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US-China trade after four years of America First

The fraying US-China trade relationship hit trade flows hard, and the new pattern of world trade is here to stay. While we don't expect the US election to lower trade barriers and rather expect trade tensions to continue, the US and China will continue to be important trade partners

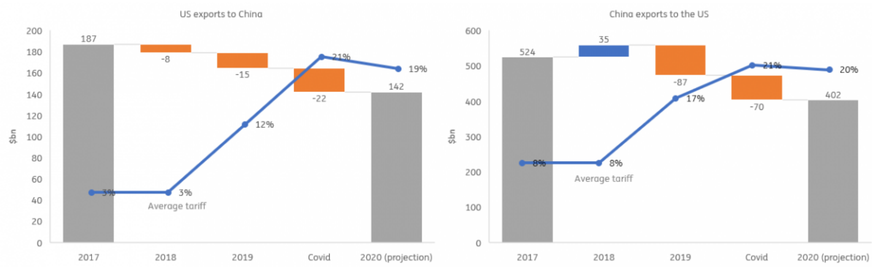
President Trump and China's Premier Xi Jinping at the G20 summit in 2019

Trade flows are down

Tariff increases in 2018-19 have had clear effects on trade in goods between the US and China. Before the pandemic, US imports from China had fallen 12% from their 2017 level. China imports from the US also fell significantly in 2019, as it increased tariffs in retaliation against the US.

US exports to China are on track to fall a further 12% in 2020, with the effects of Covid-19 overwhelming China's promise to increase imports from the US in the March 2020 'phase one' deal.

Trade fell as tariffs increased

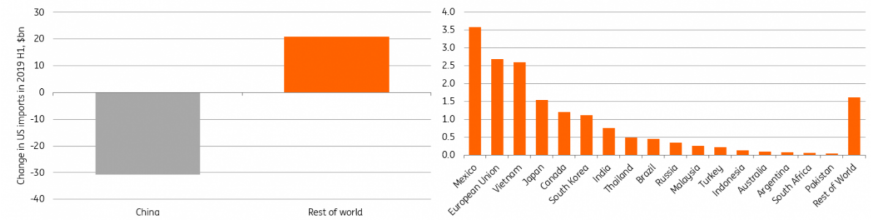


Source: US Bureau of Economic Analysis, Peterson Institute of International Economics, ING

As a result of the tariffs, the US is importing less from China and more from the rest of the world. Major US trade partners Mexico and the European Union increased their shares of US imports, filling the gap left by China. Other Asian countries have become competitive, such as Vietnam and Thailand.

The increases appear to be genuine trade diversion, rather than China's exports being re-routed through other countries to avoid the tariffs. Vietnam's imports from China increased 7% in 2019, but foreign direct investment in greenfield sites in Vietnam (building new facilities) for factory relocations showed it is also increasing its own production capacity to serve the US market.

The US is importing more from other countries, but less overall



Source: UNCTAD

Even trading at 2019 levels, the US remained China's most important export market. For the US, China is fourth after Mexico, Canada and the EU. But overall, as a result of the tariffs, there is less international trade, hitting producers and consumers as well as the shipping, logistics and communications industries.

Those trade flows are likely to stay well down

Trade policy uncertainty has given way to larger concerns in 2020, but the US elections could bring them back – if President Trump is re-elected, new tariff increases (and new trade wars) are likely. In a Biden presidency, uncertainty may be lower, but Biden's tough stance on China is likely to involve keeping the trade war tariffs in place. Non-tariff barriers may also increase, such as limiting foreign procurement and subsidising US industry.

The World Trade Organisation's recent ruling against the US steel and aluminium tariffs raises the question of whether these tariffs, but also the trade war tariffs, could be removed by international trade law taking its course. However, with the US appealing the decision and no functioning WTO appellate body to take action, firms could be waiting a long time for a WTO rescue.

While the trade war tariffs remain in place, they represent a permanent shock to trade costs, which will continue to weigh on trade volumes even once the recovery from Covid-19 is underway. The accumulation of tariffs along supply chains makes US and China exports more expensive abroad, reducing their trade with other countries, as well as each other.

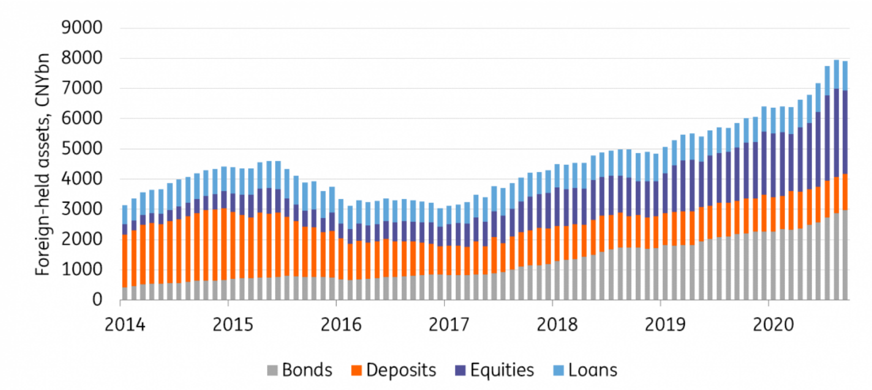
Still connected, for now

Policy interventions have made trade and investment flows between the US and China more costly and more difficult. But there are reasons to expect US-China trade to remain significant.

US imports from China are mainly manufactured goods in relatively complex supply chains. This adds some inertia into firms' responses to higher tariffs, given the costs involved in finding new suppliers. In practice, China's central position within global manufacturing supply chains makes it unlikely to be supplanted as a major supplier to the US of electronics and other manufactured goods.

The US and China were the world's top destinations for foreign direct investment in 2019, with the US sending the most greenfield investment to China of any country. Foreign holdings of stocks and bonds in China continued to increase into 2020, suggesting that firms are sanguine, for now, about the wider effects of the economies' fraying trade relationship even with current tariff levels.

Foreign investment has continued to flow into China



Source: Macrobond

Of course, investment has not escaped trade-war damage, both from the uncertainty created during 2018-19 and from policy interventions which have increasingly blocked Chinese investment into the US. While policy continues to aim to control and limit connections between the two economies, it will erode the basis of future trade flows between the US and China.