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Dollar and Sense Podcast
“US-China trade war, or trade deal?”

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DOLLAR: I'm David Dollar, host of the new Brookings trade podcast: "Dollar and Sense." My guest today is Eswar Prasad, a senior fellow at the Brookings Institution and a professor at Cornell University. Eswar is a leading expert on the Chinese economy and our topic today is the U.S.-China trade war.

So Eswar, I just want to jump right in. Let's talk about these complaints that the U.S. has about China trade practices. What do you see as important legitimate complaints, and maybe we'll get into some of the complaints that are not so legitimate?

PRASAD: So going back to 2000 when China joined the World Trade Organization, China had made a lot of commitments to open up its economy to foreign exporters, commitments to increase the ability of foreign investors to invest in various parts of Chinese economy including the services sector. Now, China had gotten a deal from the WTO where it might reduce some of these things gradually, that it would provide market access, but it would provide investment opportunities to foreign investors somewhat gradually, especially in parts of the economy that were seen as somewhat vulnerable to foreign competition.

Now, over time China has argued that it is in fact met these commitments. But the reality on the ground has been very different. It's been very difficult for foreign firms, including American firms, to operate in the Chinese market. It's been difficult for foreign investors to invest in China because many parts of the economy have remained closed. And although there has been progress in all of these areas over time, there is a sense that the commitments that China made to open up its economy have not been fully kept. In addition, even when China did open up, for instance in allowing foreign investors to participate in the Chinese growth story, it came with a lot of strings attached. For instance foreign firms were left to invest in certain industries. But really they could do so only as part of joint ventures with Chinese domestic companies and this led to further concerns that in fact those joint ventures were creating a channel for China to essentially undertake

technology transfers, some might call it theft of technology, from American and other Western firms. So this set of concerns related to market access, investment opportunities, protection of intellectual property rights, and a range of other issues. There is a sense that China made a lot of commitments, that at best it has adhered to in letter but certainly not in principle.

DOLLAR: Eswar, listening to you reminded me of a concrete example. When I was in Beijing representing the U.S. Treasury, one of the issues we were dealing with was electronic payments, meaning credit cards. And that's an area where China had agreed in its WTO accession that it would open up electronic payments. It didn't really do so. The U.S. took China to the WTO, it won the case, but it's taken a long time for China to implement and still today you don't have any international companies doing electronic payments in renminbi in China. So this is a kind of frustration a lot of firms feel. And you pointed out that that connects to the issue of forced technology transfer in the sectors where foreign firms can invest but have to have a Chinese partner, you know they're pressured to share their technology with firms that are eventually going to be their competitors. Putting that aside, what about larger intellectual property rights issues? Are there other intellectual property rights issues other than that forced technology transfer? What's the situation? Can China improve that?

PRASAD: Certainly, in areas such as services and even entertainment of course there have been a lot of complaints about China not doing enough to protect the intellectual property of foreign companies. So there is a lot more that could be done. What it is interesting, though, David, is the fact that there is an increasing alignment of interests now between China and the rest of the world because China is trying to move into an economy where it starts innovating itself rather than just relying on borrowing technology from the rest of the world.

And if China wants to start moving towards being an economy where innovation

takes place domestically, it's very hard to do that unless you have robust protection of intellectual property rights even within the country. So, China, I think is recognizing that it needs to do a lot more. Now again, it is important to recognize that on paper China does have some degree of intellectual property rights protection, both for domestic and foreign investors. The reality though is that these regulations and laws are enforced in a very patchwork way, and there is the sense in particular that foreign investors cannot really win a battle against a Chinese company in any sort of court process within China. So it is not just having better laws on the books, but also better enforcement and more consistent enforcement that treats both domestic and foreign investors on the level of playing field.

