



5. To Deal or Not to Deal: The U.S.-China Trade War Enters the Endgame

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Shipping containers from China and other Asian countries are unloaded at the Port of Los Angeles as the trade war continues between China and the U.S. Mark Ralston, AFR Getty Images, 2019.

THE U.S.-CHINA ECONOMIC RELATIONSHIP has been through multiple twists and turns over the last 18 months. There has been much frustration, tension, and anger in this process, interspersed with periodic outbursts of diplomacy, reboots, and bilateral calm, all before the next round of tariffs, retaliatory tariffs, and stalemate. It has all the hallmarks of a messy divorce. If markets are confused about where all this is going, think, too, about the long-suffering global public and what sense they make of it all as they try to plan their long-term savings and investment strategies.

It is time, therefore, to make a fundamental assessment as to whether the underlying politics and economics of the relationship will allow a trade, technological, and financial war to be averted, or whether we are now on a course toward mutually assured economic destruction.

The argument I wish to advance here in Beijing is that, on balance, despite all the political noise, the evidence still points in the direction of a negotiated deal to be done before the end of the year. I say this notwithstanding the fact that this may place me in a minority of one versus what most of the commentariat is saying around the world today. I readily concede, though, that it is a separate question as to how comprehensive or permanent any such bilateral agreement might prove to be.

The Trade War Thus Far

It is now 18 months since the formal commencement of the trade war in March 2018, when President Donald Trump signed a memo directing the imposition of tariffs on a range of Chinese products as well as restricting Chinese investments in a number of key technological sectors in the United States. For those following the details, it has been a bewildering process.

I argue that we are about to enter the endgame of the U.S.-China trade war. The negotiations set to resume early next month represent the last chance to find a way through. Failing that, we should all buckle up and get ready for the rockiest of rides that the global economy has seen since the end of the global financial crisis a decade ago. This includes the risk of America sliding into recession. Not to mention the fundamental poisoning of the well for the future of the overall U.S.-China relationship, thereby reinforcing a growing constituency in both countries who believe that the United States and China are, to borrow the title from Graham Allison's book, "destined for war."

The recent decision to recommence trade negotiations is significant in itself. It marks the beginning of phase four of the trade war. Both sets of combatants are tired but determined, convinced of the righteousness of their causes. But neither Beijing nor Washington would have taken the political risk to restart the process unless they had judged there was at least some prospect of success.

Phase one began with the imposition of the first round of U.S. tariffs last February and March, when Trump concluded that he had to act in order to get China to get serious. Phase two we could call "the Argentine reset," when both Trump and Xi Jinping agreed at the G20 Summit in December 2018 to conclude the core parts of an agreement within 90 days. This imploded in late April/early May of this year, despite the fact that both sides had started to plan signing ceremonies, with each then accusing the other of major last-minute changes to the draft agreement. Phase three could best be described, to paraphrase Shakespeare, as the "summer of our discontent," when a fresh series of tariffs were imposed by the United

States, countered by retaliatory tariffs from China, with some still scheduled to take effect in the last quarter of this year.

And, to up the ante, China announced its equivalent of the U.S. “foreign entities list,” poetically called an “unreliable entities list,” targeting American firms in retaliation for the listing of Huawei and five other Chinese tech companies. All this is occurring against the background of American hawks saber-rattling about the need for a “general economic decoupling” from China as a precursor to a new Cold War, while China began publicly rekindling the spirit of the Communist Party’s feats of endurance during the Long March and reminding everybody that China had also fought the Americans to a standstill in the Korean War.

Apart from that, it’s all been going swimmingly. As of today:

- The United States has imposed tariffs on 68 percent of all imports from China, at an average tariff rate of 21.2 percent.
- China has retaliated with tariffs on 58 percent of total American imports, now at an average rate of 21.8 percent.
- If Trump continues through with his threatened additional tariffs, by the end of the year, U.S. tariffs will impact just over 96 percent of all Chinese exports to the United States.

Given all this, what has caused the two sides suddenly to get the band back together again? Very simple. Both economies are in trouble and if this worsens into 2020, there will be a political price to pay. This would endanger Trump’s reelection come November. It would also weaken Xi on the eve of the Party’s centennial celebrations in 2021, not long before Xi has to secure support for an already controversial third term starting in 2022.

