Can We Prevent A Full-Blown Trade War

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On March 8, President Trump fired the first shot of a trade war by threatening to impose 25 percent of tariff on steel imports.

On March 22, the Trump administration released the report of Section 301 investigation into China's trade practices, and on the same day President Trump signed a memo slapping China with tariffs on some1300 Chinese products, totaling about $50 billion.

On April 4, US Trade Representative (USTR) published the list of 1333 Chinese products of $50 billion that will be subject to the additional 25% tariffs.

On April 16, US Ministry of Commerce declared a ban on U.S. companies selling goods and software to Chinese telecommunication equipment maker ZTE for 7 years.

Trade friction has been a serious problem between China and the US for long time. But few people had expected that the friction would escalate to a trade war. So how did we get to this point, and can we turn back before it's too late? This is the biggest question currently we are facing.

Indeed, China has run a large current account surplus against the United States. However, the US has run trade deficit persistently and uninterruptedly since 1980. Hence, one should first ask why the United States runs trade deficit against the rest of the world so consistently and persistently, and then one can ask why a specific country such as China runs large trade surplus against the United States.

As pointed out by our PIIE colleagues,[1] "the United States is bound to run an overall trade deficit with the rest of the world when combined US savings of the household, business, and government sectors are negative..."

Another important point is that trade deficit is not just a bilateral problem. While running trade surplus against the United States, China runs large trade deficits against East Asian economies. The geographic pattern of American trade deficit is a result of resource allocation consistent with comparative advantages.

[1] Gary Clyde Hufbauer and Zhiyao (Lucy) Lu, Macroeconomic Forces Underlying Trade Deficits, March 31, 2016, PIIE, Washington D.C.

It is true that China's bilateral trade surplus against the United States is too large. Despite trade deficit as a whole cannot be reduced by trade policy alone, bilateral trade imbalances between China and United States can. If the United States relaxes the ban on exporting high tech products to China, the bilateral trade imbalances can be reduced immediately.

For many years, China indeed has been pursuing a trade policy with mercantilist flavor, which resulted in China's accumulation of some $4 trillion foreign exchange reserves in 2014, and overdependence on foreign markets in general and the US market in particular. However, it is unfair to ignore the efforts China has made to address the imbalance, which is evidenced by the fact that the RMB has appreciated by 41 % in trade-weighted terms between 2005 and 2017. In real terms, it has appreciated by 48% during the same period of time.[2]

Furthermore, since 2008, China's overall trade surplus-to-GDP ratio has been falling steadily from near 10 % in 2007 to just above 1% in 2017. This means that China's trade account is basically balanced. To accuse China of practicing mercantilist trade policy is no longer valid.

President Trump complains endlessly that the United States has being taken advantage of by its trade partners who run trade surpluses against it. The complaining exposes the ignorance of the Present. Running large trade account deficit implies that the United States has sucked in large foreign capital over the years. To get real resources with pieces of paper, who takes advantage of whom?

Besides China's large trade surplus against the United States, another important flash point of trade friction is China's WTO compliance. In the past, even myself suspected that China failed to comply its WTO commitments. But the fact is that, since its entry into the WTO, the Chinese government has tried very hard to fulfill its WTO commitments. According to the WTO Director-General Mr. Lamy, "China has done really well in terms of implementing its long list of commitments. But no country is above criticism. …. What I can say is that members have complained about certain services sectors not being open sufficiently and that intellectual property rights [IPR] protection needs to be improved." I think this is a fair assessment. The US government itself has kept a close eye on China's WTO compliance since China's entry in 2001. To date US Trade Representative (USTR) has compiled 16 Reports on China's WTO Compliance.

In its 2016 report, the USTR said that "(t)he data confirm a dramatic expansion in trade and investment among China and its many trading partners, including the United States, since China joined the WTO." In fact, "U.S. exports of goods to China totaled $116 billion in 2015, representing an increase of 505 percent since 2001, and U.S.

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2 China – the rise and rise (and rise) of the RMB - DBS Bank, www.dbs.com/aics/pdfController.page?pdfpath=/content/article/pdf/000000_reports/specials/2017/170224cn.pdf

services exports reached $48 billion in 2015, representing an increase of 802 percent since 2001." Only after having acknowledged these positive results, the report went on to say: "the overall picture currently presented by China's WTO membership remains complex".

However, since 2017, the tone of the USTR has changed quite significantly. In the 2017 WTO compliance report and the recent Section 301 investigation report, USTR's focus shifted to China's industrial policies. Industrial policy to a large extent is beyond the scope of the WTO. In fact, in the Section 301 investigation report the word of WTO was rarely mentioned.

The USTR asserted that the goal of China's industrial policy is to displace "global industrial leaders—including U.S. companies—so that China may achieve global market dominance."[3] To achieve this goal, according to the USTR, China is guilty of using four instruments to acquire technology:

- Unfair technology transfer regime
- Licensing restrictions
- Outbound investment aimed at high tech sectors
- Intrusions into U.S. commercial computer networks and cyber-enabled theft of IP and sensitive commercial information.

