RIETI Research Institute of Economy, Trade and Industry

China in Transition

U.S.-China Trade Friction Casting a Shadow over the Chinese Economy—Impact on the supply side becoming a matter of concern

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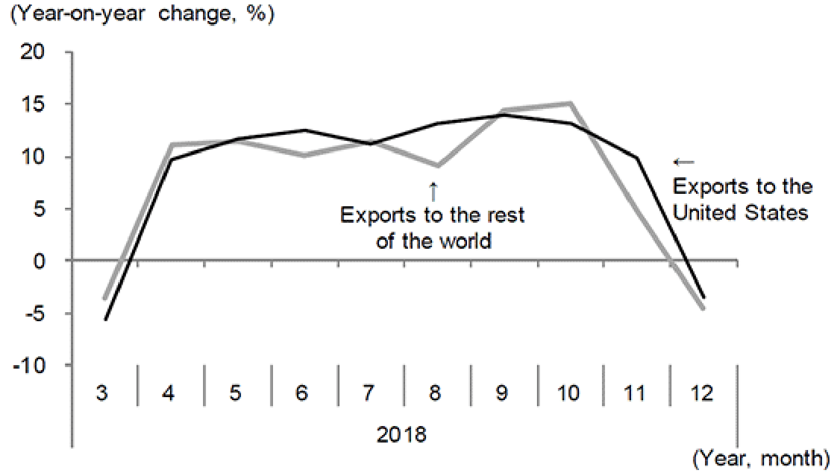
U.S.-China trade friction, which has developed into a trade war, is casting a shadow over the Chinese economy. How the trade friction will play out will be the key to the future course of the Chinese economy.

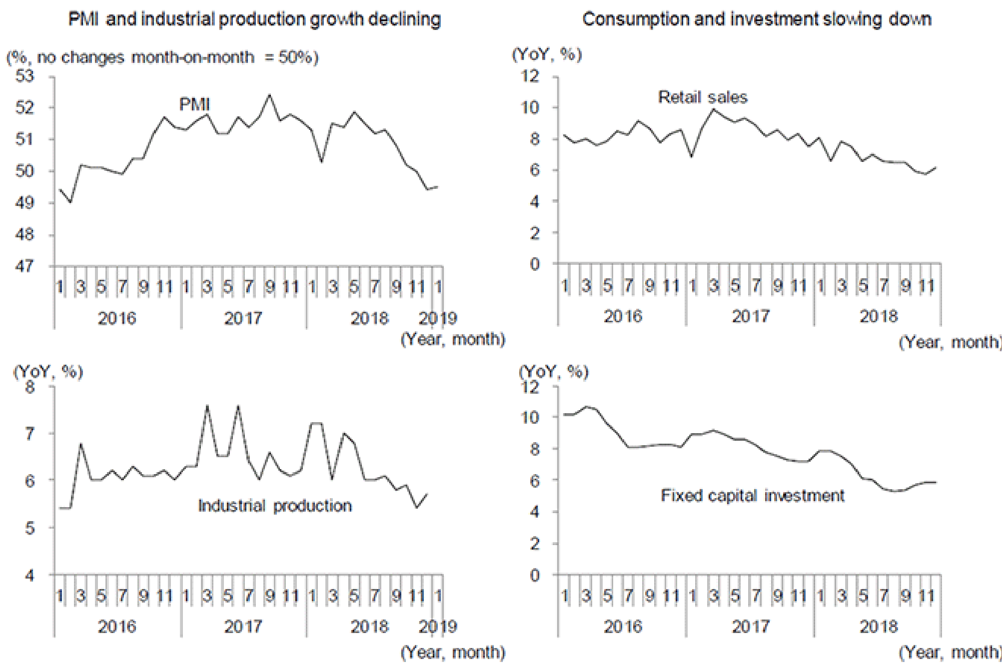
The announcement in March 2018 of the sanctions against China based on Section 301 of the U.S. Trade Act acted as a catalyst for the escalation of U.S.-China trade friction. As is symbolized by the tit-for-tat tariff hikes implemented by the two countries, the trade friction has developed into a trade war. In response, China's exports to the United States, and by extension, its overall exports, which had remained robust until October, supported by last-minute demand ahead of the imposition of additional tariffs, have slowed down sharply since November (Figure 1). In addition, since the second half of 2018, declines in the major economic indicators, including the Purchasing Managers' Index (PMI) and the growth rates (year-on-year changes) of industrial production, retail sales and fixed asset investment, have also becoming clear (Figure 2). Reflecting this situation, China's annual economic growth rate in 2018 fell to 6.6%, the lowest level since 1990 (3.9%). (The economic growth rate in the fourth quarter of 2018 was 6.4%, the same as that in the first quarter of 2009, when the Chinese economy was impacted by the Lehman crisis).

