the US appears to take precedence over a longer-term rebalancing.

Capital Flights

Investor concerns over the trade war has led to pressure on the Chinese renminbi and Chinese equity markets. Chinese authorities could allow the yuan to weaken to under 7 to the dollar, a level last seen in later 2016. Equity prices in Shanghai have fallen to near its January 2016 low. Neither of these effects is particularly worrying for Beijing yet, although a further depreciation or active devaluation of the yuan could cause havoc in emerging markets (see below).

Supply Chains

The introduction of US tariffs will force a rationalisation of supply chains. US companies that import intermediate or final products will bear the cost of tariffs in the short term, but in the longer term are likely to shift their supply chains.

Some companies are already reacting by changing their production processes. Japan Asahi Kasei has relocated production of US-bound plastic material from China to a plant in Japan. Komatsu will use its facilities in Japan, and the US to

produce parts for hydraulic excavators assembled in the US. Taiwan-based AirPods assembler Inventec has tapped its flexible its manufacturing sites outside of China. However, it is unlikely that many companies will plan massive new investment in production facilities over the short term due to the imposition of tariffs.

United States

Chinese tariffs on the US focus on agricultural and industrial products produced in Midwestern and Southern states, areas where support for President Trump was crucial in his presidential election victory in 2016.

Retaliatory 25 per cent tariffs on 6 July targeted 545 US goods such as soybeans, of which the US has been an important supplier to China. Other products including seafood, beef, dairy, crude oil, aquatic products and vehicles were also targeted.

China does not import enough from the US to directly reciprocate the total of US\$507bln in tariffs threatened by President Trump thus far. If tariffs on the remaining US\$247bln in tariffs are imposed, China may attempt to put up non-tariff barriers to US goods and services. Other ‘qualitative measures’ such as holding up licenses for US firms, delaying approval of M&As involving US companies and ramping up inspections of US products at borders are likely to be considered.

The following US firms have considerable sales to China and could be affected. It is notable that many are technology companies. It is plausible that Beijing will attempt to limit the impact of many of the companies below, given that technology related imports remain vital.

Company	Sales to China (\$millions)	Sales to China as Share of Global Total
Apple Inc.	44,764	19.6%
Intel Corp.	14,796	23.6%
Qualcomm Inc.	14,579	65.4%
Boeing Co.	11,911	12.8%
Micron Technology Inc.	10,388	51.1%
Broadcom Ltd.	9,466	53.7%
Cisco Systems Inc.	7,650	15.9%
Texas Instruments Inc.	6,600	44.1%
Procter & Gamble Co.	5,205	8.0%
Starbucks Corp.	4,512	20.2%
Western Digital Corp.	4,271	22.4%
Nike Inc. Class B	4,237	12.4%
3M Co.	3,255	10.3%
Skyworks Solutions Inc.	3,018	82.7%
Applied Materials Inc.	2,746	18.9%

The trade war will harm US growth, although the large size of the economy, and the relatively small export sector means that the impact will be relatively small.

Emerging Markets

The effect of the trade war is likely to roil emerging markets.

Supply Chains

Emerging markets – particularly those in Asia – are often deeply integrated in the China-related production chains of

exported goods. This is especially the case for US tariffs on Chinese high-end consumer products, which will affect countries such as Japan, South Korea and Malaysia.

For instance, China imported US\$52.4bln in South Korean integrated circuits in 2016. These products are then used in the manufacturing process of high-end consumer products like smartphones and other electronic devices, which are then exported to the US and other countries. As such, US tariffs will force China to import less, indirectly impacting exporters of commodity parts.