DOLLAR: Another issue that the U.S. brings up a lot concerns trade balances and particularly bilateral trade balances. China overall, as you know used to have a very large trade surplus—it got up above 10 percent of GDP back in the mid-2000s. But China's trade surplus has come down very dramatically I think it's going to be less than 1 per cent this year the broadest measure the current account. So it doesn't really seem to be any concern about China's overall balance, but the U.S. does make a big issue about the bilateral imbalance between the two economies. Could I ask you about that?

PRASAD: Now as you and I and most other economists know, David, bilateral trade deficit or indeed the trade deficit is a bit of a red herring when one talks about unfair trade practices. What tends to drive current account balances and also trade balances is largely the domestic policy of a country, when a country saves a lot more than it invests as China has been doing for the while. It has by definition [run] a current account surplus which typically also means a fairly large trade surplus. In the case of the U.S., the economy runs a large trade deficit overall because the U.S. economy is still a pretty good place to invest, domestic and foreign investors find this to be an economy where they can generate good returns, but the U.S. saving rate is low. So the U.S. saves a lot less than it invests, it has to be financed by the rest of the world and that means a current account deficit, which again,

usually translates into a trade deficit.

Now, trade policies—especially restrictions on both exports and imports—can certainly affect our trade balance but only in the short run and not in any systematic way. If one then thinks about the bilateral trade deficit, there are other determinants that come into play as well. China is now a very important part of supply chains of many companies, including American companies that serve the U.S. market. So if you think about Apple for instance, a lot of the components that go into the iPhones and iPads that you and I and others in the U.S. use, are coming from other Asian countries like Korea, Malaysia, Singapore, Japan, but all of these tend to get marked up as accounting for the trade deficit with China.

So it turns out if you eliminate this processing trade, in other words, trade that does not originate entirely in China but which is largely built on components that come in from other countries, especially Asian countries, that about halves the bilateral trade deficit that the U.S. has with China. If you account for services trade, including Chinese tourists coming to the U.S., Chinese students coming to my university and paying the tuition fees, all of this means that the bilateral deficit is even smaller. And the broader point is that the bilateral deficit is not really something that should be the focus of trade policy, and it's unfortunate that the Trump administration has chosen to frame its economic dialogue with China through the prism of that deficit.

DOLLAR: Right. So the issue of the Chinese students is interesting, there are now 400,000 Chinese students in the U.S., mostly college level but that includes high school students as well. And as you say they're often paying a full ride, so that's an important service export for the United States. I also want to second your point about trade policy is not necessarily going to improve the U.S. trade balance. It may seem obvious that if you restrict imports that your trade balance would improve, but for a variety of reasons, your exports tend to go down as well, partly because of the fact you just mentioned that a lot of

what we import from China is parts and components used by our firms to be competitive. So if you restrict that, then our firms become less productive and we end up having fewer exports. So historically when we had the big tariffs in the 1930s our trade deficit got worse, when we had the measures against Japan in the 1970s our trade balance got worse. So not really any clear relationship between trade policy and trade balances. So I think this clears up that there are some really important market access issues, intellectual property rights protection, but the trade balance issues are really quite different and not really a legitimate trade issue.

PRASAD: Certainly David, it's important to keep that historical perspective in mind as you just put on the table the notion that again, tariffs cannot really in any durable way affect a country's trade deficit. They are overall bilateral and one should really be focusing on the domestic policies. So if the U.S. wants to remain competitive against China and the rest of the world, the U.S. should perhaps be focusing on not so much Chinese unfair trading practices as on domestic policies that could improve productivity and increase American competitiveness.

DOLLAR: Ok, let's shift gears and talk about what's happening in the Chinese economy. You know the U.S. started with steel and aluminum tariffs—we don't import much from China so that's not that big a deal in the China relationship—but then the U.S. came in with 25 percent tariff on \$50 billion of products, and now tariffs on an additional \$200 billion of imports coming in initially at the 10 percent level, but perhaps going to 25 percent on January 1 unless some kind of deal is reached. So what's happening in the Chinese economy? Is this trade war having a big effect? The U.S. administration says that the Chinese economy is terrible and they're expecting the Chinese to make major concessions in light of that. So how do you see the situation?

