April 17, 2019

A dead-end war: Why China and the US have resumed trade talks

A mutual increase in import tariffs is costly for both sides

- **According to ACRA, China and the US can settle trade disputes, but probably not before this summer.** As part of the talks, Beijing and Washington have repeatedly expressed hope for normalized trade relations, but so far have not taken any concrete steps. China and the US have, however, temporary agreed not to further tighten import tariffs. If the trade war is resolved, a gradual reduction in tariffs on most goods will likely come from both sides.

- **China's introduction of additional tariffs with a weighted average value of 10 percentage points has led to a decrease in the US share in Chinese imports from 16.3% to 12.4% in 2018, as well as a decline in China's import growth rate by 3.65% during that period.** The drop in the US share is because China reduced the purchases of US energy resources and agricultural products. Lower imports from the US to China open up opportunities for other exporting countries to fill this niche.

- **Meanwhile, in several industries, a significant increase in import prices was accompanied by a growth in demand for foreign products in China.** This is the case in sectors such as animal products, transportation, foodstuffs, mineral products, and chemicals, which is due to a handful of non-price related factors. The costs of importers who failed to replace supplies from the United States rose, which negatively affected their financial results and required government support.

- **The drop in China's yuan by 4.5% in Q4 2018 compared to the same period last year also contributed to the growth of prices for imported goods (on average, inched up by 6%).** It's likely that the yuan's weakening also caused a significant decrease in China's import growth rate during that period.

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How the US-China trade conflict unfolded

The trade war is bad for the US since US exporters (mainly agribusiness and energy sector) are losing a huge market, which is why they are interested in the trade conflict to be resolved as soon as possible. Chinese importers and exporters faced a higher financial burden, which led to a decrease in the country's industrial output growth and an additional budget deficit. The Chinese government lowered VAT and welfare payment requirements.

During the 2016 US presidential campaign, Donald Trump accused China of conducting "predatory" trade policies, non-compliance with intellectual property rights, and an unauthorized absorption of foreign technologies. Trump moved from words to action in 2018. On March 22, 2018, he signed a tariffs memorandum against China, directing the Trade Representative to make a list of proposed Chinese goods subject to tariffs and pursue dispute settlement in the World Trade Organization (WTO) to address China's violations of international trade rules. Additionally, the US President directed the Secretary of the Treasury to bring forward proposals for limiting Chinese investments in US companies. Subsequently, a trade war broke out between the two countries, which potentially threatens the stability of the global economy and is therefore one of the key topics on the global agenda. Additional tariffs announced by the US and China last year have not been imposed so far. Moreover, there is a tendency towards the resolution of the trade conflict.

Figure 1. Chronology of the US-China trade conflict

Source: China Briefing - The US-China Trade War: A Timeline

The meeting between Trump and Chinese President Xi Jinping at the former's property Mar-a-Lago in Florida, scheduled for late March, was postponed. However, it is likely that another meeting will be arranged in the near future, where the parties can reach a consensus, given the importance of the trade deal for the US and Chinese economies and global markets. Uncertainty remains over this due to the lack of any formal, specific agreements on the future of import tariffs.

Nevertheless, there are grounds to believe that both China and the US are interested in lifting the additional fees as soon as possible. US exporters, especially in agribusiness and energy, are losing a huge market, so they may try to lobby for trade concessions from the Trump administration. Chinese companies, in turn, are bearing an additional financial burden, which is ultimately shifted to the state who is forced to support them, leading to an increase in the country's budget deficit. Therefore, the Chinese government is keen to improve trade relations with the US. At the same time, the main obstacle for the leaders of both countries is the need to save face during trade talks and not yield more than they receive. As such, there will probably be no simultaneous removal of additional tariffs, meaning they will be lifted gradually.

If the import tariffs, which have been imposed previously, are removed immediately, the physical volume of China's imports may further increase by a maximum of 3.65% because of the restoration of trade with the US — that's the impact of the additional tariffs on China's import growth rate, according to ACRA estimates.

If the tariffs remain in place, the damage to the Chinese economy may be 0.2–1 percentage points. Additionally, the continuation of the trade war may lead to a further drop in imports from the US, for example, in such product categories where there can be alternative supply sources. Of course, this cannot but drum up the interest of potential suppliers from other countries, including Russia (especially in sectors like agriculture, metals, and transportation).

