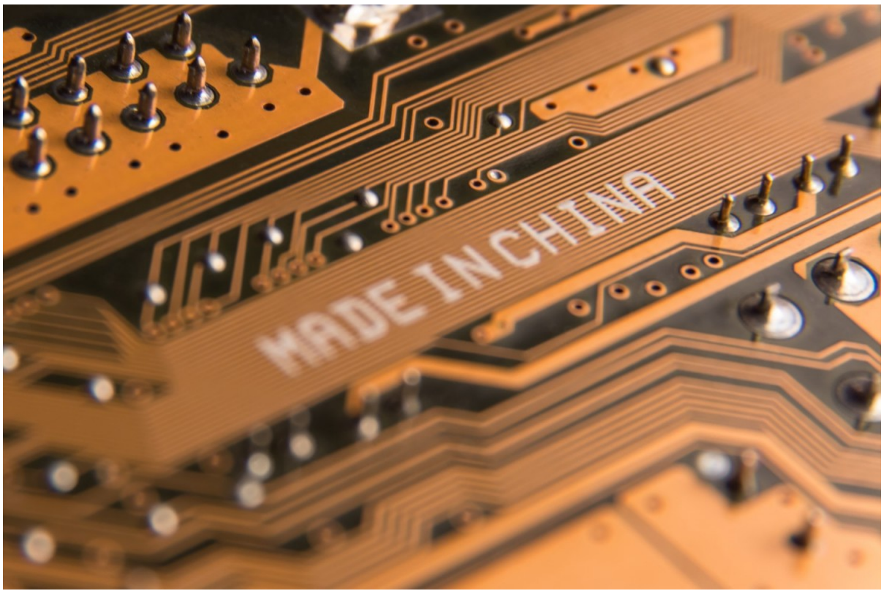
China's response to US tech war could be aggressive

Japan and Europe seem to be standing with the US to prevent the rise of Chinese technology. But China could retaliate in ways that could prove very damaging



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US adds allies to curb China's tech rise

The United States seems to have persuaded Japan and some European countries not to use Chinese technology products or sell tech to Chinese companies. This is reflected in the asset market, where sentiment towards the Chinese tech industry is negative.

The purpose of these actions is to prevent China from becoming a world tech giant in the short term, but China isn't wholly unprepared for this.

China's long-term plan to deal with tech warfare

1. It's clear that China will attempt to minimise its reliance on foreign countries to provide critical hardware and software. Facing severe headwinds from the US, China will aim to develop as many technologies as possible domestically. And with more resources being

ploughed into the sector, it's possible that China's technology will become more advanced than that of the US and its allies in the future, especially in 5G and the military.
2. China is also expected to explore the "Belt and Road" market to export its 5G infrastructure technology and related equipment. In the short term, these markets may not be able to replace the markets of Western economies, but they may become fairly large, and China has a first-mover advantage to open them up.

It is more difficult to end a technology war than a bilateral trade war. Technology warfare involves companies from more countries, each with unique technology. This makes the process a long and difficult one for China, which is why President Xi called it the "Long March".

China's short term reaction could be aggressive

The Chinese government may be patient during this "Long March" but only up to a point. Eventually, it could react more aggressively to stop the US from piling pressure on Chinese companies. Here are the possible responses from China:

1. An export ban on rare earth elements to the US. During 2014-2017, the US received 80% of its rare earth imports from China. Rare earth metals and alloys are used in many electronic goods and parts and a ban would slow down US manufacturing activities, which the current US administration wants to promote. An export ban could be temporary in order to give the US the option to return to the negotiating table.
2. China holds fewer US Treasuries. A recent fall in US Treasury holdings is likely the result of a decline in China's FX reserves, rather than a direct response to the trade war. China can only buy more US Treasuries if its foreign reserves rise again when the trade war tension eases.
3. Additional tax cuts. The Chinese government has already announced extra tax cuts for integrated circuit design and software development companies from 25% to 0% for the first two years and thereafter 12.5% for three years. These tax cuts are on top of the value-added tax cuts. We see this as a short-term solution for the "Long March" plan.

The yuan is not a weapon in the short or long term

1. An exporter losing export orders because of higher tariffs, or because there are too few business opportunities in the US and elsewhere, wouldn't benefit from a depreciation of the yuan.
2. If the USD/CNY depreciates to cross the key 7.0 mark, it could create disruption in the A-share stock market, as USD/CNY and the A-share market move together. The experience of 2015, which saw a sharp depreciation of the yuan and a collapse of the A-share market will be avoided by the central bank.
3. Allowing the yuan to cross 7.0 could also give the US an excuse to label China as a currency manipulator, though the chance is small as China's current account is almost balanced (1.05% of GDP), which does not fulfil one of the currency manipulator requirements of having a large currency account surplus.
4. Over the past four days (from 20 May to 23 May), the fixing of USD/CNY has barely changed (around 6.8990). This signals that the People's Bank of China has tried to stabilise the onshore yuan via the daily fixing. And the Chinese government is going to raise more yuan funds from offshore markets, which is a support for the offshore yuan exchange rate.

Impact on GDP

It is still too soon to estimate the damage that a technology war could inflict on China's GDP, as this is still at an early stage.

But we believe that the Chinese government will keep using fiscal stimulus and liquidity easing measures to offset any negative impacts. So keeping GDP growth at or above 6.0% in 2019 should not be an issue unless there are fewer supportive measures than we have expected.