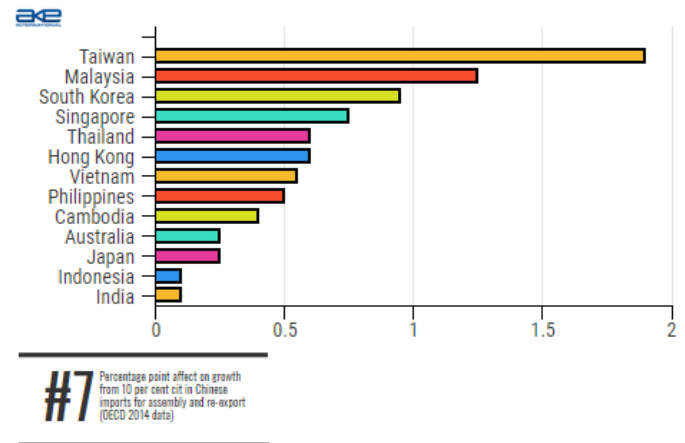


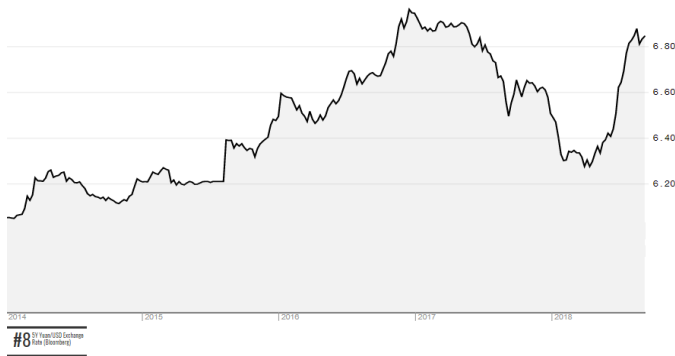
Figure 7 shows the OECD’s estimate from the magnitude of the effect of a 10 per cent fall in Chinese imports of parts for assembly and re-export. The figures are from 2014, and almost all countries are likely to be more exposed now than then. Nonetheless, data is illustrative. It shows that Taiwan is the most affected, but almost every major Asian economy should see a noticeable impact on growth. While the affect may be partially mitigated as trade diverts from China, it is nonetheless likely to be high.

There is a countervailing effect on emerging markets as both US and Chinese importers are likely to start sourcing products from other countries. This can benefit countries that have products that can substitute for those that have tariffs placed on them. Examples include Argentina and Brazil as potential alternative sources of agricultural goods; and South Korea as an alternative exporter of automobiles into China.

Yuan Devaluation

The trade war is already putting pressure on the yuan. Figure 8, compiled by Bloomberg, shows that the Yuan has depreciated against the US dollar in the second half of the year. On a trade-weighted basis the yuan has already depreciated by more than 10 per cent.

The People’s Bank of China could continue to manage the currency to prevent a further depreciation - although it is probable that Beijing will continue to manage the depreciation of the yuan. A managed depreciation would allow Beijing to partially offset the impact of tariffs. Beijing could also weaken its commitment to currency management and allow the exchange rate to drop dramatically.



A yuan depreciation (or devaluation) could have a much larger impact on emerging markets than the direct impact trade war itself. This is because a lower yuan means imports to China are costlier and creates incentive to buy from domestic Chinese producers. Commodity prices would likely fall. Other emerging market currencies would likely also fall, increasing difficulties in servicing external corporate and sovereign debt.

Financial Contagion

The most immediate impact on emerging markets is likely to be additional downward pressure on emerging market investments. Pressure is building on emerging markets due to the following factors:

1. Pure contagion from weaker emerging markets like Turkey and Argentina,
2. The higher cost of capital due to a rise of global interest rates.
3. Financial regulations (e.g. Basel III) that make it harder for Western financial institutions to hold emerging market assets, and limits banks' ability to act as market makers.

The trade war likely will accelerate the impact of three trends as it risks driving down Chinese imports from these markets. It may also cause Chinese investment into these countries to slow. The change in financial regulation has reshaped the position of emerging markets investment in the global financial system and risks accelerating contagion.

AKE has constructed the following index to quantify the short and medium-term risks to a handful of emerging economies. The data comes from the IMF and run into AKE's political and economic risk rating models.

The index focuses on:

1. The supply chain risk – how integrated are emerging markets with supply chains involving China.
2. Yuan depreciation risk - How exposed is the economy to the Chinese market more broadly? How dependent is it on commodities?
3. Financial risk – how exposed are emerging markets to a withdrawal of capital.

	Supply Chain Risk	Yuan Risk	Currency Risk	External Debt	Reserve Adequacy	Current Account	Financial Sector	Overall
Argentina	2	2	3	4	3	4	3.7	
Brazil	2	3	2	3	2	3	3.3	
Cambodia	3	3	3	3	3	4	4.2	
India	2	1	3	2	3	3	2.9	
Indonesia	2	3	2	2	3	3	3.3	
Malaysia	3	3	3	2	2	2	3.5	
Philippines	3	3	2	2	2	3	3.5	
Singapore	3	3	2	1	1	2	3.0	
South Korea	4	3	3	2	1	2	3.7	
Taiwan	4	3	3	2	1	2	3.7	
Thailand	3	3	2	1	1	3	3.2	
Vietnam	3	3	4	3	2	3	4.0	

The results are included in Figure 9. No country listed is spared the effects of trade war created shocks. AKE finds that in the short term the most exposed Asian countries are Vietnam, Cambodia, Taiwan, South Korea. The effect on Argentina is pronounced as the country is already facing a currency crisis. The direct impact of the trade war is likely more muted in India and Singapore.

