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KEY INSIGHTS

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U.S. – China Trade Outlook

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Key Insights

- The trade conflict between the U.S. and China has evolved beyond the narrow issue of the trade deficit.
- The U.S. wants fundamental changes to China's model of economic development that will ultimately slow the spread of China's influence throughout the world.
- Imminent structural changes to China's economy are impractical and unlikely, though it is in Beijing's interest to avoid tariffs in the near term.
- The shift in U.S. public and business sentiment against China means that the confrontation between the two nations will last beyond a cosmetic trade agreement.

What's happening? President Trump recently said that he will not meet with Chinese President Xi Jinping before the early-March deadline for a trade deal between the two economic superpowers. The truce between the two nations, which began in early December, was a welcome development for the global economy and financial markets, both of which had begun to show signs of stress relating to weaker trade flows and softening Chinese growth. However, the lack of progress on key sticking points has quickly revived worries about an all-out trade war — even though the confrontation between the U.S. and China has evolved beyond issues of trade imbalances.

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Significance? Though the near-term economic ramifications of an all-out trade war have shaken global financial markets, the U.S.' strategic engagement with China will have long-term implications that may take years to manifest. This is because the confrontation between the countries has evolved past a simple "trade war" and a dispute over trade deficits. Rather, the U.S. has engaged China on trade, legal, political, and geopolitical fronts to achieve what it really wants: fundamental changes to China's model of economic development that will ultimately slow the spread of China's influence throughout the world. However, it is unlikely that these negotiations will result in China's surrender of its development goals in the near-term. And, even if President Trump decides that he wants or needs to negotiate a settlement on short notice, any deal will likely be cosmetic in nature and will do little to quell growing worries in the U.S. about China's rise.

Analysis. President Trump campaigned on the idea that a bilateral trade deficit with another country is prima facie evidence of unfair treatment and that one country is therefore "ripping off" the other. While this makes for a handy campaign slogan and an easily-quantified degree of malfeasance, trade experts understand that a bilateral trade deficit is not necessarily evidence of wrongdoing by one of the countries involved. Rather, a trade deficit reflects saving and investment imbalances and differences in comparative advantages in production, currency strengths, and more. Regardless of these facts, President Trump engaged in rounds of tit-for-tat tariff hikes with China to address the bilateral trade imbalance. Though the tariffs themselves have done nothing to close the trade deficit, they did force Beijing to come to the table to negotiate once the Chinese economy began to show signs of stress.

U.S. negotiators want more substantive—and ultimately contentious—changes to the Chinese economy.

At the negotiating table in early January, Beijing reportedly offered the American delegation a six-year plan to boost imports from the U.S. and eliminate the bilateral trade deficit between the two countries. However, the feasibility of such a promise has been questioned by many economists and regardless appears to be unsatisfactory to the U.S., whose negotiators want more substantive — and ultimately contentious — changes to the Chinese economy.

Meanwhile, U.S. businesses have also expressed reservations about Chinese promises to purchase more American goods. In mid-February, Beijing reportedly offered to expand its purchases of American semiconductors in order to help close the trade gap. However, U.S. semiconductor firms apparently remain opposed to this plan because of the belief that it is just an excuse to gain access to sensitive U.S. technologies.

Concerned about access to sensitive technologies, American firms oppose Chinese offers to buy more American goods.

That both American negotiators and American firms seem opposed to Chinese offers to buy more American goods is a sign of the shifting nature of the U.S. strategic engagement with China. The diverse ways in which the U.S. is confronting China is evidence that the fight has evolved beyond President Trump's trade war. New actions that U.S. have taken against China include:

- Challenging China's model of economic development that depends on state-directed lending, non-tariff barriers, and government subsidies to certain firms.
- Demanding an end to the requirement that foreign firms enter into joint ventures with local Chinese firms whenever a foreign firm wishes to operate in China. These joint ventures often require the foreign firm to share trade secrets or intellectual property as a cost of doing business – a phenomenon known as a "forced technology transfer."
- Imposing new, aggressive limits on foreign investment in sensitive U.S technologies to prevent acquisition of those technologies. Imposed by the Committee on Foreign Investment in the United States ("CFIUS"), these limits

include minority investments in strategic companies, joint ventures in the U.S., and the like.

- Directing the U.S. Justice Department to pursue criminal charges against Chinese firms and individuals, most notably the telecom giant Huawei and the firm's CFO. The U.S. has accused the firm of violating U.S. sanctions on Iran and stealing intellectual property from a U.S. firm.
- Closing "Confucius Institutes" — Chinese-government-funded learning centers — at U.S. universities over fears of censorship, academic freedom, and espionage.
- Organizing a boycott of major Chinese telecom equipment providers among U.S. allies and banning U.S. government entities from purchasing equipment from firms that have been deemed security threats.
- Demanding changes to Beijing's "Made in China 2025" initiative, a program that aims to launch China into the pole position in next-gen manufacturing industries of strategic importance such as biotechnology, aerospace equipment, and robotics vehicles.

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Prospects for a Resolution? There is a near-zero chance that China will abandon its model of economic development that has served the country so well over the last few decades. The subsidies, lending to state-owned enterprises, and non-tariff barriers are not viewed as "unfair" in China. Rather, government actions to support industrial champions are seen as patriotic, especially given Western governments' targeting of Chinese firms abroad. Irrespective of Beijing's willingness to give up its model of economic development, the practical steps necessary to implement these structural changes to China's economy would take years to be realized. Given these political and practical limitations, structural changes to the Chinese economy are unlikely in the near term.

On the other hand, the possibility of a protracted, bruising trade war arrives against the backdrop of a broad slowdown in the global economy — a slowdown centered in China and other export-driven economies. While Xi and the Communist Party of China likely enjoy greater political insulation than Trump does in the U.S., the precarious state of the Chinese economy means that it is in Beijing's interest to avoid an escalation of tariffs in the near-term. To that end, Xi will likely continue to try to negotiate a resolution to the bilateral trade deficit and thus avoid further tariffs.

On the U.S. side, most Americans blame President Trump for the recent government shutdown. Therefore, he may feel the need to secure a "win" against China on the trade front and he might accept a promise from China to buy more soybeans, oil, natural gas, and other commodities to narrow the bilateral trade deficit between the two countries. President Trump could point to the billions of dollars' worth of goods that China would be buying and claim a win. Meanwhile, he could promise that the more sensitive negotiations on Chinese industrial policies would continue until a satisfactory agreement is reached.

The broader confrontation will live on beyond a narrow deal on the trade deficit.

However, even if President Trump decides that he wants to settle the dispute with China, his trade war has opened a "Pandora's Box" of strategic engagement between the two nations that has far eclipsed a simple trade dispute. The U.S. government is engaged with China on a multitude of fronts, and, given how public and business sentiment in the U.S. has shifted against China, it will be extremely difficult to end this dispute in a clean manner. So, while the two sides may resolve the narrow issue of the trade deficit in the coming weeks or months, the broader confrontation that has evolved from the trade war will live on.

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