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So despite all the public political position taking by each government, the truth is that both Trump and Xi, for these basic political and economic reasons, both want and need a deal. They also need one by the end of the year to prevent further damage to their economies, particularly if the tariff hikes currently scheduled for

December 15 come into effect. These are big and run the serious risk of not only poisoning business sentiment further, but also delivering material and lasting damage to the real economy of each, not to mention the world.

Each side says publicly that the trade war is hurting the other side more than itself. But the reality is that it is hurting both of them—destabilizing markets, destroying business confidence, and undermining growth. Each side also claims that it has greater economic resilience to see the other side out if the trade, tech, finance, and economic war between them becomes entrenched. On that, the jury is still out. America is certainly less trade dependent than China. But Beijing has greater fiscal, monetary, and credit policy

tools at its disposal to supplement declining external demand with greater domestic investment. The bottom line, however, is that the hard heads on both sides recognize that they are holding an economic gun to each other's heads, and it is uncertain, at best, how it would all play out if the shooting were to start.

If, therefore, we have indeed now entered a new fourth phrase of the U.S.-China trade war as of this week, there is much damage to repair. The question for us all—not just Chinese and American firms, not just these two countries' governments, but the entire world, which looks on helplessly—is whether after all the carnage of the last 18 months, will there be sufficient political will and policy creativity left to produce such a deal?

Current Chinese Economic Policy Settings and Performance

A core factor impacting both Chinese and American negotiating behavior is their respective perceptions and conclusions concerning the current state of each other's economies.

In China's case, this includes the current and prospective impact of the trade war on employment, investment, and growth. It also includes the extent to which the trade war has compounded preexisting economic difficulties arising from China's previous political economy settings going back to 2015.

I have written before that China's economic growth performance began to suffer during 2016–2018 as a consequence of significant changes to China's domestic policies well before the trade war became a reality. This has roots in Beijing's deleveraging campaign in 2015, itself a response to concern over that year's stock market crash, ballooning debt to gross domestic product (GDP), and the realization that an unfettered shadow banking sector posed real risks to the stability of China's financial system. The result was that in many cases, unproductive state-owned enterprises were given more favorable access to credit at the expense of the private sector, despite the fact that China's private entrepreneurial class had long been the dominant driver of new employment and overall growth in China's economy.

By 2017–2018, private sector sentiment and investment had begun to suffer because of conflicting signals about how large private firms could grow; the growing status of Party secretaries within the management of private firms; the vagaries of the Chinese financial system, including access to credit; and an anticorruption campaign that made many China's entrepreneurs feel anxious for their future. As a result, China's private sector growth has slowed. As a further result, overall economic growth has slowed because of factors completely exogenous to the trade war of 2018–2019.

From November 2018, as the trade war began to bite, the Chinese Communist Party and government have actively tried to address these major challenges to growth with a series of policy responses. First, there was a political reembrace of the private sector by China's leaders. Second, there have been policy shifts aimed at opening up new lines of credit to private firms, including reduced reserve requirements for banks to encourage them to lend more, broadened definitions of collateral that banks could lend against, and a directive for large state-owned banks to increase their lending to small private sector firms by 30 percent. Third, financial sector reform has been accelerated with moves to liberalize interest rates and to encourage greater foreign participation in China's financial sector to drive down costs for borrowers. Fourth, there has been a reinvigoration of broad, systemic market-based economic reform, consistent with the content

and thrust of “The Decision” of the Third Plenum of the 18th Central Committee in 2013. This was underlined on September 9 in Xi’s reported remarks at a Politburo meeting on “comprehensive economic reform.” Finally, the same Politburo meeting issued a new guidance document on “better supporting the further development and reform of China’s private sector.”

The jury may still be out on how the private sector will respond to these measures, given the risk factors outlined earlier. Nonetheless, Liu He, one of the leading voices for sustained economic reform in Beijing, sees opportunity in adversity. He has publicly described the trade war as a positive opportunity to “improve innovation and self-development, speed up reform and opening up, and push forward with high quality growth.”

