China’s options and potential impact on the GCC region

Highlights

- The US-China trade dispute shows no sign of abating soon, with both sides threatening to take additional retaliatory measures that could lead to an all-out trade war.
- China’s large trade surplus with the US limits its ability to reciprocate only by raising tariffs, pushing it to consider other available alternatives, although none of them is ideal.
- It is likely that in time China and the US would make some mild concessions sufficient enough to reach a deal, so both sides can claim “victory”.
- In case of a protracted trade dispute or a full-blown trade war, Gulf countries could be affected mainly through a possible decline in the oil price, but with abundant financial resources the impact should be easily contained.

Trade tensions that started early in the year as mere threats and skirmishes have intensified of late, turning into what could become an all-out trade war. Such a war will have a negative impact not only on the countries directly concerned but will most likely engulf much of the world. Global growth will slow and the economic recovery that the world had been anxiously waiting for since the onset of the financial crisis of 2008 could be derailed.

The situation so far

By way of background, President Trump announced in March a 25 percent tariff on steel imports and a 10 percent tariff on aluminum imports from China, Europe, Canada and others. The response of the affected countries was initially measured in an attempt to leave room for negotiations. Shortly after, an agreement was reached with the Europeans to postpone the tariffs for two months in the hope of reaching a deal. The deal did not come through and the tariffs entered into effect in June.

The US started a second round of tariffs in July by slapping a 25 percent tariff on $34 billion worth of Chinese goods and was followed recently by tariffs on $16 billion. President Trump threatened to impose more tariffs if China reciprocates. China did reciprocate and the US is now considering slapping a 25 percent tariff (instead of a 10 percent initially suggested) on $200 billion worth of Chinese goods that could become effective this fall. A two-day talks in Washington in late August between the US and China failed to make any breakthrough.

President Trump had indicated earlier that he would be willing to consider tariffs on all Chinese imports amounting to more than $500 billion. He also had threatened to impose a 25 percent tariff on imported vehicles justifying it on national security grounds. This would affect almost $50bn of European exports. More recently, however, a ceasefire was declared between the US and the EU. The two sides agreed to freeze any additional tariffs and to start negotiations aiming at reducing trade barriers between the two blocks.

The US-EU agreement did not set a time schedule for these negotiations. The truce may have led some to believe that a transatlantic trade agreement is easy to reach but according to several statements, it seems the agreement meant different things to different people. While the US declared victory even on agricultural goods, for the Europeans, agriculture is off the table. The French are adamantly against discussing it. So it is not clear how long the talks will take, what issues will be covered, and whether or not they will succeed. If other trade agreements are any indication, reaching a deal, even if possible, will take a long time.

The “low road” to protectionism

Bilateral negotiations and deals are not the best way to address global trade problems. They can fix some but will certainly create others and more so with other countries. As Mr. Carney, the Governor of the Bank of England has put it, there is a “low road” to protectionism focused on bilateral negotiations and a “high road” of liberalization of global trade; the low road will cost jobs, growth and stability while the high road could support growth and more inclusive globalization. It appears that we are traveling the low road unless disputes are resolved at the multilateral level and preferably in the context of existing trade dispute mechanisms—such as the one in the World Trade Organization—in ways that strengthen the international trading system and the global economy.

Protectionist measures cannot address trade concerns but will
definitely harm growth. Besides the adverse impact on sectors and regions in the countries involved, a trade war will create a lot of uncertainties, heighten the level of risks, weaken confidence and put on hold new investments. While the initial impact of tariffs may be small, the knock-on effects on global financial markets and supply chains could be much larger.

**What are China’s options?**

China has number of options to deal with the escalating trade dispute with the US.

**Option 1—Reciprocating on tariffs**

The first option would be for China to reciprocate and to adopt a tit-for-tat approach with the US. Indeed, China just announced its intention to put tariffs on $60 billion of American imports. This shows the imbalance between the two countries. It has been argued, and rightly so, that China would run out of goods or services to levy tariffs on since it imports from the US much less than it exports (more than $500 billion versus $125 billion). In other words, China cannot reciprocate on tariffs one for one but will need to consider other measures.

