

## The China-US trade war: The long and short of it



Only a focus on longer-term structural issues, not a short-term mercantilist approach, can shape the China-US economic relationship to the benefit of both the countries, says **DILIP PARAMESWARAN\***

TRADE DISPUTES BETWEEN China and the US have contributed to a volatile start to the year for global markets, and investors continue to worry about a further escalation in the tension.

To make sense of this trade war and to understand its future evolution, it is important to separate the mercantilist from the structural views. The mercantilist view focuses on the trade deficit, analyses the reasons for it and proposes solutions accordingly. The structural view tries to understand the forces behind the evolution of trade between the two countries and examines the longer-term factors that are likely to shape it in order to find solutions.

The mercantilist complaints essentially arise from the large trade deficit that the US has built up against China over the years. President Trump often takes a mercantilist stance when he complains that China (and other trading partners, including Canada, Mexico and the EU) has taken unfair advantage of the US in trading.

A frequent mercantilist complaint is that China has manipulated its currency to gain a competitive advantage in trade. While China maintained a fixed exchange rate from 1995 to 2005 (five years before and after its entry into WTO), it then allowed its currency to appreciate by 27% over the next eight years. More recently, China has struggled to keep the renminbi from sinking, and even the Trump administration has refrained from labelling it a currency manipulator.

The other causes cited by the mercantilists for the trade imbalance include China's reluctance to open many sectors of its economy to imports and foreign investment, and the support extended to several industries through state-directed lending policies and a low cost of financing.

In fact, one of the key reasons for China's trade surplus is the massive pool of low-cost labour that could be moved to the urbanised coastal regions to support a huge build-up of manufacturing facilities, lifting over 500 million people from poverty in the process. The mercantilist complaint also ignores the fact that western consumers have benefited from lower inflation and higher consumption in the process. While it is true that American workers have suffered from Chinese competition in some industries, we must also remember that the overall unemployment rate in the US is now close to historical lows.

Some of the solutions that result from a mercantilist analysis are purely short-term and unsustainable. For example, last year China promised to purchase more agricultural products from the US in order to level the trade balance, but such a rebalancing does nothing to alter the longer-term direction of the two economies and the trade between them.

Even if tariffs succeed in reducing the trade deficit with China, inherent differences in cost mean that other low-cost countries will be ready to take its place, simply shifting the trade balance from one country to another.

TO UNDERSTAND THE longer-term trajectory, we must instead turn our attention to structural issues. At a fundamental level, China is itself at a critical juncture as it faces rising costs, an aging population and the need to rebalance its economy towards domestic consumption. As a result, it is doubtful if it can rely on exports to the same extent in the next 10 to 20 years as it has done in the past.

As the Chinese economy matures further, it is only natural that it would want to focus on services, higher-value exports and domestic consumption as drivers of growth. After all, how long can it keep manufacturing cheap plastic products for the world? The government's "Made in China 2025" plan is just a reflection of this desire to shift to higher-value and more advanced products.

It is in this quest for greater value addition that China is running up against US concerns related to intellectual property. The US has argued that China seeks to obtain technology and intellectual property by unfair means, including forced technology transfers to Chinese partners, making technology sharing a precondition for market access and even outright theft of technology.

While the US (and other western countries) cannot expect China to give up on its longer-term goals, China must also recognise that it needs to form fair partnerships with the western countries in order to transform its economy further. One of the key elements of the longer-term solution will be to understand that a more prosperous China would offer an attractive market for western products and technologies.

As the negotiations proceed, the US and other western countries should lay greater stress on appropriate institutional mechanisms for an orderly sharing of technologies and benefits.

The two points of view, mercantilist and structural, are not necessarily exclusive. For example, mechanisms to ensure access to Chinese markets for western companies would also help rebalance trade over time. But drawing a clear distinction between the mercantilist and structural views makes it clear that tariffs are not a long-term solution.

The future of the China-US economic relationship depends on how successfully such structural issues are resolved in the longer term, and not on how quickly trade can be rebalanced in the short term.

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