PRASAD: Those numbers you cited David certainly sound very big and those have fed into the narrative in Washington that Washington really has Beijing in a chokehold with

these tariffs, that China is going to have no alternative but to cave in. But it's worth remembering that the Chinese economy is now the second largest in the world. It's about a \$12 trillion economy. It's about two thirds the size of the U.S. economy. So it's not really a small economy that the U.S. can easily take to the woodshed. Certainly the American market is very important for China. About 18 percent of Chinese goods exports come to the U.S., but this is not where the greatest growth is coming. And interestingly, although as you referred to earlier the Chinese overall trade surplus and current account surplus are coming down, the bilateral trade deficit that the U.S. runs with China is in fact increasing.

To some extent because the Chinese currency, the renminbi, has weakened a little bit relative to their dollar in recent months, partly because of the strength of the dollar against all of the currencies. But the U.S. economy is growing quite robustly while the Chinese economy is slowing down a little bit.

Now, if one looks at the Chinese economy overall, there's been a sense that the economy is not doing that great but in fact most indicators suggest that this slowing in growth if anything has been very modest. Most indicators like GDP growth but also more granular indicators such as industrial production, retail sales, all have come in quite strong in recent numbers. So, if there are any effects from the trade war, they may be coming through confidence which could affect investment, which could affect consumption in other parts of the economy in the future, but certainly we're not seeing them yet. Donald Trump seems to take great glee from the fact that the Chinese stock market isn't doing very well, and that is certainly true. The stock market isn't doing well, there are lots of financial risks in the Chinese economy, the currency has been weakening, but so far all of this hasn't really added up to very much weakening of the economy.

DOLLAR: I think the trade war comes at an awkward time for China. You know there had been a long period of credit expansion fueling the economy and then starting about a year ago China really began to rein in the growth of credit, trying to deal with

financial risks. They've had some success with stabilizing leverage, so the Chinese economy was already slowing down. Stock market peak last January, had already declined a fair amount by the time you get into the spring and the summer. So I think the trade war comes on top of that. But as you say, the slowdown so far is rather modest. It's particularly surprising their export growth has held up very well overall, their export growth to the U.S. has held up very well. Some of that may be front-loading as companies anticipate perhaps there'll be higher tariffs on January 1. But the breadth of the Chinese export expansion is pretty impressive. But I guess I would quickly add, exports are just not that important to the Chinese economy anymore so that's one piece of the picture, but the growth of consumption is much more important driver that's held up pretty well so far.

So the sense that the economy is in terrible shape, that definitely seems like something of an exaggeration, but it certainly is slowing down.

Now, you mentioned that the currencies depreciated, I think it's depreciated about 10 percent the Chinese yuan against the dollar. So another issue that comes up in the relationship is the accusation of currency manipulation. So could you say a little bit about what's happening with the Chinese yuan, how that compares with other currencies, and whether you see this as a currency manipulation situation?

PRASAD: It certainly sounds extraordinarily convenient and coincidental that many Chinese imports into the U.S. now face a tariff of 10 percent which is almost exactly offset by the renminbi's 10 percent weakening against the U.S. dollar. But part of this reflects in my view market fundamentals because after all the Chinese economy is slowing somewhat while the U.S. economy is picking up. The Federal Reserve has already initiated a series of interest rate hikes and chances are that if the U.S. recovery continues to be strong and, or if rates of inflationary pressures start emerging that the Fed will tighten even more. So if you put all of this together it is not surprising that the renminbi is weakening relative to a dollar that is stronger against virtually most other major currencies.

Now the Chinese central bank, the People's Bank of China, has argued for a while that what it is trying to do is manage the currency's value against, not the dollar, but a basket of currencies, and that basket attributes a weight of only about one fifth to the U.S. dollar. Even relative to that basket, the renminbi has in fact depreciated by about 2 or 3 percent this year but that's a far more modest depreciation. So between what has been happening to the Chinese currency relative to that basket and adding in the fact that you mentioned earlier, David, that the current account and trade surpluses have shrunk very significantly, it's going to be very difficult for the Trump administration to make a case, although it has continued trying to do so, that the Chinese are trying to manipulate their currency. On an analytical basis, it's really hard to make that case anymore.

