THE BROOKINGS INSTITUTION
Dollar & Sense podcast
What have we learned from the trade war with China?
November 25, 2019

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(Music)

DOLLAR: Hi, I'm David Dollar, host of the Brookings trade podcast, "Dollar & Sense." My guest today is Eswar Prasad, a professor of Economics at Cornell University and a Brookings senior fellow. Eswar was actually the first guest on our podcast exactly a year ago. We talked about Chinese trade issues [and] U.S.-China relations. So we're going to revisit that 12 months later. So, great to have you on the show, Eswar.

PRASAD: David, it's a real honor to be back on your show, and I'm glad to see how well the podcast has been doing for the last year. So it's great to be back on after the year where some things have changed and some things haven't.

DOLLAR: Right. So it's interesting to look back. I think our discussion holds up pretty well. I encourage listeners to go back and listen to that.

But let's start with what's happening to the Chinese economy. So we've had a year of tariff escalation from both sides. Lots of other things going on. What's happening in the Chinese economy? I know you've got this nice tracking index for China and other major economies. So, what does that tell us?

PRASAD: So China is not special – if it ever was. Like the rest of the world, China does seem to be slowing down, although the economy is still growing at a fair clip. Recent indicators suggest that some of the shine is certainly coming off the Chinese growth momentum. If you look at indicators such as industrial production, fixed asset investment – which are good barometers of the Chinese economy – those are now growing at somewhere in the range of about 5 percent year on year. Retail sales, which is seen as a proxy for domestic consumption, is growing at about 7 percent a year. And all of these indicators set off a good bit relative to where they were a year ago.

So certainly the Chinese economy is slowing down. Now, what is interesting, of course, is that the Chinese government's response to the slowdown has been relatively restrained. There have been some cuts in the policy interest rate. There have been cuts in the required reserve ratio – the amount of deposits commercial banks are required to hold at the People's Bank of China, which is the central bank. There have been some tax cuts and a few other fiscal stimulus measures, but certainly the government has not ruled out the big guns. Part of the reason might be that China is actually slowing to a more sustainable growth rate of somewhere in the range of 5 to 6 percent. And some of your own analysis has shown this might be good for China in the long run if in fact growth can be somewhat more balanced rather than being driven by unsustainable levels of investment.

DOLLAR: Yes, I'm impressed that some of the technocrats seem to be quite willing to let the growth rate slowed down. Certainly to 5.5 percent. They may not happy to be happy if it goes much below that, but they seem willing to see the growth rates slow down and they haven't overreacted to their cyclical downturn.

PRASAD: The key challenge for China, of course, is whether this growth is going to be consistent with the sort of employment growth that they would like to have, and also whether there is credit going to the parts of the economy that can generate good productivity growth. So if you have decent employment growth, accompanying GDP growth in the range of five and a half to six percent, and if you have decent productivity growth to boot, then it all becomes sustainable.

The problem, however, is that a lot of the credit that is going out of the banking system once again seems to be shifting largely towards state owned enterprises rather than enterprises and the more dynamic parts of the economy, such as the service sector or the small and medium enterprises. And that poses the real concerns in terms of both employment and productivity growth. So whether the Chinese government will allow growth to slip much below five and a half percent is far from clear because that could have knock on effects on employment and productivity.

DOLLAR: So when we talked a year ago, Eswar, we discussed a lot of distortions in the Chinese economy: lack of market access, forced technology transfer, weaknesses in intellectual property rights protection...this set of structural issues. The U.S. and China have not come to any agreement yet, but China is always gradually reforming and opening up. So has there been any important policy changes over the past year?

PRASAD: So China is certainly trying, as you say, to open up and reform the economy on issues such as intellectual property rights protection. China does seem to have a better […] regime in place. And they've also talked about more effective enforcement of the provisions that are already in place.