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Nonetheless, the central near-term challenge facing Chinese economic policymakers, given the combination of domestic and international factors now bearing down on their country, is how to stimulate growth while not recreating the systemic financial risk of the past. Central bank governor Yi Gang stated in June that “the room for adjustment is tremendous” in China’s fiscal and monetary policy toolkit, with “plenty of room in interest rates and in required reserve ratios.”

China has reduced the reserve requirements for financial institutions to encourage an expansion of their loan portfolios, including new relaxations announced in the course of the last week. Chinese regulatory interlocutors also tell me that they have considerable room to move on this score as well. One further area in which credit reform is under way is the People’s Bank of China’s new policy on benchmark interest rates, which would move toward aligning the

cost of borrowing for firms and households with interbank lending rates, improving the transmission of central bank rate decisions to the broader economy. The implementation of such a reform should lower borrowing costs for firms and households, independently of lowering benchmark rates.

Further pathways for easier access to capital for domestic tech companies have also recently been announced with the establishment of the Shanghai Stock Exchange’s Science and Technology Innovation Board, which began trading at the end of July. Companies can list on STAR, as it is known, by registering with the exchange, without any need for further government approval. Profitability and minimum capital requirements are also lower if a company shows strong technology or innovation potential

Fiscally, Beijing has reembraced economic stimulus to support growth, albeit using more subtle levers than previously, such as cuts to the value-added tax, targeted consumption stimulus packages to the electronics, communications, auto, and constructions sectors, as well as renewed infrastructure investment in urban rail projects—a long-favored stimulus lever. There are also ongoing discussions in Beijing on allowing provincial governments to issue more debt for infrastructure development. Premier Li Keqiang’s comments on September 4 seem to indicate that this will come soon. There is also some capacity for

renewed housing stimulus to bolster China's property market should prices begin to sag, notwithstanding Beijing's anxiety about a creating a new class of asset bubbles.

On international economic policy, China has followed a two-track strategy: escalating tariffs in response to U.S. actions while simultaneously reducing tariffs on the rest of the world. By June 2019, China had increased its average tariff rate on U.S. imports to 20 percent while reducing its tariffs on the rest of the world's imports to an average of 6.7 percent. In January 2018, the average tariff rate on all imports to China stood at 8 percent. Furthermore, in July 2019, the Ministry of Commerce reduced the number of restricted sectors to foreign investment from 48 to 40. This includes the new ability for majority foreign ownership in subsectors such as value-added telecommunications. This year also saw a substantial increase in the Ministry of Commerce's "Encouraged Catalogue" for foreign investors, which provides preferential treatment by way of fast-track approvals, reduced land prices, and tax incentives. This list shows a heavy preference for attracting foreign investment in high-tech manufacturing, agriculture, health care, and artificial intelligence sectors. These are all preliminary steps, but they are positive when we contextualize how foreign investment and value chain participation have driven historical tech advancements in China.

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In apparent response to U.S. and broader international pressure, China has also begun to adjust its intellectual property regulations. In March, the State Council removed a number of provisions in the Technology Import and Export Regulation that had drawn the ire of the U.S. Trade Representative's office as proof of China's predatory practices on foreign intellectual property. These appeared to be welcome announcements for the U.S. Trade Representative who then dropped a related complaint against China before the World Trade Organization in June. The National People's Congress Standing Committee also amended the Trademark Law and Anti-Unfair Competition Law in April, which made it explicitly illegal for companies to secure trade secrets through electronic hacking. The legal burden of proof for trademark violations also shifted from the plaintiff to the defendant when evidence is strong. These amendments were fast tracked and made effective immediately.

It is difficult, of course, to separate the trade and nontrade policy factors currently bearing down on China's overall economic performance—just as it is difficult to assess at this early stage the likely effectiveness of the raft of policy measures outlined here. Nonetheless, the net impact of all of these factors—policy and market, foreign and domestic—has been a slowing of Chinese growth. But this is not a slowdown tantamount to economic collapse, as a number of American commentators seem to hope.

