The US-China Trade Conflict Escalates—How Will China Cope?

- **Responding to the US's second phase of tariffs on Chinese imports, China has confirmed its intention to retaliate, paving the way for potential further escalation of the trade conflict.**
- **In the absence of further escalation, the trade conflict's impact on China's net exports will likely remain reasonably small; we see bigger downward pressure on real GDP growth stemming from weaker confidence and lower business investment growth.**
- **We expect looser fiscal and monetary policies and targeted export sector support measures to alleviate some of the economic pain imposed by the tariffs.**
- **We expect China's real GDP growth to decelerate from 6.7% y/y in mid-2018 to 6.0% by the end of 2019; we estimate that roughly half of the slowdown is attributable to the trade conflict.**

THE US AND CHINA TAKE THE TRADE CONFLICT TO A NEW LEVEL

The trade dispute between the US and China escalated notably following the Trump administration's announcement on September 17 that the US would impose tariffs on USD 200 bn worth of Chinese imports, effective on September 24. The tariff rate will initially be 10% and is scheduled to rise to 25% on January 1, 2019. Prior to this announcement, 25% tariffs had already been applied on USD 50 bn worth of Chinese imports, an action that was subsequently matched by China.

On September 18, China responded to the US announcement by reaffirming its intention to retaliate; it will impose tariffs ranging between 5% and 10% (down from the initial plan of 5% to 25%) on USD 60 bn worth of shipments from the US—also effective on September 24—taking the total tariff coverage to USD 110 bn worth of US imports. This time around China was not able to retaliate in kind given that its imports from the US, totalling around USD 155 bn in 2017, are significantly smaller than the US's purchases of Chinese merchandise. Nevertheless, with its centrally-planned economy, China has options to retaliate further in other ways, including via SOE guidelines for doing business with US companies, additional direct regulations for American firms operating in China, and limiting Chinese tourism into the US. The US has room for a third phase of tariffs, given that it imported over USD 505 bn worth of Chinese goods last year. Indeed, the White House warned against counter-tariffs, stating that "if China takes retaliatory action against our farmers or other industries, we will immediately pursue phase three, which is tariffs on approximately $267 billion of additional imports". We assess that pursuing the third phase would result in severely disruptive consequences to both economies; accordingly, we continue to monitor the risk of a further escalation very carefully.

THE IMPACT ON THE CHINESE ECONOMY

The conflict will adversely impact both the US and China through weaker trade, lower business investment growth, and diminished disposable incomes due to higher prices. The impact will be felt throughout the world

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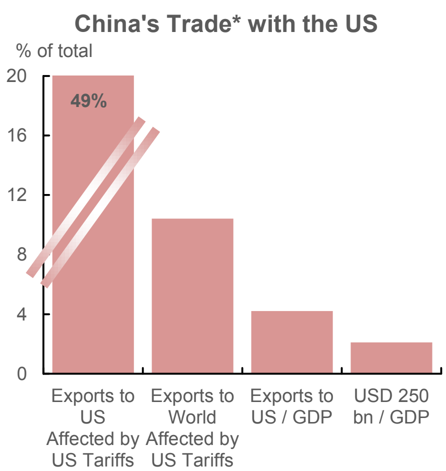
Chart 1



*2017 data. Sources: Scotiabank Economics, IMF.

economy through integrated global supply chains and sentiment spillovers. Indeed, we highlight that there are no winners in a trade war. In the following we focus on assessing how the trade dispute will impact the Chinese economy.

For a while now, we have highlighted that an escalation in the trade dispute is the largest downside risk to China's economic outlook; the risk has now become reality and the Chinese economy will be under downward pressure over the coming quarters. We expect most of the headwinds to be felt in 2019, with China's real GDP growth likely to decelerate from 6.7% y/y in mid-2018 to 6.0% by the end of 2019. We estimate that around 0.4 percentage points of the slowdown is attributable to the trade conflict. While we have long anticipated a gradual easing in China's output growth, we highlight that the drivers behind such deceleration have recently changed. Instead of an organic loss of momentum due to the economy's structural changes and authorities' deleveraging efforts, the growth slowdown is now driven by trade conflict-related issues as deleveraging efforts are set to become less stringent.

The US is China's main export destination, purchasing around 20% of all Chinese shipments abroad. Following the escalation of the conflict, around half of Chinese shipments to the US will face tariffs; the targeted USD 250 bn worth of Chinese exports to the US represent 10% of China's global shipments (chart 1). Against this backdrop, **Chinese exporters may face lower demand for their products in the US if tariffs result in higher prices or if the US is able to find substitutes for Chinese goods.** However, given that USD 250 worth of Chinese exports are equivalent to "only" 2% of China's GDP, **we assess that even a significant drop in the US demand for Chinese goods could be compensated by more proactive fiscal and monetary policies.** We also highlight that **the US dollar has appreciated by around 9% vis-à-vis the Chinese yuan since April 1, which should help offset some of the upward price pressure on Chinese goods in the US**. Moreover, the Chinese government has expanded its export tax rebate program to alleviate the pain felt by the country's exporters and instructed trading companies to actively seek alternative markets for their products.

The Chinese economy has gone through a marked change in recent years, with output growth nowadays relying mostly on domestic consumption instead of the external sector. In fact, net exports were a drag on growth in the first half of 2018. With China's retaliatory action, imports from the US will also trend lower; therefore, we assess that **the direct impact from net trade on China's real GDP growth will be relatively small**. **Our main area of concern is the trade conflict's effect on Chinese business sentiment; deteriorating confidence can delay business investment decisions and alter hiring intentions, leading to broader downward pressure on domestic demand**. Moreover, if the conflict continues for an extended period of time, there is a risk that China's investment prospects deteriorate more dramatically as manufacturers may start shifting production facilities elsewhere, such as into neighbouring Vietnam.

In terms of the expected impact on Chinese consumer spending, we point out that—due to the government's control over media—consumers' discontent does not spread as easily in China as it does in the US. Therefore, **the impact on Chinese consumer confidence and household spending will likely be relatively limited**. Only if we saw significant job losses in the affected manufacturing sector, would consumer spending prospects soften more notably. While we continue to monitor such trends very closely, we consider that prospects for the Chinese consumer remain solid for the time being; the median real disposable income per capita increased by 8.4% y/y in the first half of 2018, accelerating from the 2017 pace of 7.3% y/y. In addition, **the Chinese government's retaliatory tariffs have been planned in such a way that they minimize the impact on the consumer**.

In the current uncertain environment, the Chinese government has two somewhat contrasting policy objectives that seem to be dominating: 1) supporting economic growth as trade tensions weigh on the outlook, and 2) containing financial risks and imbalances in the economy by deleveraging, which is a prerequisite for further economic liberalization. The first objective seems to be becoming increasingly important; **China has announced that it will take a more flexible approach to fiscal policy** (e.g. tax cuts, infrastructure spending, support for private investment in transport, gas, and telecommunications) in order to offset the adverse economic impact. In addition, **monetary policy is set to remain accommodative to support the economy**. The People's Bank of China will continue to provide the financial system with ample liquidity, ensuring that sectors with favourable growth prospects will continue to have access to funding. In addition, further reductions in the reserve requirement ratios can be expected over the coming quarters.

We expect the US–China trade conflict to remain in place for a while, past the US midterm elections in November and potentially well into 2019. Given that the White House has not articulated a clear objective that China would need to accomplish to resolve the situation, achieving an early end to the tensions seems unlikely. While we continue to monitor the potential for further escalation, we assess that policymakers on both sides will have a strong incentive for solving the trade dispute through dialogue once the adverse impact on the economy has become more evident.