One can see this as being spurred by the U.S. China trade war. In other words, China wants to appear that it is already dealing with concerns the U.S. has about intellectual property rights protection, perhaps in the hope of getting a better deal, but perhaps also in the hope that a better IPR regime might be good for China itself in terms of promoting domestic innovation and promoting better productivity growth within China. The key question, as always with China, is whether the de facto changes are going to match the day to day changes and there I think are some real questions.

If one looks at one other area where there were some reforms in the last few years, but they seem to have slowed down over the last year and a half, it is the financial sector and also the capital account. Now, after the pressures that emerged on the Chinese economy and specifically on the Chinese currency starting in mid-2014, for a couple of years, the Chinese government was clamping down on capital outflows and to some extent on certain types of inflows as well. It seems like they're going back to relaxing some of those capital account restriction measures, which might be a good thing for China's own financial market development and for giving its investors opportunities for portfolio diversification.

In terms of the domestic financial market, China does seem to be toying with the idea for allowing some financial firms, including some small banks, to fail as a way of generating more market discipline. There have been instances in the past few years where the Chinese government has come close to the brink in terms of allowing trust companies or banks to fail and most often they have pulled back. But now it seems they are willing to let things ride a little further in the hope that some failures will actually be good in terms of promoting a more market-based financial system.

DOLLAR: So that's a tricky balance they're trying to find there. They need to let some of these financial institutions go bankrupt. They've got bankruptcy law. They have procedures. They need to let some of that work. But I think they're worried that if there are too many bankruptcies too quickly, it's going to start causing panic. There've been some interesting stories about people lining up, bringing a run on the bank. So the story about the all the workers from the bank standing out on the street with big wads of cash to try to encourage people to think that actually the bank was solvent. So it's just a difficult thing to get rid of all this moral hazard that's built up in their system.

PRASAD: Yeah, the substance and the optics are a bit complicated because on the one hand the government does want to indicate that it does still have full control of the banking system and there is no need to panic. But on the other hand, if it continues to be interpreted by all depositors – whether they're households or big corporations or small corporations – as essentially meaning that there is still implicit 100 percent guarantees backing whatever financial assets depositors can get a hold of, that's not so good for the financial system.

So it is interesting that while on the one hand the Chinese government does seem to be trying to convey the message that all is well, even with these financial institutions that are in trouble, at the same time it is also allowing, in some instances, stories to get out, even in the Chinese media, that there are some firms that might be left to go under without creating too much of a stir among the public. Basically reassuring most depositors that they're going to get paid back, but they should watch out where they put their money.

DOLLAR: Let me turn to the issue of China's trade policy separate from this U.S.-China trade conflict. The Peterson Institute here in Washington did an interesting calculation. Before the trade war, China's average import tariff was 8 percent. What's happened since the trade war is China's tariffs vis a vis the U.S. have gone up above 20 percent. That's the Chinese retaliation in the trade war. China's tariffs to other partners have gone down – not enormous amount, but down to 6.7 on average. So it seems like China is opening up to the rest of the world. It recently concluded this RCEP agreement, the regional comprehensive economic program, with ASEAN Partners and Japan and South Korea. So is China opening up to other countries?

PRASAD: China's strategy, especially when it comes to dealing with the trade tensions with the U.S., is not just to try and mollify the U.S., but to also do an end run around the U.S. And the way it can do this is by creating trade deals with regional partners, with partners around the world, and also bilateral deals that give it better terms and hope that this will to some extent offset the pressures on the economy caused by the U.S.-China trade tensions. And it's also very important for China to be able to resist any fears that it might have [that] the U.S. could rally other trading partners who have similar concerns about China's economic and trading practices from creating a common front against China.

So I think we will see a lot more of this sort of actions. Now, of course, the concern that some countries, such as India, have is whether these partnerships might end up creating trade deals that are largely favorable to China and that are based on China's desires for trade arrangements that ultimately benefit it more than other countries.

DOLLAR: Yeah, I noticed India dropped out before this agreement was finalized. Is that the main reason why...what you were just saying? Is this a good idea for India to drop out?

