The US-China Trade Conflict—What To Expect In The Near-Term

- **The US and China may reach a basic agreement regarding their trade relationship in the near future—possibly even this week—yet any deal details would likely be scarce.**

- **Both countries have strong incentives to prevent further escalation of the trade conflict, though trade tensions will likely remain in place for the foreseeable future.**

Market attention is currently centered on the meeting between US President Donald Trump and Chinese President Xi Jinping on December 1, which follows the conclusion of the G20 Leaders' Summit in Buenos Aires, Argentina. The trade dispute between the US and China has started to generate adverse economic consequences in both countries and we assess that both parties involved have a high incentive to prevent the conflict from escalating further. By now, tariffs have been implemented on around USD 360 bn of bilateral trade, covering 55% of the flow of goods (2017 values) between the two countries; chart 1 depicts the evolution of the trade dispute to date.

We are cautiously optimistic that China and the US will soon reach a basic high-level agreement—potentially even at the end of this week—that would stabilize the trade conflict at the current juncture. Nevertheless, prior to achieving such an outcome, trade-related protectionist rhetoric from the US administration will likely be rather aggressive, in line with President Trump's proven negotiating style. Such an approach has already been evident this week with President Trump threatening to proceed with further import tariffs on Chinese goods. Nevertheless, should an agreement be reached, it would likely include very few details, leaving room for continued trade-related uncertainties over the coming months.

We expect China to provide the US with a few tactical concessions, allowing President Trump to claim a victorious turn in the bilateral relationship. During negotiations for the United States-Mexico-Canada Agreement (USMCA) and the US-Korea Free Trade Agreement (KORUS FTA), relatively small revisions—that followed strong US rhetoric against the agreements—were sufficient to alter the Trump administration's positioning toward the deals; we expect to see a similar development with the US–China trade conflict.

From China's point of view, the trade dispute is putting the economy under downward pressure, encouraging the Chinese administration to push for a near-term resolution. Moreover, offering the US some concessions, such as a promise to reform its intellectual property rights framework or to ease access for foreign firms, should not be a deal-breaker; in fact, we believe that such reforms are necessary irrespective of pressure from the US if China wants to successfully advance its official industrial strategy and become a global technology powerhouse by 2025.

Assessing the situation from the US viewpoint, we highlight that stabilizing the trade relationship is also important for the US economy; otherwise, tariff rates are

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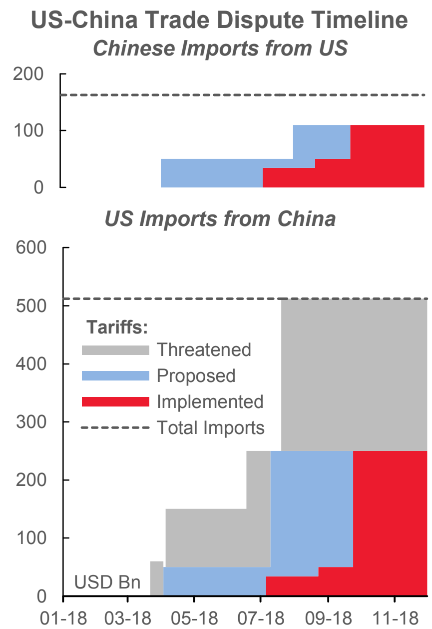
Chart 1



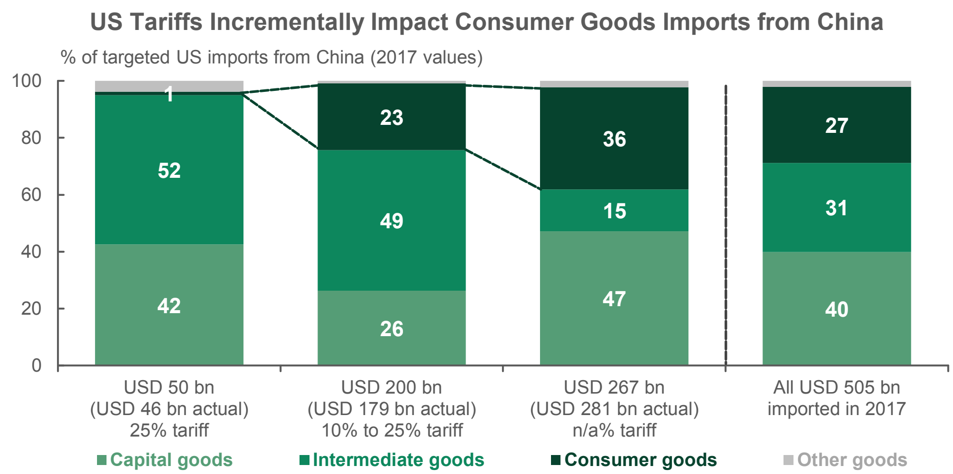
Sources: Scotiabank Economics, PIIE.

scheduled to rise in January 2019 from 10% to 25% on USD 200 bn of imports from China. Almost one quarter of these imports consists of consumer goods (chart 2); with retailers' profit margins under pressure, firms would likely be forced to pass the higher duties onto consumer prices. A sharp rise in consumer goods prices would be a notable hit to US disposable incomes, a development that would not be in line with the Trump administration's plan for maintaining its support base as the 2020 presidential election approaches.

US consumer prices have so far in the trade dispute been fairly sheltered, as the country's administration has implemented levies mostly on capital and intermediate goods. Moreover, the Chinese yuan's significant depreciation (of almost 10%) against the US dollar since last April has helped offset some of the tariff-driven price pressures on imported Chinese goods. Nevertheless, a similar respite could not be expected should the trade conflict escalate; we assess that it is highly unlikely that the Chinese administration would allow the yuan to depreciate further 15% (or more) against the US dollar, given that it would be increasingly destabilizing for the Chinese financial system.

We assess that both the US's and Chinese incentives are in line with stabilizing the trade conflict relatively soon. Nevertheless, our expectations for the depth of any agreement are not very high. Moreover, we do not anticipate the trade dispute to fade away all together but simply preserve the status quo for the time being. Given that the US trade deficit is only getting bigger—reflecting strong demand in the US on the back of the solid economy and fiscal stimulus—trade aggressions will likely remain in the US administration's policy tool kit in the foreseeable future with any of the US's trading partners at risk of being targeted.

Chart 2



Sources: Scotiabank Economics, US ITC, International Trade Centre, USTR.