

The Dangerous Myth The U.S. Is Winning The Trade War With China



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EDITOR'S PICK

56,088 views | August 4, 2018 @ 10:33 PM



There's been a spate of high-profile press headlines and news stories pointing to seeming evidence that the U.S. is winning the trade war with China. Two examples on the economic side suffice: "China Loses Status as World's Second-Largest Stock Market Amid Trade War with U.S.," which focused on the fall of the total value of Chinese equity shares being traded compared to those on Japan's stock market, and "The Chinese Economy Starts to Feel Impact of U.S. Tariffs," which, in part, pointed to slowing growth of China's economy.

In the political realm there was this: "As China's Woes Mount, Xi Jinping Faces Rare Rebuke at Home," which reported on an unprecedented strikingly transparent paper published by the noted Chinese constitutional scholar, Xu Zhangrun of Tsinghua University, openly expressing his concerns about the "totalitarian" tendencies of Chinese leader Xi Jinping.

As any decent economist will tell you, it's critical to distinguish between correlation and causation. Much of the current news stories on the impact on China of its trade war with the U.S. score a very low grade in this regard.

China has registered tremendous rates of GDP growth for years, which do reflect genuine economic successes spurred on by truly innovative reforms—although even these data are taken with large grains of salt by any serious observer of China in light of the questionable precision of the government's official statistics.

But there's a dirty little secret: deep-seated economic troubles have abounded within China for some time, indeed for decades—or at least they were evident as far back as the early 1990s, when I began working there.

Those problems, about which I have written in this [space](#) a number of times, unmistakably stem from the contradiction inherent in the country's self-titled "socialist market economy" program. How do you spell "oxymoron?" China has been on a quest to have its cake and eat it too. The pressure engendered by these opposing forces has been building up over time. Given the sheer scale of China, which after all is the most populated country on the planet, it should be no surprise that the Chinese have had a long run of it. But time is beginning to run out. Something will have to give.

Ultimately, however, an economy increasingly reliant on mammoth state-owned enterprises (SOEs) that have always hemorrhaged losses—only to be band-aided up by four equally large state-owned banks (SOBs) pretending to lend money to the SOEs while the SOEs make believe to pay back the loans—will seize up. The rub is that the SOEs and SOBs constitute the Communist Party's *raison d'être*.

Throw on top of that a Potemkin private sector, which some well-respected China analysts a few years ago thought was on a sustainable growth path and potentially could overtake the SOEs' role in the Chinese economy. But they were confused by *cyclical* aberrations to a cemented *secular* trend of SOE dominance (a bit of irrational exuberance); ill-defined and unenforceable property rights, which have propagated strong incentives for corruption; and a tragic social policy that limited—at an arbitrary level—the number of children a couple could produce, which, after decades of enforcement, has created a tightening demographic noose on a young, vibrant workforce to provide for an aging population.

Has the trade war ratcheted up anxiety within China? Of course. But there was a lot underway even before the trade war began in earnest, not only economically but also on the political side.

Many Chinese I know will say privately they are deeply worried about [Xi Jinping's power-grab](#). Not only did he deliberately stock the highest levels of the Party leadership with comrades who have no substantial independent power-base or public charisma, and thus might qualify as an heir apparent, but he also strong-armed his colleagues to alter the constitution to essentially remove term limits for the top Party position, thus paving the way—at least for now—for Xi to retain his authority as long as he likes.

The political fomentation these developments have produced among the population has little if anything to do with U.S. trade policy or Donald Trump. Without question, Professor Xu's public stand is very bold, but he is hardly alone in his views. How Xi responds to Xu will be critically important in assessing China's political path going forward.

In this vein, it would not be too Machiavellian for Xi, who desperately wants to maintain, indeed fortify, the lifeblood of the SOEs, to actually grab hold of the trade war with the U.S. as the narrative behind the economy's growth slowdown. The bully Donald Trump is just the scapegoat Xi and the Party need now. Indeed, Trump's actions provide Xi with even greater cover to pump more money into the SOE-SOB shell game.

Xi's pet project—the [Belt Road Initiative \(BRI\)](#)—can be seen as another version of the same ruse. BRI is the opportunity for China to seemingly support altruistically the economic development of its backyard (and way beyond) and at the same time export the huge excess capacity of the SOEs.

