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TARIFFS ON CHINA: EXPECT DE-ESCALATING TRADE FRICTION AND NOT ESCALATING TRADE WAR

SUMMARY

- The US Trade Representative announced tariffs of 25 percent on a list of Chinese products in retaliation against Chinese trade policies; China responded with its own retaliatory tariffs on US exports.
- The US tariffs are designed to minimize impact on US consumers. They target a wide range of products, mostly those paid for by government and businesses rather than by consumers.
- By contrast, China's tariffs are designed to inflict maximum pain on politically influential US industries.
- Neither government has enacted tariffs yet. If enacted to the letter, they could reduce the profits of S&P 500 companies by tens of billions of dollars, or even more in an escalating trade war.
- However, a de-escalation of trade friction is more likely. The US government is using tariffs as a bargaining chip, and wants to avoid retaliation that would hurt agriculture and rural communities.
- The US metal tariffs could be a roadmap for understanding the China tariffs. Announced with a bang, but implemented with a whimper, they ultimately exempted a majority of the sources of imported metals.
- In any case, tariffs on China will not affect the overall US trade deficit. In fact, the US trade deficit will increase in 2018 and 2019 because of larger budget deficits.

The Office of the US Trade Representative on April 3 released a list of 1,300 Chinese imports targeted for a 25 percent additional tariff; the US imports approximately $50 billion dollars of these products annually. The US government justifies the tariffs as a response to four unfair Chinese economic strategies: China forces US companies to transfer intellectual property and technology to Chinese companies in exchange for market access; its regulations undermine US companies' control over their technology in China; the Chinese state supports Chinese acquisitions of US high-tech companies; and China conducts cyber espionage.

The 1,300 targeted products are a grab bag which benefit from Chinese industrial policy, and exclude those "likely to cause disruptions to the U.S. economy" or which "are subject to legal or administrative constraints." The USTR also excluded products likely to directly impact US consumers. Of the remaining 1,300 categories of products, the government is the majority consumer or payor for many. They include medical equipment (governments pay for a majority of US health expenditures), hardware for law enforcement, and machinery used in government-funded infrastructure projects. Other tariffed imports include capital and intermediate goods used in manufacturing. A wide range of agricultural equipment are tariffed as well, as are mining and construction equipment. A couple of tariffs are mystifying: Cassette players? Jukeboxes?

China's government retaliated by announcing its own tariffs on April 4, likewise targeting $50 billion of annual US exports to China. In contrast to the US tariffs, which are designed to minimize impact on US consumers, the Chinese tariffs are designed to inflict maximum pain on politically influential US exporters.

They target agricultural products, including soybeans and other grains, ethanol, beef, orange juice, tobacco, and whiskey. They also target exports of autos, chemicals, and aircraft.

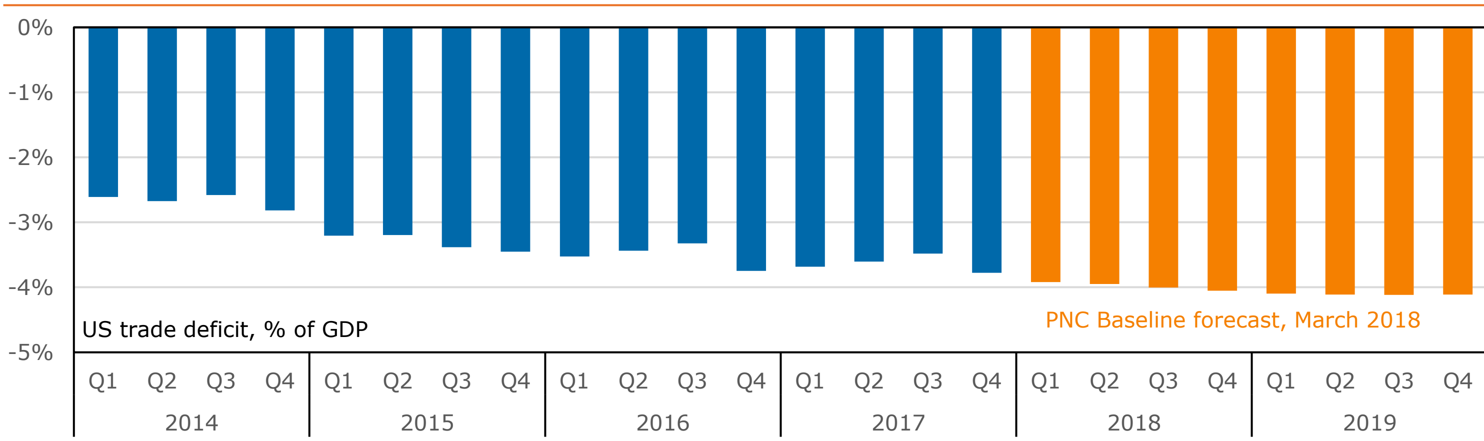
Neither country is enacting tariffs immediately. The USTR will hold hearings on the tariffs on May 15, so actual implementation could not be before late May at the earliest. The Chinese government likewise has delayed implementation of the tariffs, presumably until they know what the US will do.

Enacted to the letter, the tariffs would have a small negative impact on US real aggregate incomes. The most tangible impact would be on US exporters, who would lose sales to other countries that compete for Chinese customers. If the US tariffs cause Chinese companies to lose US sales, their market share would generate some higher US production, but also higher imports from other low-wage, low-cost foreign economies like Mexico. This outcome would cause a reduction of tens of billions of dollars in the roughly $1 trillion annual earnings of the S&P 500 companies. An escalating trade war, in which the US and China fall into a vicious cycle of competing to out-retaliate against each other, could be even costlier.

But de-escalation of trade friction is much more likely. The US government is explicitly framing the tariffs as leverage in trade negotiations, meaning they do not really plan to implement them. Trade politics also push the US response toward the status quo: Agriculture and rural communities are politically influential and supported the president in 2016, and would be hurt by both the American tariffs, which would raise their cost of production, and the Chinese tariffs, which would lower the prices of their products. The precedent of the steel and aluminum tariffs is another reason to think the China tariffs will be watered down: The metal tariffs were announced with a bang but implemented with a whimper, ultimately exempting the sources of a majority of imported metals.

In any case, the tariffs will have zero impact on the US trade deficit, which is the US's net borrowing from overseas. Just as a family that earns $5,000 a month and spends $6,000 must borrow $1,000 from someone else, the US economy's spending, or demand, exceeds its production, and it sources the difference in foreign imports. US national net borrowing can be broken down into household savings, businesses' net retained free cash flow, and the combined budget deficits of all levels of government. The federal government could reduce the trade deficit by reducing its budget deficit, or the Federal Reserve could reduce the trade deficit by raising interest rates to reduce consumption and business investment and thereby increase private savings. But unless the US reduces net foreign borrowing, policies to reduce imports from China will just cause US importers to shift their sourcing to other foreign markets. In the near term, the trade deficit will actually increase because the Tax Cuts and Jobs Act and Bipartisan Budget Act of 2018 are increasing the fiscal deficit (See chart below).

CHART: US TRADE DEFICIT TO WIDEN AS DOMESTIC DEMAND GROWS FASTER THAN GDP



Sources: BEA, Moody's Analytics, PNC Economics,

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