**Option 2—Using taxes and exchange rate instruments**

The second option that could be considered in conjunction with reciprocal tariffs is to adopt non-tariff measures against the US. These could possibly include imposing additional taxes or fees on US companies working in China, and orchestrating a devaluation of the renminbi in a way to compensate, at least partially, for the increase in the cost of exports to the US. But both of these measures have their drawbacks.

First, a devaluation of the currency if targeted at the US alone will further complicate any possible negotiations in the future. If it is generalized, China’s other trade partners will be affected leading possibly to currency wars that will ultimately come back to haunt China. Chinese officials have recently reiterated that currency manipulation will not be used to promote exports in an apparent response to Mr. Trump’s accusations. The renminbi has already depreciated by some 7 percent against the dollar since May, which is not sufficient to compensate for a 25 percent tariff but will cushion the impact. It was estimated (by former IMF Chief Economist Olivier Blanchard) that China will need to depreciate its currency by more than 12 percent to fully offset the impact of the 25 percent tariff.

Second, a fall in the value of the renminbi would lead to higher inflation that would trigger subsequently restrictive fiscal and monetary policy with a negative impact on growth—which has already come down from its highs a few years back. Third, a sharp depreciation could increase the external debt burden (with total debt estimated at $750 billion) affecting consumption and growth. And fourth, a toorapid slide could affect confidence and lead to capital outflows—something that China witnessed in 2015—forcing it to use its reserves to reverse the trend.

As for imposing taxes and fees on US firms, this measure will harm foreign direct investment as these companies may leave the country, adding to the already existing complaints of foreign investors who are not treated on an equal footing. This will certainly dissuade other potential entrants from coming to China since these taxes cannot single out American companies.

**Option 3—Pursuing trade arrangements with other countries**

The third option is for China to pursue trade agreements with other countries similar to the one recently agreed between the EU and Japan. Working with other Asian partners connected by supply chains on trade arrangements either collectively or individually could help. A push to impose wage and price controls to manage costs (still possible in China), possibly in collaboration with other Asian countries, could partly offset the increase in the export cost. An agreement that includes Japan will have more weight but given the current diplomatic rift between the two countries this may not be possible. In any case, any trade agreements need a synchronization of interests, and will take hard work and a long time to achieve, if at all.

**Option 4—Opening up new markets**

The fourth option is for China to pursue vigorously other markets through different initiatives such as the One Belt One Road Initiative. But the economic benefits would take a long time to materialize, and hence this cannot be an appropriate response. Besides, these markets do not come even close to replacing the huge American market.

**Option 5—Avoiding retaliation altogether**

Finally, China could decide to avoid any retaliatory measures in the belief that the US imposed tariffs are not sustainable and will eventually damage the US economy. Producers in some sectors have already started to feel the impact, putting pressure on the administration to change its stand. But the full impact will take more time to show up. The US administration has recently approved $12 billion to farmers who are affected by tariffs. The US can afford to provide such help given the good standing of the American economy, a standing that may have influenced the timing of waging the trade war. But if this continues, pouring more money on all the sectors that are hit by higher tariffs will be very costly to the US if tariffs escalate or the economy slows down. Already there are domestic concerns about the administration’s trade policy.

China could take a strategic decision not to respond if it considers that American threats are not credible, given the domestic backlash against trade restrictions. In game theory, the response of each player in a sequential game depends very much on whether the other player’s strategy is credible. A strategy is not credible if it hurts its initiator when implemented. In the context of the current trade disputes, tariffs will hurt both countries and the question becomes who is going to blink first.

The decision of not taking any actions could have some advantages for China. A decline in the demand for Chinese goods
through imports could lead to some depreciation that would partly offset the increase in export costs with the US and at the same time enhance competitiveness with other countries without resorting to deliberate currency manipulation. This could also push China to boost domestic demand to drive growth—something that many countries including the US had been asking China to do to reduce its current account surplus and the accumulation of foreign reserves through structural reforms that would lower savings and support consumption.