In my view the Section 301 report is based on hearsay, imagination and subjective judgments. I was wondering how the Trump government can based its important policy decision on such a low quality report. The obvious answer is that decisions have already been made. The purpose of the investigation is to find some justifications for the decision. Due to time constraint, here I am not going to elaborate on all major factual mistakes made by USTR.

Let me say a few words about how far the USTR's views on China's outbound investment have departure from the reality. In the Section 301 investigation report, the USTR asserts that, "China pursues an outbound industrial policy with government capital and highly opaque investor networks to facilitate high-tech acquisitions abroad."

In reality, from 2005 to 2016, Chinese companies have made 234 investments including M&A in the United State.[4] Among these investments, 78 are in the finance and real estate, 35 in the entertainment and tourism, 26 in the transport, 25 in the oil and gas, only 17 in the technology.

[3] Report on Section 301, p47.

[4] Chinese Investment in the US Dataset ™

According to US sources, the total amount of invested in the technology sector is just $21bill, a very meager sum of money. Among this total

- The largest came from Lenovo, which acquired IBM's personal computer section.
- The second largest came from HNA, a private air liners based in Hainan Island in China

Lenovo spent the $6.8 billion for Think Pad. Its venture has never been universally applauded in China, and now Lenovo is making big losses.

As for HNA, nobody is quite clear, why it was happy to spent $ 6 billion to buy Ingram Micro, a distributor of information technology products.

Other Chinese investments in the technology sector in the United States were quite small, mostly less than $100 million

In contrast, according to US National Association of Realtor[5], from 2009 to 2015 Chinese spent some $100 billion in purchasing real estates in the United States. Compared with money China spent in the finance, real estate and entertainment sectors in the United States, money spent in the technology sector is a peanut.

More importantly, nobody knows what sorts of advanced technology the Chinese investors has and will get through their investments. The irrationality of the sectoral distribution of Chinese companies' investments demonstrated that, there is neither a well-thought-out strategy by the government to guide or coordinate Chinese companies, nor there is an effective market mechanism that can incentivize Chinese companies to invest in a rational way. Hence, many decisions on investing abroad are irrational and large losses have been made.

The USTR claims that the Chinese government "has devoted massive amounts of financing to encourage and facilitate outbound investment in areas it deems strategic." But the USTR failed to produce any evidence to support this claim. Chinese companies' investments such as those by Lenovo and HNA are decided by themselves and they have to raise money for investment themselves.

The Section 301 report conjures up a Chinese government that has a well-thought-out strategy and an army of Chinese companies that obediently carry out government order. This perception is utterly untrue. Neither China government is that omnipotence, nor Chinese companies are that obedient and patriotic. Otherwise, China would not lose $1trillion between 2015-2016, when the RMB was under depreciation pressure.

5 The National Association of REALTORS® is America's largest trade association, representing 1.2 million members, including NAR's institutes, societies, and councils, involved in all aspects of the residential and commercial real estate industries.

Since 2016, faced with large capital outflows, the government was worrying about capital flights in the name of outbound OFDI, and applied brake on OFDI. Then, correspondingly, the USTR stretched its imagination in opposite direction.

It quoted “some observers” as saying that “the government’s recent restrictions on certain outbound investments serve to enhance Chinese companies’ incentives to align their investments with government policies and priorities.” What can I say! Whatever you do, your intention must be devious! This is USTR’s way of thinking.

Certainly, neither China’s fulfillment of its WTO commitments is impeccable; nor problems raised by the US side are entirely unreasonable or nonnegotiable. China has large room for improvement in WTO compliance, especially in the areas of financial service sector opening and intellectual property rights protection.

A puzzling question is why the US government decides to start a trade war with China, despite the dire consequences it will create to both economies and the rest of the world?

The answer can be found in the National Security Strategy of the United States of America report released in December 2017. According the report signed by President Trump, the United States “will respond to the growing political, economic, and military competitions we face around the world.” “The competitors that challenge American power, influence, and interests attempting to erode American security and prosperity” are China and Russia, who are followed, in order of threats, by North Korea, Iran and Transnational threat groups, from jihadist terrorists to transnational criminal organizations. This report is ushering an era of a Second Cold War. Compared with this war, one can just forget about the looming trade war.

One hopes that the trade war will be avoided, through negotiation and mutual concessions. Then US and Chinese leaders can turn their attention to the broader problem of avoiding the Thucydides Trap, thereby preventing a clash with consequences that would dwarf those of a trade war.

History tells us: war can break out between countries, just because of misperception of each other’s intention. Now the misperception between China and United States has become very serious. Both sides should redouble their efforts to eliminate the misperceptions before it is too late. I am sure that this meeting will contribute to the increase in mutual understanding between China and the United States, and the elimination of misperceptions between the two countries