Figure 1. China's exports to the United States and the world
－Clear indication of a fallback in demand after the last-minute upsurge－



Source: Compiled by the author based on data provided by the General Administration of Customs of China.

Figure 2. Clear Signs of Slowing Economic Growth in China



[Click to enlarge]

Note 1: Cumulative from the beginning of each year for fixed capital investment. Figures for January each year are not available for fixed capital investment and industrial production, and the cumulative figures for January-February are used for these two months.

Note 2: Retail sales measured in real terms using CPI as the deflator.

Source: Compiled by the author based on the CEIC database (Original data from the National Bureau of Statistics of China).

In the current U.S.-China trade war, at first, China took the tough stance of trying to "stop the war with war," but it has turned conciliatory toward the United States as the extent of the damage done by the trade war to the Chinese economy has become conspicuous. A Chinese white paper titled "The Facts and China's Position on China-US Trade Friction," released by the

State Council on September 24, 2018, indicated that China will implement, as national policies, most of the measures demanded by the United States, such as promoting sound development of the U.S.-China trade relationship, strengthening the protection of intellectual property rights, respecting foreign companies' legitimate interests in China, and deepening reform and widening opening-up.

As a major step toward reconciliation, at a summit meeting between Chinese President Xi Jinping and U.S. President Donald Trump on December 1, 2018, the United States gave China a 90-day reprieve (until March 1, 2019) from additional import tariffs and the two leaders agreed to immediately start negotiations. At a cabinet-level consultation meeting held in Washington on January 30-31, 2019, as part of the negotiations, the two countries discussed such issues as the protection of intellectual property rights, China's practice of forcing U.S. companies to transfer technology to Chinese partners, subsidies for state-owned enterprises, cyber theft targeting U.S. companies, and foreign exchange policy, in addition to the reduction of tariffs and opening of the market.

How the Chinese economy will perform in 2019 depends on whether an agreement on ending the trade war can be reached by the deadline. Let us consider two scenarios—one with an agreement reached by the deadline and the other with no agreement reached by then. First, in either scenario, Chinese exports to the United States will decline in the first half of 2019 as demand falls back in reaction to the last-minute upsurge before tariff imposition. If an agreement is reached by the deadline, the economic growth rate will bottom out in the second quarter and will increase in the second half of 2019 in line with recovery in exports, consumption and investment. In this optimistic scenario, the economic growth rate in 2019 will decline slightly from 6.6% in 2018. However, in the pessimistic scenario, in which an agreement will not be reached by the deadline and the tit-for-tat tariff exchange will escalate, the Chinese economy will slow down further, with the annual economic growth rate possibly falling below 6%.

In the short term, the U.S.-China trade friction is dampening the Chinese economy, mainly through a decline in demand. Over the medium to long term, the trade row could depress China's potential economic growth rate through supply-side factors. First, in order to avoid additional costs associated with U.S. tariff hikes against Chinese products, some industries will relocate business operations out of China to Southeast Asia and other regions. Moreover, the United States is strengthening restrictions on acquisitions of U.S. high-tech companies by Chinese companies. This, combined with strengthened capital control in China, has led to a steep decline in Chinese direct investments in the United States, from 46 billion dollars in 2016 to 29 billion dollars in 2017 and to 4.8 billion dollars in 2018 (Thilo Hanemann, Cassie Gao, and Adam Lysenko, "Net Negative: Chinese Investment in the US in 2018," Rhodium Group, January 13, 2019), making it more and more difficult for China to acquire technologies from the United States.

For China, which is catching up with the industrial countries from behind, importing technology from abroad has been one major factor contributing to its high economic growth. If China can no longer make the best use of this advantage of being a latecomer to raise productivity as a result of its trade war with the United States, its potential economic growth rate may decline. In response, China should devote more effort not only to indigenous innovation but also to industrial upgrading and the reform of state-owned enterprises.

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