- China's second-quarter economic growth officially stood at 6.2 percent, down from first-quarter growth of 6.4 percent. This is the slowest growth rate for China since 1992, when official records were first published. Some analysts believe growth is actually lower than this, approaching the 6 percent threshold long believed to be crucial to sustain improved living standards and resist rising unemployment.

- Business sentiment in the manufacturing sector has been gloomy, with official manufacturing PMI reporting contracting output in six out of eight months from the beginning of this year. A recent survey of Chinese exporters was pessimistic, with 40 percent of respondents viewing the trade war as a “permanent state,” up 7 percent.
- Foreign capital is pulling back from China, with \$5.9 billion leaving China’s stock mutual and exchange traded funds in 2019. Around \$2.9 billion of this amount left in August, the greatest outflow since 2017. Both foreign and Chinese firms alike are increasingly looking to move parts of their supply chain offshore to countries such as Vietnam.
- Infrastructure development, long a reliable driver of economic growth has begun to decline, with fixed asset investment growth hovering just under 6 percent growth through 2019, well below the 7 to 8 percent growth regularly reported through 2017.
- Retail sales grew by 7.6 percent in July, down from a high 9.8 percent growth in June.
- There is a growing predilection for Chinese consumers to save more according to surveys, rather than spend their discretionary income. This undermines the effectiveness of economic stimulus designed to increase consumption, such as tax cuts. Household pressures are also building with rising pork prices—up by 25 percent in August. Pork represents 60 percent of China’s meat consumption.
- Official urban unemployment figures increased in July to 5.3 percent, equaling the highest unemployment rate on record of February 2019. Of particular concern are the growing proportion of China’s young, unemployed recent university graduates.

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Taking all these factors into account, the bottom line is that Chinese growth is considerably weaker than it was three years ago. It is on track to become weaker again because the combination of the trade war, recent domestic economic policy settings, as well as the lack of response so far from the Chinese private sector to the new policy signals that have recently been put in place.

However, a weakening economy does not mean the economy is on the verge of collapse. China’s economy is much more robust than that. It continues to have headroom for future economic growth through further

urbanization and a rising middle class. Furthermore, exports, while significant to China’s overall growth performance, are not as significant as they were historically.

But if natural growth in Chinese domestic consumer demands fails to offset the negative impact of declines in the traded sector of the economy, then the bottom line is that there are still sufficient fiscal and monetary policy tools available to the government, including future large-scale stimulus, should that prove necessary to sustain growth at or around 6 percent.

In other words, China's overall economic circumstances, as we head into the final quarter of 2019, are difficult but by no means dire. From Beijing's perspective, the trade war has also provided Chinese economic reformers to regain greater control over the policy agenda, enabling them to readjust economic policy direction over time in a manner more supportive of the private sector and the market. While it remains to be seen whether these measures will go far enough to have significant impacts on the substantive investment behavior of China's entrepreneurial class, they do represent some steps in the right direction.

For these various reasons, there seems to be little sign of panic among economic policymakers in Beijing. Concern, yes, but not panic. In the context of the trade war, U.S. policymakers need to be aware of that. At the same time, there is still sufficient concern in Beijing to cause Xi to conclude that, on balance, it is better for China to put the trade war behind it if it can—or at least to do so until the end of 2020, when a new set of American political realities may present themselves following the next election.

Current State of the U.S. Economy

The global economy at present, however, is the sound of two hands clapping, not just one. And that other hand is the United States itself. In trying to analyze the likelihood of an early conclusion to the trade war, we need also to have an objective understanding of the robustness of American growth as we approach the last quarter of 2019 and how it is seen in Washington and in Beijing.

President Trump, as he is given to do, has overstated the impact of the trade war on the Chinese economy. He has also understated its impact on the U.S. economy through the disruption of American global supply chains, the sectoral interruption of America's agricultural industry, declining business and consumer confidence, as well as the volatility of financial market reactions to the gyrations of the trade war over the last several months. As with China, however, it is difficult to clinically separate trade and nontrade factors impacting current and future U.S. growth.

We are familiar with the length of the current U.S. business cycle. It is already the longest since the war—10 years of continuous growth since America's recovery from the global financial crisis in 2009–2010. Markets, therefore, for some time have been factoring in their own assumptions of when this long-term business cycle will reach its natural conclusion.

