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US-China trade war increases systemic economic risks, but China more vulnerable than US

The escalating trade dispute between the US and China will have a disproportionately severe impact on the Chinese economy though it raises risks for the global economy. The dispute comes at a time of a slowing Chinese economy and financial stress.

Scope Ratings says that the trade protection measures introduced by the governments in Washington and Beijing are crimping global economic activity. The new tariffs apply to goods making up a growing portion of global trade. The United States (AA/Stable) and China (A+/Negative) accounted for 24% and 16% of the global economy in 2018 in addition to 19% and 27% of global growth that year, so further escalation in the Sino-American trade war poses systemic implications for the global economy and financial markets.

In its 2019 Sovereign Outlook, Scope forecasted a slowdown in global growth this year to 3.0-3.5%, from 3.6% in 2018.

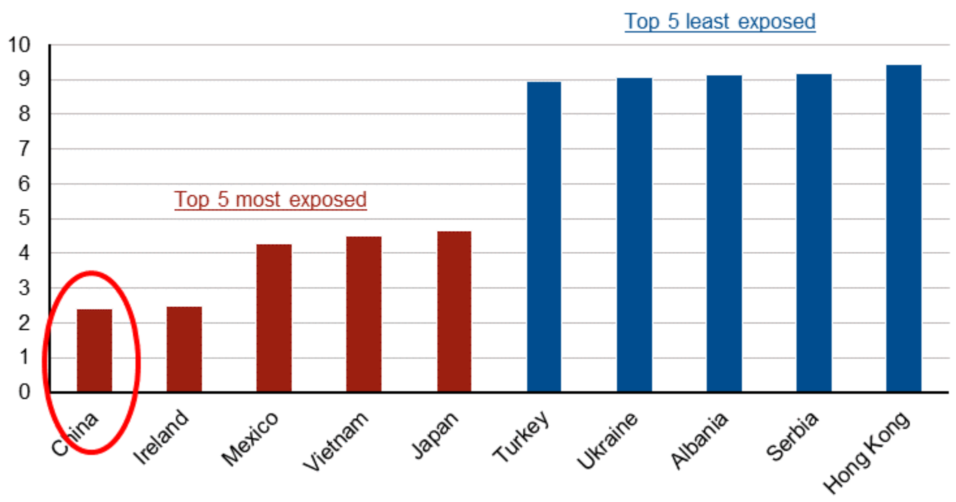
US businesses and consumers ultimately pay a share of the price for higher tariffs on Chinese goods, which is why the implications of the reescalation of trade disputes are certainly not insignificant for the US economy. Scope expects US growth to slow to around 2% in 2019.

However, from an economic point of view, China nonetheless holds the weaker hand in trade negotiations.

The US can simply add extra tariffs to more Chinese exports to the US than China can to American imports in view of a record Chinese goods *surplus* of USD 419n with the US in 2018 in addition to China's comparative economic vulnerabilities, given the current economic slowdown and structural economic transition.

Conversely, from a political vantage point, the costs and benefits are unclear, and depend on the timeframe in question. The US administration has more at stake in the short term ahead of presidential elections in 2020, but it is also with an eye on the elections that President Donald Trump is ready to escalate trade conflicts given they play well with his political base (even if such protectionist policies are divisive within the Republican Party).

Figure 1: Trade war exposure (scores): top 5 most exposed and top 5 least exposed to US-centred trade conflicts (excludes the US itself from rankings)



Source: Kameryan, Levon and Dennis Shen. "Scope External Vulnerability and Resilience Grid, and Trade War Exposure Rankings", 13 December 2018 (Scope Ratings GmbH).

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Last Friday, the US administration announced tariff increases to 25% from 10% on a sizeable USD 200bn in Chinese imports, after 10% tariffs were put in place on the same goods last September. Negotiations have run into trouble in recent weeks over how and when to lift existing US tariffs in response to Chinese measures aimed at addressing US complaints. On Tuesday, the US administration detailed plans for tariffs of up to 25% on the remaining approximately USD 300bn of Chinese goods exports to the United States. For its part, China has retaliated, with counter-tariffs of 5%-25% on about USD 60bn of imports from the US, taking effect on 1 June.

US President Donald Trump and Chinese President Xi Jinping are expected to meet at the G-20 summit in Japan on 28-29 June to attempt to reach a compromise. The global economic implications of the trade disagreements could be exacerbated were the US administration to announce tariffs on European automobiles and auto parts, a move that could trigger EUR 20bn in EU retaliatory trade barriers.

In December 2018, Scope ranked China (see **Figure 1**, previous page) as the country most exposed to US-centred trade conflicts, followed by Ireland and Mexico.

While China does have alternate levers in the trade disagreement, such as devaluing the renminbi in a so-called "currency war", it is restricted in using such instruments to a much greater extent in view of existing depreciation pressures on the yuan (-2.6% since mid-April; currently 6.9 to the dollar), and the associated risks to external and financial sector stability. Tools to cushion the blow for exporters – such as tax rebates – face eventual limitations owing to a wide fiscal deficit – projected at 6.1% of GDP in 2019 by the IMF, from 4.8% in 2018 and just 0.9% as of 2014. In addition, the oft-cited leverage that China has as the US's largest foreign creditor (the United States owes China USD 1.1trn as of February 2019) is less of a bargaining tool than supposed. While selling US Treasury holdings could send US borrowing rates somewhat higher, falling US bond prices would lower the value of China's remaining Treasury bonds.

As such, it remains in both sides' interests to reach an agreement – even if a temporary one. How and when such an agreement is found may depend, however, on the extent of weakness in US financial markets, in the US economy in response to trade uncertainties, and in public opinion, given the US President's attention on markets and the economy ahead of presidential elections next year.

In the year to April 2019, China's total trade surplus declined USD 32bn compared with the year to April 2018. However, China's trade surplus with the United States *grew* over the same period USD 40bn, even as tariffs were put in place on Chinese goods, as China's exports to the US grew but imports from the US contracted.

Despite significant talk of the United States cutting its trade deficit with China as the ultimate objective, China's trade surplus with the US is now larger, even if this has come in significant part owing to Chinese economic softness. Moreover, China's export of goods & services now accounts for *just* 19.5% of GDP as of 2018, down from 36% in 2006. As such, while China certainly remains exposed to US protectionist policies, one could argue that it's comparatively less exposed than it might have been in years past.

Ahead of its credit rating agency peers, Scope revised the Outlook on China's A+ ratings to Negative on 21 September to reflect significant public-sector deficits and a growing public-sector debt stock, and high levels of total non-financial sector debt. Non-financial sector debt on the basis of Bank for International Settlements data stood at 253% of GDP in Q3 2018, near double the 142% of GDP as of Q4 2008.

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