DOLLAR: Right so a little bit of depreciation from the Chinese currency driven by the market definitely helps China keep its exports up. But as we've discussed, it's really not that important for the Chinese economy anymore. There are other measures that they're taking to try to keep up healthy growth, they've got some fiscal stimulus they're planning and I've argued for a long time that they have a lot of fiscal space, and if they need to stimulate the economy, some combination of tax cuts and more spending on health education, these kinds of services, that's going to help them maintain healthy growth. So the picture overall for growth looks pretty good going into 2019.

PRASAD: In fact, David, I think the points you've made and some of your writings that a slightly lower growth rate would actually be beneficial for China because they could get better quality growth but fewer risks building up in the financial system and the rest of the economy, I think those are very valid points. At one level, this trade war might provide a cover for the Chinese leadership to accept lower growth, saying that this is brought upon by the U.S. trade war and the trade hostilities more broadly and that the Chinese economy will have to adapt so it's actually work in their favor.

DOLLAR: Yeah turning it to their favor that would be very clever. Last topic I want to

take up, Eswar, is this upcoming meeting between President Xi Jinping and President Donald Trump in Buenos Aires on the occasion of the G20 summit at the end of November. And I think there may be some pre-meeting with Liu He and Steve Mnuchin. And so there's some hope, you see some signals from the administration that there might be a deal that would prevent this escalation. The U.S. tariffs are going to escalate to 25 percent on January 1 unless something happens. So I want to start by asking you, how do you see the parameters of a trade deal, what's a realistic trade deal for the two sides? We can get later into the issue of whether it's going to happen or not. Let's talk about what's the deal look like.

PRASAD: Indeed, David, such hopes have come and gone many times and I think it's frustrating to the Chinese in particular that the administration doesn't seem to speak with one voice on trade. But if you were to think about a deal I think there is certainly a deal to be had. The Chinese have indicated in the past that they're willing to give Donald Trump a headline win by agreeing to purchase more U.S. goods. You've talked about how they could purchase more agricultural products but also liquefied natural gas. The Chinese would be happy to buy more that would in the short-run certainly put a dent in the U.S. bilateral trade deficit against China.

China is also willing to undertake some of the market access measures that the U.S. would like it to take. As we discussed earlier, some of the issues related to intellectual property rights protection, China might see us in its own interests. Now China might want to make those changes in its own way at its own pace. The U.S. might want them to move more aggressively, but certainly that is a basis for negotiation there.

The difficult part though I think is that the trade conflict is really just the surface issue here. There are many hawks in the Trump administration who see a much broader economic conflict with China and the recent statements we've heard espoused by Mike Pence, in fact I think often channeling the views of the hawks in the Trump administration

who don't want to give an inch to China. So if one side that is looking for unconditional surrender while the other side is looking for a deal, it's going to be very difficult to come up with a deal that both sides can live with.

DOLLAR: No. So I think you've got the main parameters of a deal there. And I would just add there are other aspects that are going to be hard to solve. The U.S. is concerned about China's "Made in China 2025" industrial policy. U.S. is concerned about Chinese state enterprises and subsidies to them. While the Chinese might be willing to do some things on these issues, they're not going to put an end to their industrial policy and they're not going to close all their state enterprises. So in order to get a deal, the U.S. would have to be pragmatic and accept progress in many areas, but lack of progress and probably those last two items I mentioned.

I think it could be in President Trump's interest to accept the deal because this escalation of the trade war is going to be damaging to the U.S. economy, and Chinese economy, world economy. After the midterms, the president did have some tweets and some comments suggesting that he was open to a deal with China, so I think that's certainly possible. But as you say, you've got this faction within the administration and other policy people around Washington who really would like to see the U.S. and China decouple, and they're not going to be interested in a deal unless there's total surrender from China, which we're not likely to see. So maybe we just take a moment and talk about this decoupling scenario. How realistic is it for the U.S. to decouple from the Chinese economy?