According to ACRA, if Washington and Beijing fail to settle their trade dispute, there can be a potential increase in product categories in the Chinese market like meat and edible meat offal (17.5%), fruit and nuts (15.9%), oilseeds and fruits (25.4%), cereals (8.4%), animal products that are not included in other articles (8.3%), food industry waste and finished animal feed (8.9%), aluminum and aluminum products (16.2%), and vehicles and parts (16.2 percent).

China's imports of US agricultural products and mineral resources fell most sharply

Higher tariffs on US goods, which were imposed in four stages in 2018, led to a sharp fall in imports of US commodities to China (from 3.4 to 0.4 percentage points). In particular, oil shipments from the US to China slumped by 85% in Q4 2018, while crude exports from Russia, Saudi Arabia and Iraq grew by 70%, 74% and 94% respectively. Additionally, China significantly cut imports of US liquefied natural gas (80%) and liquefied propane (100%). The situation was similar in the import structure of non-ferrous metals: China reduced the purchases from the US by 89% in Q4 2018, while boosting imports from Brazil (+25%), Australia, Chile and several other countries.

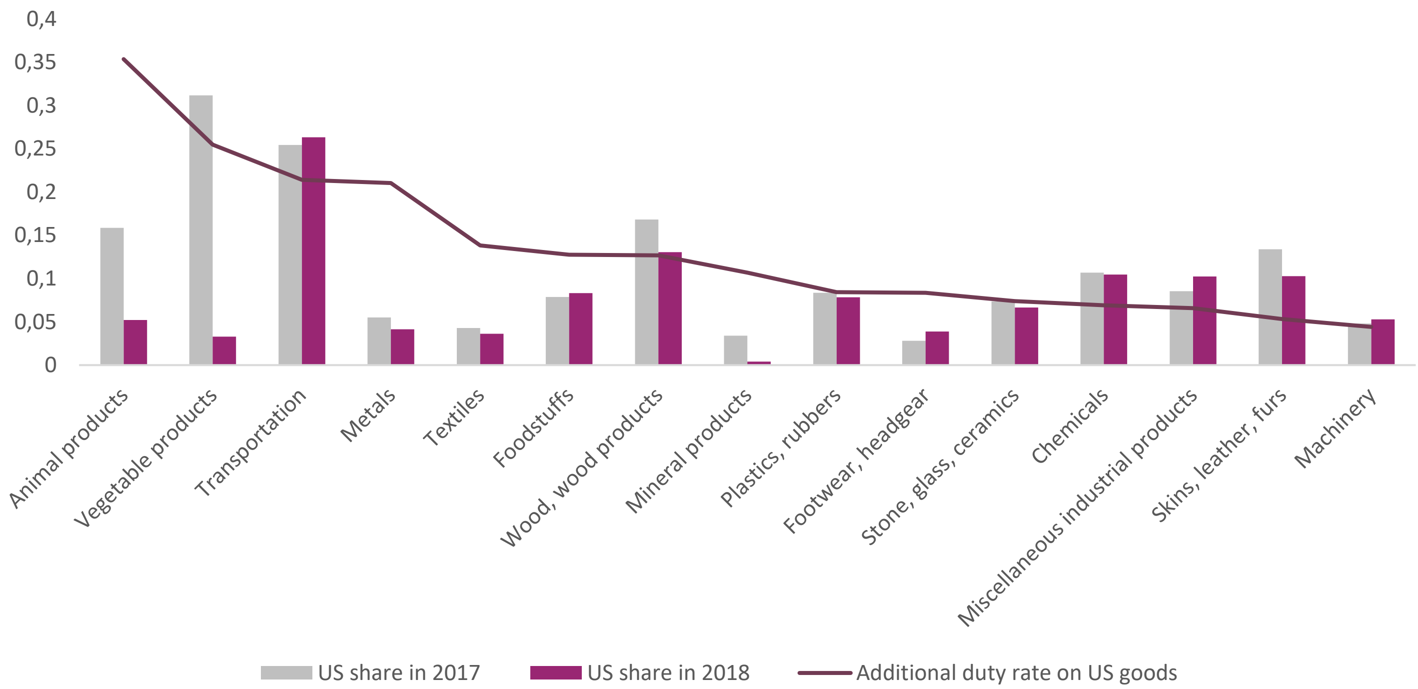
As for animal and mineral products, subject to the highest additional tariff rate of 10-35 percentage points (see *Fig. 2*), Chinese importers switched to suppliers with more attractive terms.

