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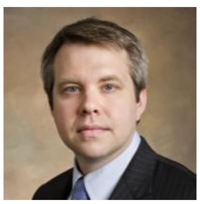

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# PRAGMATISM LIKELY TO PREVAIL IN U.S.-CHINA TRADE SPAT

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**KEY POINTS**

- U.S.-China trade tensions increased after the Trump administration announced plans to impose tariffs on a reported USD $50 billion to USD $60 billion of Chinese imports at the end of March.
- In response, China announced potential retaliatory tariffs on up to USD $3 billion of U.S. imports, triggering another round of tit-for-tat tariffs unveiled by both sides in the following days.
- Despite the escalating confrontation, we believe that the risk of a full-blown U.S.-China trade war is remote.
- The following piece outlines what's at stake in the dispute, potential outcomes, and why technology transfer could be the source of continued conflict.

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## U.S. NEGOTIATORS SEEK A PATH TO RESOLUTION

Imposing tariffs on China fulfills a campaign promise for President Trump, who has long criticized China for its trade imbalance with the U.S. Beneath the headline-grabbing tariffs, however, it's important to keep in mind that the U.S. and China are working behind the scenes and looking for ways to resolve their trade differences.

Trump administration officials have reached out to their Chinese counterparts and made specific proposals in several areas. These include lower tariffs on U.S. car imports, increased Chinese purchases of U.S. semiconductors, and a commitment from China to open up its financial services industry. Other possible asks include a reduction in the U.S. trade deficit with China, remedies for technology transfers, and greater market access for foreign companies in some industries.

Contrary to the hard-line stance suggested in recent headlines, a number of the U.S. demands relate to areas that China had already planned to open up or signaled its willingness to negotiate. Moreover, the U.S. has given China space to negotiate via a 30-day public comment period that can be extended.

## Beneath the headline-grabbing tariffs, however, the U.S. and China are working behind the scenes and looking for ways to resolve their trade differences.

### CHINA SIGNALS WILLINGNESS TO CONSIDER SPECIFICS OF U.S. DEMANDS

Until recently, Beijing's mantra has been to respond to provocations from the Trump administration in a proportional and calibrated way. This means not taking the bait in press announcements, but rather considering the core content of U.S. proposals to see what they can quietly accommodate.

Two retaliatory measures at Beijing's disposal—namely, selling some of its vast holdings of U.S. Treasuries and devaluing the yuan to make Chinese exports more competitive—aren't likely to materialize, in our view. Both measures risk widening the conflict with the U.S. and would have negative second-round effects on China. Moreover, they would contravene Beijing's efforts to appear as the more responsible party in the dispute, an image it is trying to cultivate as China seeks to increase its global influence.

### TARIFFS UNLIKELY TO DENT CHINA'S ECONOMY

Imposing 25% tariffs on USD $50 billion of goods comes to USD $12.5 billion—a fraction of China's USD $12.2 trillion gross domestic product. However, the uncertainty resulting from possible tariffs and its impact on investment decision-making may prove to be more harmful over time, though the long-term impact is hard to quantify. We estimate the impact of the tariffs will likely fall well short of the headline USD $50 billion. However, its impact will depend on how consumers and producers respond to changing relative prices and to what extent substitutes are available.

Ultimately, U.S. consumers, Chinese producers, and upstream suppliers will bear the costs of the tariffs; how much each side pays will vary by industry. For example, Chinese producers could pass on the full costs to U.S. consumers, a likely scenario if few substitutes are readily available. Alternatively, Chinese producers could opt to absorb all the cost increases in an effort to keep market share.

### TECHNOLOGY TRANSFER MAY POSE A GREATER OBSTACLE FOR NEGOTIATORS

Technology transfers from U.S. to Chinese companies and other controversial business practices are under renewed scrutiny in light of Beijing's "Made in China 2025" program. Under this initiative, China's government plans to heavily subsidize 10 high-tech industries to promote home-grown companies, which has drawn criticism from U.S. and European officials for giving Chinese firms an unfair advantage.

Targeted industries in China's 2025 program include microchips, robotics, aerospace equipment, and electric cars. We believe that the potential issues arising from China's subsidies in these areas could be a source of ongoing tensions with the U.S., particularly if China were to create overcapacity in semiconductors, an industry deemed critical to the U.S. economy and security. Going forward, we may well see an outcome where tariffs appear relatively measured compared with possibly greater restrictions on technology and Chinese investment in the U.S.

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