On top of that, there is the rolling debate of the continued effectiveness of U.S. monetary policy. The stimulatory effect of Trump's 2017 tax cuts have already been delivered to the economy. Of themselves, they are no longer contributing to further growth. At the same time, the U.S. Federal Reserve has been reluctant to lower interest rates more rapidly than they have done, particularly given these are already sitting near historically low levels. Whether or not a further reduction is necessary, desirable, or deliverable, given the curious relationship between the chairman of the Federal Reserve and President Trump, remains to be seen. This includes whether any further monetary policy action can indeed extend the already long U.S. business cycle.

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However, the most recent U.S. economic data reflects continuing, relatively strong growth. Annual GDP growth has remained above 2 percent since January. Unemployment continues to decline from its highs of 2010 to its current level of 3.7 percent. The Federal Reserve's most recent "Beige Book" is optimistic on wage growth.

But we are beginning to see some impact on the U.S. domestic economy and, indeed, on the wider global economy, as global trade takes a battering from not only the trade war but also the wider forces of global protectionism. These protectionist forces have been eating away at U.S. and global financial market sentiment for a long time, while eroding business and consumer confidence and substantive investment behavior by firms. Given the size of their economies, the U.S.-China trade war lies at the center of this. Some recent economic data is beginning to show this:

- Last week's job creation figures were below expectations.
- America's manufacturing sector contracted last month, for the first time in three years.
- Consumer sentiment figures compiled by the University of Michigan reported the lowest figure in almost three years, including the biggest one month drop since the end of 2012.

Economists estimate that existing tariffs are costing America 0.6 percent of GDP growth, or more than \$100 billion annually. President Trump's actions also seem to admit a growing sense of anxiety about the

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state of the economy as of the end of August, when he let slip that he was mulling further income tax cuts. His incessant calls for the Federal Reserve to lower interest rates belie a high level of concern.

In summary, while the United States is beginning to take a hit from the trade war, it would be wrong to say that its nonresolution would necessarily push the country into recession. Many of the economic indicators mentioned continue to be strong. But the

risk nonetheless remains, reinforced by declining business and consumer confidence indicators. These, together with the underlying headwinds noted earlier, should give the president sufficient pause for reflection about the state of economy in 12 months' time—that is, on the eve of next U.S. presidential election. For these reasons, President Trump, when looking at his own political destination in 2020, on balance is likely to prefer to bring the trade war to a negotiated conclusion by year's end, if possible.

How Could China and the U.S. Conclude a Trade Deal by Christmas?

Given all of the above, and the underlying political and economic assumption that as of now, it is still in both sides' interests to end the trade war, then what in practical terms must be done to help get such a deal agreed, and what might be a mutually acceptable landing point? Here are five things that might help.

First, China should provide the United States with its own draft text. It should be the same as the last 150-page text but include only the drafting changes necessary to satisfy China's "red lines" announced on May 13, and nothing more. These would be removing the U.S. provision to retain \$50 billion of tariffs

after the agreement is signed; removing the provision for the United States to unilaterally reimpose tariffs in the future if it decides that China is not honoring the agreement, as well as the prohibition on China taking retaliatory action; and inserting a provision in the text that China will give effect to the agreement consistent with its constitutional, legislative, and regulatory processes, rather than specifying the precise nature of these enactments. The details of how this could be done could be clarified in a side letter to the agreement.

The bottom line is that if the United States objects to China's actual behavior in the future, it will take action anyway. Why would the United States want to destroy the rest of the provisions already secured in the draft agreement by insisting on these three positions, which it could deal with by other means anyway in the event of any future Chinese noncompliance?

There are, of course, other views on how to handle the current U.S. negotiating requirement to maintain tariffs on \$50 billion of Chinese exports once a deal is signed. For example, Wendy Cutler, vice president at the Asia Society Policy Institute, is a veteran U.S. trade negotiator. She argues for immediately removing the majority of U.S. tariffs while leaving in place the original tranche of \$50 billion on the basis that these tariffs specifically targeted China's unfair intellectual property practices. This would be a substantial reduction from the existing U.S. tariff burden. She argues that with clear benchmarks and timeframes for lifting the remaining tariffs, Beijing could sell this to their people as a big and broad U.S. concession. But I am not so sure, given that China has publicly declared the removal of all tariffs when the agreement comes into force as a Chinese red line.