Commodity Prices

The trade war will almost certainly impact commodity demand in the short and medium term. For several commodities – including oil and gas – the effect on prices may be partially mitigated by supply conditions. In particular, US sanctions on Iran that come into effect in November, the potential disruption due to unrest in Venezuela, and continued crises in Libya could support hydrocarbon prices.

There are several ways in which the Trade War could affect commodity demand. Firstly, while the overall impact of tariffs on the Chinese economy is relatively small, the impact on the manufacturing sector is larger. Along with construction, which continues to hold up well due in part to government support, manufacturing is the sector that per unit of GDP created purchases the most raw materials and uses disproportionate amounts of hydrocarbons. Secondly, the depreciation of the yuan would likely reduce Chinese demand for all commodities. A large devaluation could have a sizable impact, although this remains unlikely. Third, a financial crisis in emerging markets would hit global growth and commodity demand.

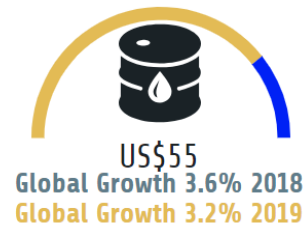
Forecasts indicate that the baseline Brent Crude price over the next two years is around US\$70. This is based on a forecast of global growth of 3.8 per cent in 2018, and 3.6 per cent in 2019. The potential for economic harm created by the trade war could result in a 0.2 per cent decrease in global growth in 2018, and a 0.4 per cent decrease in 2019. The corresponding impact would on oil demand growth falls from a baseline of around

1.6m bpd in 2018 to 1.5m bpd, and from a baseline of 1.4m bpd in 2019 to 1m bpd.

BASELINE OIL PRICE:



WORST CASE OIL PRICE:



AKE forecasts a worst-case oil price of US\$55 over the next two years – although this assumes that there are no large supply shocks. Nonetheless, it is highly likely that prices will remain volatile over the medium term. Other commodities are likely to be similarly affected.

Long-term impact

Continuation of Sino-US tensions

US Treasury Secretary Steven Mnuchin has invited China’s top economic official, Liu He, for negotiations on trade to de-escalate the trade war. Beijing has apparently rejected talks, although may be brought to the table before the tariff rate on US\$200bn of Chinese goods is increased from 10 per cent to 25 per cent on 1 January 2019. However, any agreement to end the trade war will likely involve long and complicated negotiations, especially given Washington’s concerns over continued forced technology transfer and intellectual property protection. There is no obvious negotiated agreement.

Neither the US nor China has shown much flexibility in their positions thus far, although Washington may believe that the strong US economy means that it is negotiating from a position of strength. The fundamentals of the trade war should work in Washington’s favour. In simple terms, US exports to China are less than a third of Chinese exports to the US – which implies that high tariffs will hurt Chinese companies more.

Beijing may offer some concessions, including the increased purchases of commodities from the US, but core concerns of intellectual property protections and technology transfer will remain. Thus, tariffs will likely remain in place and production shifts away from China. China will reduce both imports and exports and increase domestic production of high-tech products and become more self-sufficient.

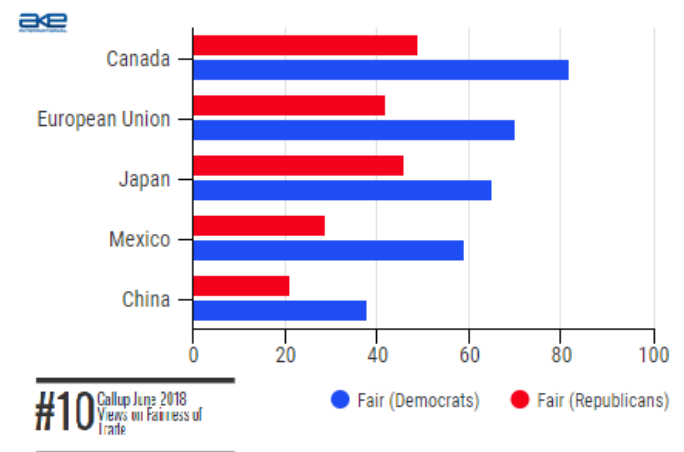
Yet concerns over Chinese ‘unfair’ practices, including the theft of technology and the forcible transfer of technology, are shared throughout the US government. The Department of Defense, Commerce, and Congress support moves to combat Chinese in this sphere. While the use of tariffs by the Trump Administration is controversial, there is wide bipartisan support for measures to prevent forced technology transfer, sanctions against Chinese companies accused of cyber