PRASAD: For India, joining the trade deal would certainly have been a plus in many dimensions, but I think the government backed out at the last minute for a couple of reasons. One is that while agriculture and manufacturing goods were covered by the RCEP, services trade was covered only in very limited fashion, and services exports are quite important for India. So there was a sense among Indian government officials that this trade deal might end up becoming asymmetric where India would not get access to foreign markets for its services exports but might end up opening its markets to imports of agricultural and other consumer goods.

The other big concern for India was about whether the terms of the deal could be enforced when it came to China. China has, as part of RCEP deal, promised greater market access. But as the experience of Chinese accession to WTO has shown, what China agrees to in principle might not always be followed through in practice. So there was a real concern among Indian officials [that] the RCEP did not have enough in terms of the ability to monitor as well as enforce the commitments made by other trading partners – in this case mainly China – to stand to their commitments in terms of market access.

DOLLAR: I think this was something of a public relations victory for China. I think it was really an ASEAN-led effort in a lot of ways, but RCEP became seen as very much a Chinese-driven negotiation. So I think China gets quite a bit of soft power from bringing this about. But as you say, most trade economists find that it's a pretty shallow agreement; does not cover services, as you were saying; and [it] actually brings about rather modest tariff reductions. So China's getting a fair amount of credit when, in fact, there really doesn't seem to be that much substance to this agreement.

PRASAD: You're absolutely right, David. I think the reading that this is not going to be an economic game changer is correct. But what you referred to earlier in terms of soft power: there this does shift the balance in favor of China. It does show that China is willing to come to terms with other major trading partners, including regional powers, that find it very difficult to resist China's pull. And even countries like Japan that are seen as Asian counterweights to rising Chinese influence are part of the deal.

India is seen as another counterweight and decided to stay out of the deal, which might portend some interesting trade discussions ahead in the coming months or years within the Asian context about how dominant China is going to be and how much it can get its way with all of the other trading partners in Asia and beyond.

DOLLAR: So let's come back to the U.S.-China trade relationship. You know, as you and I discussed last year, there are a lot of distortions in China that the U.S. and other partners are unhappy about. A question I grapple with a lot is: is China really fundamentally different than other large emerging markets? So thinking about India, Brazil, South Africa, Mexico, these large emerging markets are Chinese practices in terms of market access in IPR very different or compared to, say, South Korea and Taiwan 20 years ago? Or is the issue really just that China is much bigger and more successful, but basically, it's the same set of practices we've seen before?

PRASAD: I think the way you've characterized or framed the question is quite valid. If you think about the broad group of emerging market economies and how they've approached this policy, starting with very basic elements such as infant industry production. Going back to two or three decades ago, the notion that domestic industries needed to be protected until they could stand up on their own and face export competition. How domestic industries needed to be favored, subsidized so that they could, again, mature before facing external competition.

Many emerging markets have and continue to follow this playbook. But China, of course, gets the most attention because it is a very large economic player. It's now the second largest economy in the world. [It] counts for a huge fraction of global trade. So anything that China does gets a lot more attention. And, in particular, anything that China does gets a lot more attention in Washington because of the enormous bilateral trade deficit that the U.S. runs with China. And, of course, given China's size and the fact that it is seen as not just an economical but also geopolitical rival, any issues related to China get a lot more traction. And as we've seen, this is not just an issue related to the present administration, but a bipartisan one where both parties feel that a 'going tough' approach on China is really necessary, given how China might have taken advantage of the rules of the multilateral trading system and so on to benefit its own industry and economy.

DOLLAR: I think there can't be any simple answer to the question I asked. But when I listen to these discussions in Washington, it often strikes me there are a lot of people here who characterize China as fundamentally a planned economy. Fundamentally a government-run planned economy. And I don't think any of us can disagree that they've had spectacular success. So if they're a fundamentally planned economy, then they've actually made planning work, which no one else has done before. On the other hand, if they're a mixed economy with market forces – and obviously they still have state enterprises, government intervention. If they're similar to what we've seen before in South Korea and Taiwan, well, then, frankly, we've seen this before and it's a model that actually works quite well.