Trade tensions also affected imports of vegetable products: China's soybean imports from the US fell by 98.8% in Q4 2018 compared to the same period last year (imports fell by 50% year-on-year). Meanwhile, China ramped up the purchases from Brazil (+38% in 2018), but the total physical imports of vegetable products fell significantly.

At the same time, the US share of product categories like wood, metals, and textiles in China's imports did not decrease so dramatically in 2018 compared to the previous year. As far as the transportation sector is concerned, the US share even increased despite the additional tariffs.

This is probably because of higher import costs from other countries. The growth in import tariffs had little impact on the supplies of other product categories from the US to China, since their value (4–8 percentage points) and the US share in China's imports of these goods are relatively low.

Figure 2. Imports of animal and vegetable products suffered most from additional tariffs on US goods



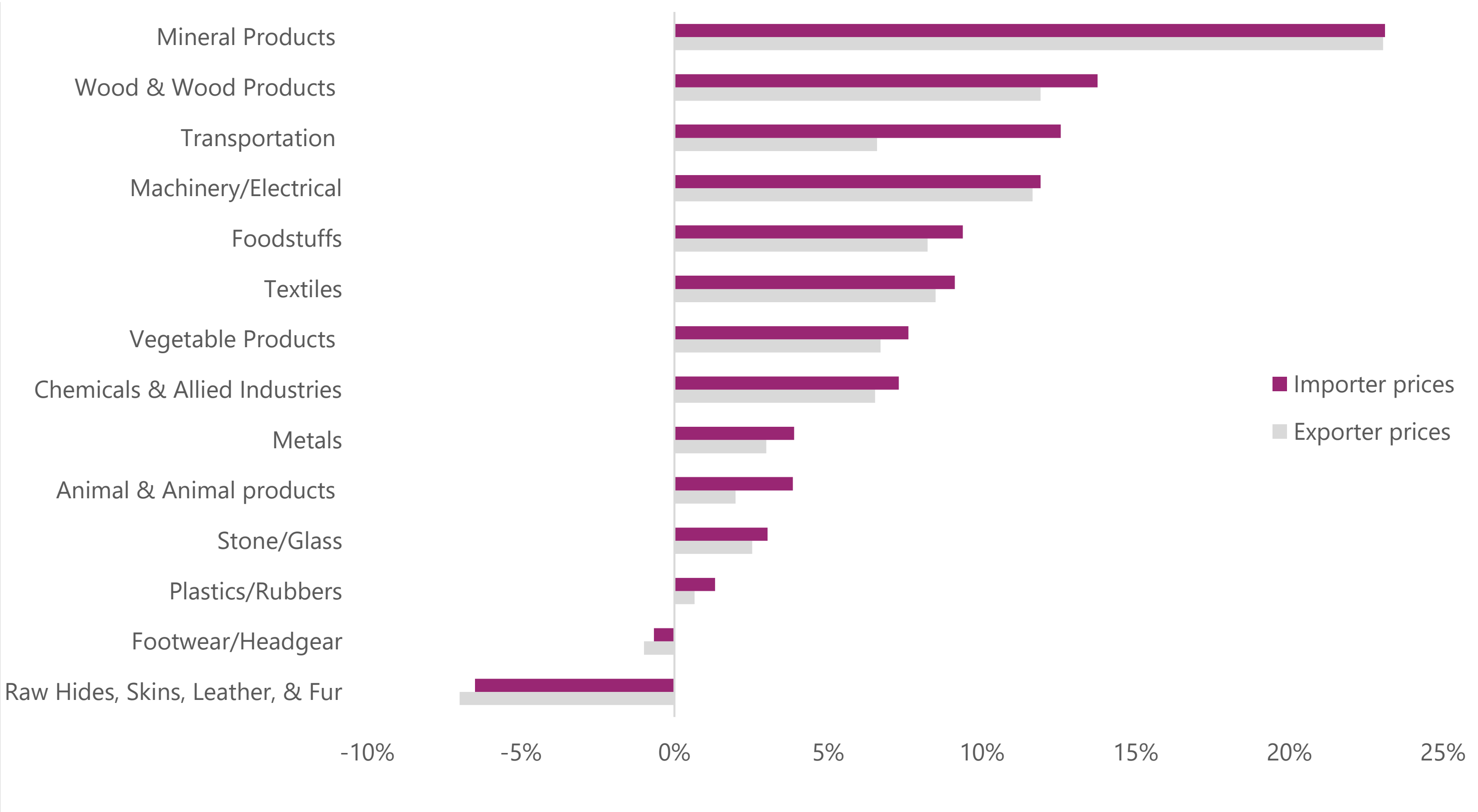
Source: ITC Trade Map, Center for Agricultural and Rural Development, Iowa State University