Second, China should improve on the original offer of a \$200 billion reduction in the bilateral trade deficit over time. This is lousy economics. But it is important to Trump personally and politically. China may not be able to meet Trump's May counterproposal on the quantum of the proposed bilateral purchasing agreement, but China might be able to find a number somewhere in between.

Third, China must retain the draft agreement's existing provisions on the protection of intellectual property and the outlawing of forced technology transfer. These are critical structural changes in China's trade and economic practices for the future. On the question of state subsidy for Chinese industry and enterprises, China will never outlaw this in the text of a bilateral agreement, not least because many countries around the world have similar practices. Look at U.S. agriculture, for example. But it may be possible to have both countries declare their respective positions on state industry policy for the future in a communiqué accompanying the release of the signed agreement. This should not be a blank check for China. China should also stipulate which domestic and international arbitral mechanisms will be applicable to place the quantum of any such subsidies in the future within fixed limits. This would mean complying with competitive neutrality laws and tribunals domestically, as well as those with come under the World Trade Organization internationally.

Fourth, none of the above will work unless both sides act now to create a positive political atmosphere for when the Chinese negotiators arrive in Washington early next month. This is not a feel-good question. It is about concrete actions. China could kick start this by placing a large order now for American soy beans and corn. That helps Trump's angry farmer problem in his Republican heartland. The United States could respond by deferring the currently scheduled 5 percent increase on October 1 on top of the 25

percent tariff already imposed on \$250 billion worth of Chinese exports. Failing to do this would further alienate the Chinese leadership, as it would fall precisely on the 70th anniversary of the founding of the People's Republic, a big event in the Chinese political calendar. The United States might also consider issuing permits for some of the more nonsensitive applications already received from dozens of U.S. firms wishing to sell their product to Huawei—applications that are currently languishing on the commerce secretary's desk.

Fifth, both sides should regard the November 16 Asia-Pacific Economic Cooperation Summit in Santiago as the last chance saloon for getting the deal signed. That would mean technical level meetings in Beijing in September. High level negotiations between Vice Premier Liu He and U.S. Trade Representative Robert Lighthizer in early October. With outstanding issues to be agreed at a 14th and final round of negotiations in Beijing in early November. Getting the deal done before Thanksgiving will be critical to undergirding U.S. business and consumer confidence going into the Christmas shopping season.

Conclusion

I have been among a small minority of analysts who have consistently argued that despite the public political fireworks over the last year or so, the underlying interests of both presidents make a deal more likely than not. But a failure to manage the next two critical months carefully could still cause the whole process to implode.

To be clear, both sides have already spent a lot of time preparing Plan B for 2020—namely, to let loose the dogs of economic war between the two countries, each appealing to underlying nationalist sentiment to blame their domestic economic woes on each other, all to secure their respective political futures. In that case, we should all get ready for the risk of recession next year.

Indeed, if a new negative spiral begins, deeper resentment and retrenchment sets in, precipitating a broader decoupling of the two economies. For example, a recent article in a People's Bank of China-affiliated journal defending China's recent actions in currency markets called on China's policymakers to prepare for the worst should bilateral relations fail to improve. This was a call to develop domestic autonomy from U.S. suppliers and capital, promote the renminbi more heavily in international transactions, and to support European efforts to develop independence from the U.S. dollar-dominated international financial system.

With each passing cycle of conciliation and then escalation, the political cost of granting concessions worsens, as the nationalistic impulses become harder to calm. With each passing month to November 2020, the political incentives for Trump to pivot the missteps of the once "easy" trade war and pin all blame on China grows stronger, and the temptation to tap anti-Chinese nationalism rises. The same will apply in China. And in the United States, the unwillingness of many Democratic candidates to recite anything but a blanket hawkish stance to China only pushes Trump further to the right.

We are now at a critical window of opportunity in this trade war. We must hope that economic and political self-interest prevails over some of the darker forces at work in the politics of both countries—for China's sake, America's sake, and the world's.