PRASAD: I think underlying these are conflicting impulses within the Trump administration. Some members of the administration want to strike a deal with China because they think that would be a win-win situation. Others see no possibility of a deal. And I think Trump himself is conflicted. On the one hand, he seems to want to be seen as a dealmaker who can strike a deal with anybody, but at the same time he wants to be seen

as very tough on China, because it plays well to his domestic base and indeed even some members on the other side of the aisle, the Democrats, do view a get tough on China approach as being a sensible approach. Now the issue on trade, of course, is that trade is not necessarily a zero sum game, it can very well be constructed so that both sides in a trade partnership do benefit. But there members of the Trump administration who clearly want to view this in more existential terms. They're concerned the Chinese industrial policies embodied in the "Made in China 2025" plan that you refer to could end up eviscerating some parts of the U.S. economy where the U.S. does have a comparative advantage, let alone an absolute advantage. And this is where I think the ability to broker a deal really breaks down.

If the conflict between the two economies is seen as an existential one, that China's rise must mean a decline in the U.S., or that the U.S. can prosper only if China is held down. Framing it that way makes it very difficult for the Chinese to come to the table because they can accept a deal that they see as in their interests, even if they give away some things to the U.S. in the short run. But if their core views about industrial transformation, about transforming the overall nature of the economy, if those are challenged by the U.S., it gets framed in China as essentially the U.S. trying to hold down China, and that would not be acceptable. So I think the atmospherics are going to be as important as the substance here and the signs are not that encouraging as of now.

DOLLAR: And the attitudes of other countries will be quite critical as well. We just recently had that meeting, the APEC meeting in Papua New Guinea. And to me, it reflected the fact that a lot of countries really do not want to be forced to choose between China and the U.S. There are a lot of countries that share the U.S. concerns that we've discussed—market access, intellectual property rights—but they would like to see the U.S. negotiate greater openness in China so that there can be more trade and investment. If the U.S. goes down the road of trying to decouple from China, I'm skeptical that other

countries are going to follow us. Even close allies like Australia, Japan, South Korea, they're just so economically integrated with China now it's just hard to see them making a choice to isolate China.

So the risk is if we go down the decoupling road, we don't really have partners. Even our own firms are unlikely to follow us down this road. So I'm not sure the hawks have really thought through the economic costs of trying to separate. And certainly if you were going to go down that road, you would want to have a broad coalition involving Europe and Japan, Australia, et cetera. The kind of group we built together in the Trans-Pacific Partnership and in the Transatlantic Partnership, rather than going it unilaterally.

PRASAD: You're right, David, that in many countries, many of China's other trading partners, that share concerns about China's economic and trading practices, the same concerns that the U.S. has. So the U.S. could have created a common front or take on China and find a way to engage China with the world economy in a much more constructive way. Instead, the situation we have right now is because of poor strategy and poor tactics. The U.S. is now seen as an untrustworthy and unreliable ally. So the notion that just because the U.S. is the largest economy in the world and has these longstanding relationships, that everyone will line up in America's corner if the U.S. were to force other countries to choose, that could turn out to be a very mistaken assumption.

DOLLAR: Right. So we've got real issues between the U.S. and China, some potential to craft a deal to address them. But we have a lot of political issues, a lot of uncertainty, so I don't think we're going to venture any predictions about what comes out of Buenos Aires and subsequently. I guess I would end by saying that even if there is some kind of near term deal that averts the escalation of the tariffs, probably these trade issues are going to continue as a source of tension between China and the United States for the foreseeable future.

PRASAD: That prediction is certainly one I can agree with David. I'm glad we don't

have to make any others.

DOLLAR: Thanks again for being here Eswar.

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