PRASAD: That is an interesting question for us economists, David, and I know you've done a fair bit of work looking into this issue yourself. Whether in fact China's […] of its own type or whether ultimately this is going to be reined in by basic laws of economics. I think most of us economists, especially those of us trained in the West, would like to think that a liberal market-oriented system is going to work a lot better in the long-run. And China seems to be, in many respects, a counterexample that has worked quite well so far. I think in the broader scheme of things, the interesting question is whether China's approach to economics as well as domestic politics is one that is going to get traction in other countries in the world, especially at a time when the U.S. economic and political order does seem to be facing some quite serious challenges.

DOLLAR: Yeah, I think some of the things China has done – the some of the market access restrictions, getting foreign investors to come in on terms that are pretty favorable to China – that all required the fact that China has this enormous market that everyone's going to try to get into. I think of many other developing countries, they sound big, but everybody's small compared to China. Except potentially India, but potentially because it's still a couple of decades before India would have that kind of market power. I think if some of these other emerging markets tried to do some of the things China's doing, it would not, in fact, work very well there.

PRASAD: Yeah, that's still a big difference. You mentioned India. I mean, India's economy has been doing quite well. Indian officials have crowed about the fact that India's growth rate, at least until the last couple of quarters, seem to be even higher than China's for a brief period. But the reality is that India's economy, depending on how you measure it, is about one quarter to one fifth of China's economy. So in terms of sheer economic heft, it's very hard to match China. And what is interesting is that China has used its economic heft to a very good advantage in terms of striking deals with other countries that give China a lot of benefits and some might some might argue disproportionate benefits.

DOLLAR: So when we talked a year ago, we were somewhat pessimistic about a trade deal – a comprehensive trade deal – between the U.S. and China, and I think we've proved to be right so far. I'd like to talk about what are the prospects for a trade deal with the U.S. and China.

At this point, they seem to have broken things into a 'phase one' and then a 'phase two,' perhaps even a 'phase three' down the road, which probably makes some sense. So how do you see the prospects? Let’s start with phase one. How do you see the prospects for some kind of first phase trade agreement between China and the U.S.?

PRASAD: These days in Washington, you can't take anything for granted and things change by the week, if not by the day. A couple of weeks ago, it looked like there was a reasonable prospect for a phase one deal. What is very important for China in the phase one deal is at least a minimal rollback of already imposed tariffs. And what the Trump administration seemed to be offering was really just a suspension of the increase in tariffs that was due to take place in mid-October and a new round of tariffs that were supposed to take effect in December. Those latter two additions to the trade sanctions seem to be off the table. But whether China can give the U.S. what it is seeking in order to get what it wants, which is a rollback of some tariffs, remains to be seen.

There seem to be indications that such a rollback on both sides was in prospect, but it seems like the hardliners in the Trump administration have made it much harder to make progress on that dimension. So at the moment, it seems like even a phase one deal is hardly a certain thing. Even if you look at the key sweetener that seemed to resonate with Mr. Trump, which was the amount of agricultural purchases the Chinese were going to make, the administration clearly wants China to commit to a specific number that would become the basis for, you know, Trump declaring that he had achieved significant outcome on the trade negotiations. I think China is very reluctant to commit to a very specific number because that could end up setting a precedent for other quantitative targets.

Remember when all of this got started, what the Trump administration was pushing for was a specific commitment by China to bilateral deficit reduction. The discussion has moved from there, but I think there is a concern among Chinese officials that putting in the deal specific numbers might resurrect those sorts of arguments. So at the moment I think even a limited phase one deal is far from clear. And, of course, the question even to conclude a successful phase one deal is what sort of commitments they will have to be from both sides on what they will work on in terms of phase two. And there are many deep fundamental disagreements between the two sides on some of the issues that include what you mentioned earlier: intellectual property rights protection, market access, market opening and so on.

