The US-China Trade Clash: Two Views

By Simon Lester

US President Donald Trump is leading his country into a trade quagmire. The intensification of skepticism and hostility towards China and recent aggressive actions will be difficult to undo or pull back from.

By Aidan Yao & Shirley Shen

While a positive development, the prospect of trade talks restarting between the US and China is unlikely to lead to a major breakthrough. US President Donald Trump seems set on a collision course with Beijing before the US midterm elections in November.
The Debate: Yao & Shen

This Dispute Could Hit Global Supply Chains

By Aidan Yao & Shirley Shen

The prospect of trade talks restarting between the US and China has brought a sigh of relief to markets that have been agitated by the escalation of trade tensions. While a positive development, we doubt if the meeting will lead to a major breakthrough, given the structural differences underpinning the trade dispute and the political motives that will likely keep US President Donald Trump on a collision course with Beijing before the US midterm elections in November.

We have two research notes published this month examining how the trade war may impact the two key players: the US and China. However, as we explained in the second note, the impact would not be confined on a bilateral basis, as a significant portion of Chinese products hit by the US tariffs are not manufactured entirely in China. Our data show that processing and assembling exports make up over 40 percent of export values, despite the fact that the ratio has been declining over the past decade (see Figure 1). For products such as electronics, over 40 percent of export values are still created by China’s supply-chain partners. Our analysis in Figure 2 shows that of the top four categories of goods (see Figure 3), between 23 percent and 43 percent of export values can be traced to foreign producers. Figure 4 provides an illustration of how the global supply chain functions in the production of electronic goods that meet the final demand in the US. It shows that China, Mexico and Canada are important “carriers” of export values for upstream producers, such as Japan, South Korea, Taiwan, Germany and even the US itself.

This supply-chain connection means that the shock from the China-US trade war will be contagious for many countries that co-produce with China. As China’s exports to the US decline, its imports of components and inputs from supply-chain partners will also decrease, spreading the negative shock across the global production process. Figure 5 provides an illustration of which countries are reliant on China’s role as the “factory of the world,” and how big their exposures are to the products that will be hit by the US tariffs. Japan, South Korea and Taiwan are large producers of value carried by China’s exports (mainly electronics) to the US. The second block of Figure 5 presents these exposures as percentages of their nominal gross domestic product (GDP). It shows that Singapore, Taiwan, Japan, Malaysia, South Korea and Vietnam all have more than 1 percent of their GDP exposed to the potential shock from the China-US trade war. Under the assumption of 25 percent tariffs on $250 billion of Chinese exports, we estimate the direct (albeit partial, as we consider only the top four categories of goods) impact on these countries will be between 0.02 percent and 0.64 percent of GDP, with Asian countries bearing the brunt of the shock (see Figure 6 overleaf). As for China, this burden-sharing will reduce the hit for its own economy, which we estimate to be worth 0.2 percent.
China, Mexico and Canada are important ‘carriers’ of export values for upstream producers, such as Japan, South Korea, Taiwan, Germany and even the US itself. This supply-chain connection means that the shock from the China-US trade war will be contagious for many countries that co-produce with China.

But not all is bad news. For China’s competitors in the US market, many of whom are also China’s supply-chain partners for different products, there are potential gains if they pick up the market share that China leaves behind. Figure 7 shows the top foreign suppliers of the tariff-hit goods to the US market. To estimate their potential gains from the market-share redistribution after China’s exit, we present two scenarios: 1) the entire market share left by China is re-allocated proportionally to non-US producers; and 2) only half of the market share is redistributed among foreign producers, with the other half picked up by US domestic firms. Assumption 2 is underscored by Figure 8, which shows that the import penetration of the tariff-hit sectors in the US ranges from 20 percent to 60 percent, meaning that the US products are not completely uncompetitive. Figure 9 illustrates the long-term gains for some of China’s top competitors, while Figure 10 combines them with the short-term knock-on effects, showing that Mexico and Canada are net beneficiaries of China’s loss, while most Asian countries are (net) casualties of the trade war.

A few caveats in conclusion. First, the export value-added data is from the OECD, with the latest update being 2011. We have to estimate the 2017 numbers based on some assumptions, which we think are logical, but may not match the reality. Second, we assume the negative tariff shocks will be directly passed onto China’s supply-chain partners, assuming unitary price elasticity of demand (e.g., quantity and price adjust proportionally). We also make no consideration for any behavior changes of producers due to exchange rate variations. Finally, even though Figure 10 puts the positive and negative impacts side by side, it is worth noting that the negative shocks will likely hit much faster than any potential gains are realized. For many countries, the latter is only possible after a significant expansion of their existing production capacity, which may take time and is subject to uncertainty.

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