The transportation industry saw the largest rise in prices due to additional tariffs

China's retaliatory tariffs on goods from the US in certain industries have had a strong impact on import prices, which have taken on additional financial burden. The transportation sector felt the biggest effects, followed closely by the livestock and wood processing industries (see Figure 3). It's important to consider that the rise in prices in most industries was also affected by the fall of the yuan (by 4.5%).

At the same time, the impact of additional tariffs for categories like mineral products, vegetable products, and machinery/electrical was practically minimal in 2018. This was due to the low share of imports from the US or a switch to alternative suppliers.

Figure 3. Price changes in foreign exports and Chinese imports in 2018 compared to 2017



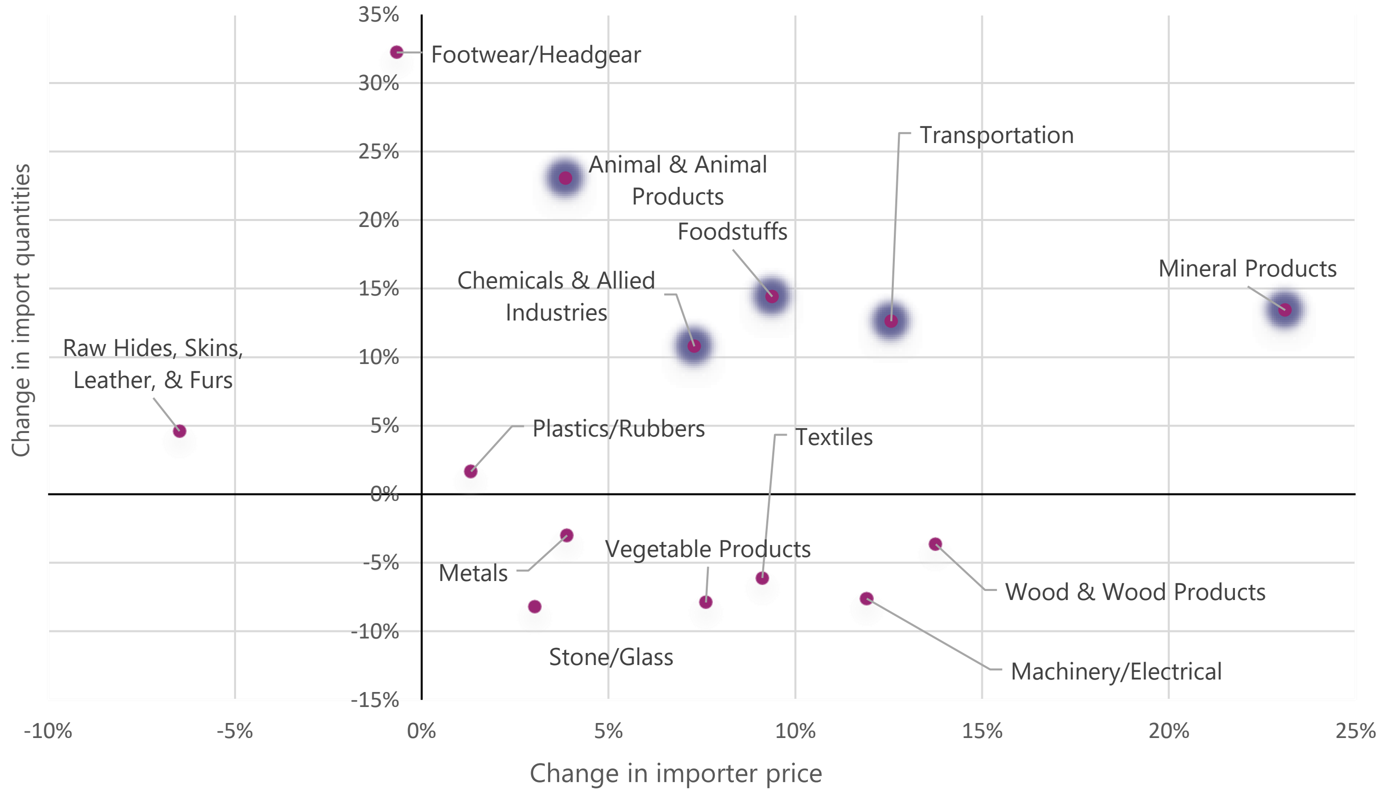
Sources: The Wind Economic Database, ACRA's calculations

"The prices of exporters" means the prices of foreign suppliers before tariffs are imposed, and "the prices of Chinese importers" means the prices after tariffs are imposed. Since in this case we are talking about price changes in Q4 2018 compared to Q4 2017, the difference between them is due to the additional tariff rate for US products and the US share in Chinese imports by product category in 2018.