DOLLAR: Right. So you're right that there are some serious obstacles to a phase one deal. I'm an optimist. I'd like to think they'd probably get to this phase one because it seems pretty logical and pretty simple. Even if China doesn't commit to a specific number, I think they can agree to language that will clearly open them up to purchasing a lot more on the agricultural side compared to the last years. So I'm skeptical they're going to get much back beyond where they were. The best U.S. year, I think, was about 30 billion dollars of exports, agricultural exports, to China. Not sure we'll get much beyond that, but I think the Chinese can make some kind of commitment. I would guess the Trump administration would be willing to at least partially roll back, but the last round of tariffs was 15 percent on 110 billion. You'd think you could find some compromises once you start dividing these things up. It doesn't have to be all or nothing.

So let's assume I'm right and they reach some kind of phase one agreement in the next two months or so, let's say. It's probably not going to have a big effect on either economy, but how do you then see the prospects for a phase two?

PRASAD: So, first of all, I'm a little less optimistic than you are about phase one, David. And the question really is, even if phase one is concluded, whether that deals with the fundamental problem caused by the trade tensions, which is the amount of uncertainty that is adding to the other factors that are tamping down business investment in both countries – and specifically private business investment in the case of China. So it would take a fairly significant phase two deal where there are commitments from both sides that are seen not just as comprehensive, but also durable. And I think right now the concern among the Chinese is that if they make a significant amount of concessions, you could still end up with an agreement that is nearly signed, but then the ever-mercurial Mr. Trump changes his mind at the last minute leaving the deal unfinished.

Even in terms of phase one, I think there are some clear wins, as you pointed out, that are relatively easy. You know, China buying more U.S. goods, the two sides agreeing that China should keep its currency's value somewhat stable. On phase two China could, as it has already indicated it is doing, agree to more market opening; a better intellectual property rights protection regime; better enforcement. But I think this issue of enforcement of the overall trade agreement; whether that is going to be symmetric or asymmetric; what the provisions are for one country to retaliate against the other if, in fact the provisions of the deal are violated; those have been sticking points. And I think those are going to remain sticking points. But a successful phase two deal, I think, would cover not just the substantive issues, but also the questions of monitoring and enforcement, which I think are really important.

DOLLAR: Right. And then the last thing I would just bring in is U.S. politics. Probably a deal, any comprehensive deal, is probably going to have to reflect compromise. And from political point of view, maybe in the president's interest not to have an obvious compromise, but instead to leave a certain amount of tariffs in place so that he's got a tough policy toward China [and] doesn't have to defend a deal which inevitably is not going to be perfect.

PRASAD: That's right. And a tough policy against China plays well, not only in Washington, but in the heartland. As you probably saw, just a few days ago the U.S. China Economic and Security Review Commission, which is a bipartisan commission where the chairperson is actually someone appointed by Nancy Pelosi, came out with recommendations that suggest taking a very hard line against China on issues related to intellectual property rights, investment in the U.S., how the U.S. should deal with Chinese technology giants, and so on. So given that the elections season is looming, given the bipartisan support for staying tough on China, it's hard to see why Trump would have an incentive to strike a very broad deal with China.

DOLLAR: I'm David Dollar and I'm talking to Eswar Prasad. We've updated our discussion from a year ago. Certainly some things have changed in the Chinese economy and seems a positive that the technocrats there are accepting a slowdown without panic. On the other hand, we haven't really made any progress in the U.S.-China trade negotiations and even a phase two certainly is not guaranteed. And then the more complicated issues that would be taken up in a phase two really seem quite daunting. So we're left in this very uncertain world where it's hard to know what the economic relation between the U.S. and China will be. So thank you very much, Eswar.

PRASAD: Thank you, David. It's been a real pleasure. And I wish your podcast the very best. It's already had a wonderfully successful year, and I hope that continues. Thank you.

DOLLAR: Thank you all for listening. We'll be releasing new episodes of Dollar & Sense every other week, so if you haven't already, make sure you subscribe on Apple Podcasts or wherever else you get your podcasts and stay tuned.

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