**Although options are limited, a deal is still possible**

In all cases, China’s options seem to be limited in scope especially if other bilateral trade agreements succeed. Both sides would need to make some concessions to reach a deal. China may have to consider giving in on some issues (intellectual property rights and increasing imports from the US for example) and the US may need to soften its stand and reduce its demands knowing that China cannot possibly meet all of them. This way, both sides could claim “victory”. In any case, China will not likely, under any circumstances reverse the opening-up-to-the-world path that it had embarked upon four decades ago and become again inward looking. But this would be unthinkable. For the opening-up policy has served it very well and transformed it from one of the poorest countries to the second largest economy in the world and in the process has lifted some 800 million people out of poverty.

If a deal is not agreed, the world could be facing two possible bad outcomes: intense and protracted trade tensions, or a full-blown trade war that would not end until countries involved realize that self-inflicted damage cannot be sustained any longer. In both cases, there will be implications for all other countries including those that are not directly involved including Gulf countries.

**The impact of a protracted trade war on the Gulf region**

How would the Gulf region be affected by a possible trade war or prolonged trade disputes? In principle, the trade war has no immediate effect on the region, which is not directly involved or implicated in the current trade rows. The Gulf is basically an importing region with large trade deficits outside oil. So there are no reasons for other countries to impose tariffs on its exports and definitely the region does not have any interest in imposing tariffs on its imports. But there will be some indirect second-round effects on the region through a few channels.

First, when global growth gets hit, the demand for oil decreases and so does the price. Moreover, China and other Asian countries linked to it though supply chains are major oil importers and are expected to be affected the most by a trade war, putting further downward pressure on oil prices. The impact on oil prices will be more pronounced if oil supply increases in the coming period due to OPEC’s decision to increase output in conjunction with an expected substantial increase in US oil production. In case OPEC and Russia agree as they did in 2016 to rebalance the oil market by restricting supply, then this may create some problems with the US. Second, the increase in tariffs will raise prices in most trading partners especially in the US. While the impact of tariffs on prices in the US has so far been muted, it will certainly accelerate in time. Take the case of steel and aluminum. Steel enters the production of many goods such as cars, trucks, appliances, among others. So does aluminum, which is an input in many products from transportation to packaging. When duties are levied on other imports, the impact on prices will be much higher. Given that Gulf countries import most of their goods and their currencies are pegged to the dollar, inflation will pass through. This will necessitate a more restrictive set of policies, with an adverse impact on growth.

Third, and relatedly, if inflation in the US picks up on account of higher tariffs, the Fed will need to raise the policy rate at a faster pace. To keep the peg to the dollar in the absence of any capital controls or restrictions, Gulf countries would need to raise their interest rates at least in tandem with the US.

Fourth, the world is currently witnessing capital outflows from emerging markets to mature markets, mainly the US due to higher interest rates and the strong dollar but also because of the uncertainty and risks triggered by trade disputes. Although the Gulf has not been affected as much, some have already experienced capital outflows. In addition, the expected inflows of capital into the region as a result of the inclusion in emerging markets indices i.e. FTSE and MSCI, may be moderated by these uncertainties triggered by trade tensions. The GCC countries may then need to raise their interest rates faster than the US rates to attract capital with adverse effects on investment, growth, and unemployment.

In conclusion, current developments point to continued deterioration in trade tensions between the US and China. China has a number of options to consider, but none of them seem to be very appealing. One possible resolution to this impasse is for China is to make some concessions that are not too harmful and for the US to soften some of its demands so a deal could be reached where both sides get out of the crisis “victorious”. If the trade dispute drags on for a long time, the Gulf region will be affected through the second-round effects stemming from a potential drop in the oil price and by the need to raise interest rates faster than expected if inflation in the US starts to pick up, pushing the Fed to adopt a more restrictive monetary policy. But given their financial resources the region can weather these effects with minimum damage.