Chinese imports reacted in different ways to the rise in import prices in Q4 2018

Importers' price changes with regards to additional trade tariffs were reflected in different ways in import volumes depending on sector (see Figure 4). In a number of industries, such as engineering, metallurgy and wood processing, there is a negative relationship that is quite natural - when prices increase, consumption decreases and vice versa. However, in categories such as mineral products, transportation, foodstuffs, animal & animal products and chemicals & allied industries, the situation was different. Imports increased at the expense of high domestic demand, despite rising prices.

Figure 4. Import demand increased in 5 industries despite rising prices



Sources: The Wind Economic Database

According to ACRA's assessments, this situation can be explained by several reasons not related to price:

Table 1. Non-price related reasons for the increase in imports to China

Food production	With prosperity growing in China, consumers increasingly prefer foreign products, considering them safer. In particular, this applies to children's goods.
Minerals, chemicals, and related sectors	The growth of the Chinese economy is accompanied by increased demand for the most important and widely used materials and commodities. Therefore, the demand for oil in China in 2018 increased in annual terms by 3.7% and by 34% for gas, despite the rise in global prices (+27.7% and +9.5%, respectively). This can be explained both by the general demands of the growing economy and by the active transition of Chinese energy from coal to gas, with the government's desire to have sufficient reserves of this resource within the country.
Livestock production	The growth in demand, especially for beef, as well as pork and other products in China due to increased prosperity; concerns among Chinese importers over additional tariffs in 2019; a reduction in the number of pigs in the country (by 0.9 million in 2018) due to African swine fever.
Transportation	In Q4 2018, China increased aircraft purchases by 60% compared to Q4 2017, and also increased imports of other vehicles, which can be attributed to fears of Chinese importers regarding the introduction of new tariffs in 2019 in the absence of available alternatives.

Source: ACRA's calculations

Those Chinese companies which failed to put their increased costs (caused by additional tariffs) onto customers have encountered financial difficulties. A weakening yuan has put additional pressure. In this context, in 2019, the Chinese government undertook certain measures to boost the entire economy and especially the manufacturing sector, including lower VAT and welfare payments for companies (since April 1, 2019). According to ACRA's estimates, such measures could be strong enough to support the above mentioned companies.

However, the economy support measures push up the structural budget shortage in China by 0.4–0.8 pps. In 2018, the total shortage amounted to 2.6% of the GDP, while the 2019 target set forth by the government assumes growth up to 2.8%. Moreover, in 2018, the GDP growth rate slowed down to 6.6% in 2018 (compared to 2017), and in 2019, it could further decline to around 6%. If the US and China fail to resolve their trade disputes, and the trade war that is putting pressure on both Chinese exporters and importers continues, it may impair the creditworthiness of China.

Calculations and data sources

ACRA used the data about imports from the US and the global import data obtained from the International Trade Center, as well price indices and trade volumes obtained from the Chinese data base WIND. The product group data for Q4 2017 and Q4 2018 (before and after the increase in tariffs) were compared and then aggregated by industry depending on their weight in the imports by product category.

Industry tariffs (15 in total) imposed on the goods imported from the US were aggregated on the basis of the share of respective product groups (equal to HS 2 under the international classification) in an industry subject to additional duties. Respective data at the level of 6-digit HS codes were obtained from Center for Agricultural and Rural Development, Iowa State University.

The impact of the new tariffs on the import volume was evaluated using an econometric equation, wherein the dependent variable was the import volume in Q4 2018 compared to Q4 2017 and the independent variables were the price variation in the same period, the product of the US import share in Q4 2017 and the cumulative additional tariff rate imposed by China on US goods in 2018, the annual average growth for 2012–2017 and the additional growth of production output in 2017–2018, and the high demand for certain product groups (e.g. meat, food products, energy resources, etc.).

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