Meanwhile, the naïve Trump trade team is becoming a bit giddy about seemingly making inroads into the belly of the China trade beast. The team is wrong on three counts.

First, and what should be the most obvious, is that this White House is underestimating the determination, the conviction and, most importantly, the temperament—at least for now—of the Chinese. The Chinese are nothing if they are not a patient bunch. To say that all of their initiatives throughout their history have been methodically designed for the long-haul would be a paramount understatement. I know this will come as a shock, but this is different from many other parts of the world, where short-termism and instant gratification are a way of life. Recognize the U.S. or its current President here?

Second, and which is becoming clearer each day to the U.S. population, is that Trump's war machine is exacting a far greater toll on the U.S. than on China. It's well known that tariffs hurt U.S. consumers both because the imported goods they buy become more expensive, but also because in U.S. markets that aren't fully competitive, domestic firms producing similar products to what are otherwise imported get shielded and are allowed to charge U.S. consumers higher prices. Needless to say, that's the meaning of "protection" behind an activist tariff policy.

At the same time, tariffs inflict pain on firms located in the U.S. that use Chinese imports as inputs in their production process to make finalized products for sale. For them, the issue is how much of those increased input costs can they absorb before they're forced to raise prices on the finished products to maintain profitability. The result can be lost sales otherwise made domestically.

Or, if these U.S. firms *export* those final products to third countries, there will likely be a reduction in U.S. export revenues. Of course, that will increase the U.S. trade deficit. That's precisely the opposite of the ultimate goal with which the Trump team is singularly obsessed. It's a fetish that no economist worth his or her own salt would have.

But there's an even more perverse effect: a significant amount of U.S. imports from China are produced by U.S. firms with operations *within* China. Those U.S. firms will be negatively impacted just the same as if they were actually Chinese firms shipping those imports to the U.S. Guess what will likely happen? Those China-located factories of U.S. firms will redirect their *sales* of exports from China away from the U.S. towards consumers in other markets—markets that are, by definition, not subject to the U.S. tariffs imposed on China.

If the imposition of U.S. tariffs on such exports from China become long-lasting or highly elevated, it could well create an incentive for those firms to shift *production* from China to other markets in Asia, [especially to countries in the ASEAN](#), where labor costs are far lower than in the U.S. If the Trump trade team believes its tariffs on China will result in U.S. firms shifting their production from China to the US, they are sadly mistaken.

In contrast to Washington's shoot-oneself-in-the-foot strategy towards China, Beijing's tariffs on U.S. imports inflict far less pain on Chinese firms and consumers. Why? It's simple: there's an asymmetry of import patterns between the two countries. Whereas China is one of the top three sources of U.S. imports, which were valued at around US\$550 billion in 2017, the most significant importers to China are Korea, Japan and the E.U. In 2017, Chinese imports from the U.S. were only about US\$135 billion.

As Trump gets wind of the complaints from U.S. consumers, workers and business owners that the costs they're enduring at home from his China war campaign are becoming large, he's doubling down on his bet that the U.S. population is willing to put up with short term pain for long term gain. If the design and execution of his trade strategy were actually geared to deliver on that paradigm, he might have a chance. But it is not. Here's why this is a fatal error: The Trump guys are fighting the wrong battle with China and using the wrong weapons.

In a very real sense the White House is living mistakenly as if it is caught up in a battle strategy dilemma best coined by former U.S. Secretary of Defense Donald Rumsfeld, who quipped during the Iraq war that "you go to war with the army you have, not the army you might want or wish to have at a later time." It is just the opposite for Trump. He doesn't avail himself of the use of the appropriate arms to deal with China—weapons that are effective and fully available.

The real battleground is not the pricing by China of its exports to the U.S.—in particular Washington’s belief that the Chinese are setting their prices too low. If only price-setting was truly an economically meaningful, indeed even feasible, exercise for China to pull off! If it was, then the imposition of a tariff—which after all is nothing but a tax added to a price—might be a potent weapon to bring about intended results. In fact, if anything, Trump’s war is actually helping to drive down the value of the RMB relative to the U.S. dollar, which amounts to an across-the-board decrease in the price of *all* of China’s exports to the U.S.