espionage, and tougher checks on Chinese investment. Other countries share Washington’s fears.

Concerns over trade competition from China are also likely to persist. AKE forecasts that both main US political parties will continue to support measures to protect manufacturing industries from foreign competition – both from China and from other states. There are several factors driving this forecast:

1. Increased inequality, and awareness of the differences in living standards. Both inequality and awareness have increased since the 2008 global financial crisis. Before the crisis, the slow growth of real wages was at least in part covered by the easier access to credit.
2. Social media and the rise of alternative sources of media has made it easier for those that lose from globalisation and the candidates that appeal to them to mobilise supporters and raise funds.
3. The success of the Trump campaign could result in future candidates attempting to co-opt some of issues he raised.

The following result from a Gallup poll in June 2018 highlights the popular perception by members of both parties that trade with China is unfair:



There are strong constituencies within the Democratic Party as well, who support attempt to protect workers from foreign competition. These constituencies are represented by figures such as Vermont Senator Bernie Sanders, Massachusetts Senator Elizabeth Warren, and others. Two candidates who are members of the Democratic Party and the Democratic Socialists of America are expected to win seats in the November 2018 Congressional election and this trend may continue in the 2020 election as well.

The Future of Tariffs

It is highly likely that both the Trump Administration and future administrations will continue to impose punitive

measures on Beijing in response to Chinese economic practices. The extensive use of tariffs and export quotas, however, appears particular to the Trump Administration. It is plausible that the current Administration or a future one would use alternative tools to pursue its policies towards China.

There could be an attempt to try to deescalate hostilities over the medium term – but tariffs on some Chinese goods will likely remain, while non-tariff barriers may also increase regardless of the administration. The mode of future protectionist policy may change – with the potential for tighter future trade deals, increased ‘social conditions’ (eg. worker rights, wage demands more extensive tougher local content rules), or the imposition of harsher checks.

Long term impact on Global Trade

In essence, trade deals and the WTO-sponsored trade system is about creating predictability to trade and investment relationships. Few trade deals dramatically cut tariffs or non-tariff barriers. The majority instead focus on reducing uncertainty. Indeed, the WTO and many other trade agreements explicitly state that one of their goals is to increase the predictability of the trade policy. Attempts to quantify the impact of reducing trade uncertainty suggest that it can add increase trade by more than 5 per cent.

The Trade War has upended many of the conventions that regulated trade between WTO states. The Trump Administration has used mechanism to justify protectionism that deviate from established practice. This includes the use of Section 232 and Section 301 to justify the imposition of tariffs and quotas. The Administration has also ignored WTO norms on Most Favoured Nation status. US policies have thus undermined the relative predictability of the global trade order, and thus could have a long-lasting affect on trade.

Impact on Emerging Markets

The shock of the trade war could create substantial short-term harm to emerging markets. However, at least in Asia, there will be a countervailing impact in the long term. Producers who want to continue to export to the US without tariffs will move production. This affect may be large given the size of the tariffs compared to the value-added of Chinese production. For instance, if Chinese production adds 25 per cent value to imports that form part of a supply chain. A 25 per cent tariff doubles the cost of production compared to destinations with lower tariffs rates.

Both affects are likely to be muted in the short term, as it takes time for most companies to reorganise the shipping networks, and supply chains. Most companies are likely to wait to see if the trade war deescalates. However, there could be benefits to a handful of countries in the medium and long term.

AKE notes that the following countries in Asia are most likely to benefits from the reorganisation of supply chains:

- Bangladesh (garments, low-tech products)
- Cambodia (garments, low-tech products)
- India (high-tech manufacturing)
- Myanmar (low-tech manufacturing from Chinese firms)
- Thailand (mixed)
- Vietnam (cell phones, electronics and other high-tech products)