Rather, for the U.S.—as well as for the rest of the world—the strategic challenge with respect to China is that it is not a bona fide market economy and thus prices do not hold the import in conveying value as they do in most other economies. China’s prices are not freely set by supply and demand; yet it is equally fanciful to think that in such a complex economy, all prices are administered. In such a situation, Trump’s tariffs largely amount to a hindrance for Beijing. Think of them as white noise. The Chinese believe correctly that for them, Washington’s tariffs are a side-show. Frankly there’s a bit of chuckling about it in Beijing—at least for now. Even worse for the U.S., as noted earlier, the tariffs are just the type of medicine Xi actually would have loved to ask his doctor to prescribe for him to provide camouflage to further prop up the SOEs and SOBs.

So, what we have really going on now is the proverbial picture of two men fighting, with the larger man outstretching his far longer arm pushing back at the forehead of his smaller opponent, who is swinging wildly his short arms trying to land a punch but is simply unable to reach and make contact.

How could contact be made? It would if the U.S. stopped fiddling around with tariffs and with this two-man, that is, *bilateral*, fight and went for the jugular: The White House should enlist a *multilateral coalition* of the most powerful members of the WTO and formally find China in fundamental violation of its 2001 agreement acceding to the WTO and require it to renegotiate its terms of accession, as I’ve argued earlier in this [space](#). Many WTO countries have been subjected to the same problems emanating from Beijing as the U.S. in varying degrees. The case for the “logic of collective action” couldn’t be more compelling.

It is regrettable, that despite implementing some ingenious policies—in fact, utilizing a genuinely innovative process of reform experimentation from which the U.S. and many other countries can greatly learn—China simply has not fully lived up to its numerous legal commitments agreed to in writing 17 years ago to enact and execute the detailed reforms that would transform its system into a market economy.

Beijing already bristles at the fact that it is still being treated by the WTO as a “Non-Market-Economy”, which, in essence means China is subject to different methodologies in calculating penalties, among other matters. But in so many dimensions—from China’s requirements for technology transfer, to the misapplication of its body of economic-related laws, to the administrative intrusion in business decision-making in order to stifle competition, among other areas—we’ve gone way beyond the point where China’s WTO classification is a mechanism that has any utility in getting to the heart of the matter.

Renegotiation of China’s WTO accession across-the-board is the only avenue worth pursuing, and the most appropriate one to test China’s resolve to abide by trading rules it will agree to on a global basis. Dare I say it is the “adult approach” compared to the current circumstances. It places the incentives exactly where they should be: it would then be fully up to China to decide if it wants or does not want to be a WTO member and if it does want to be a member, then on what terms. Most importantly, it will leave Xi with little wiggle room to show his cards as to what kind of economy he believes the Chinese people want.

There should be no doubt this will be a messy process both inside China and outside of it. But to be frank, we all have little choice at this juncture, especially if the WTO is to have any credibility going forward. Continuing with the status quo could well mean the WTO’s days are numbered.

Why does this approach offer a chance to bring about real results for China? Because what deeply worries the Chinese leadership most is maintaining social stability at home and not having the domestic population lose confidence in the direction and performance of the Chinese economy.

Should Xi decide to substantially downgrade China’s WTO commitments or fully withdraw from the WTO, there is a high likelihood that will set off a significant crisis of confidence at home—not to mention abroad, which, in turn will fuel the fire in China. Within China, at the very least such a crisis would be the tipping point for the SOE-SOB house of cards as citizens pull their money out of Chinese banks and try to buy dollars and other foreign currency. It would also decimate China’s stock market. As large as Beijing’s foreign currency reserves are—more than \$3 trillion, the largest in the world—it is equivalent to roughly 25% of China’s GDP. While that might help stabilize an economy as large and as complex as China’s for a short period of time, those resources will not save the day.

Xi and his economic advisors know this story well. But they’re counting on this White House to continue its flailing tit-for-tat tariff war. If Trump was serious about understanding where are China’s real pressure points, he’d take a crack at trying to understand this story as well. It’s the only chance he has to actually being declared the winner.

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