International Journal of Business and Economics
Vol. 4, No. 1, 2019, pp. 21-32
http://ijbe.ielas.org/index.php/ijbe/index
ISSN (online) 2545-4137

https://doi.org/10.5281/zenodo.2590677

US-China trade war: Was it really necessary?

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Received: 2019-01-12 **Accepted: 2019-02-12** **Published online: 2019-03-11**

Abstract

The business world has observed another shocking measure taken by the US president to impose 25% tariffs on Chinese imports worth USD 150 Billion in total to the USA in order to reduce the deficit of US-China bilateral trade. The counter measure was the quick anti-tariff on USD 50 Billion US goods to China. The net result might be the reduction of bilateral trade between the two countries substantially. The most likely conclusion of this country specific impose of tariffs is the substitution of imports from other countries by US importers other than China. While the US trade deficit with China might fall and with other countries it will continue to rise, meaning the US trade deficit with the rest of the world will not be considerably changed. Majority of the experts and economists argue that the combined trade deficit with the rest of the world can only be reduced either by increasing the internal demand and meet that demand by local products (importing less from outside) or simply by exporting more to the other countries. As China has the largest market for many consumer and industrial products, there is a huge potential for the US to increase its exports like agricultural products, energy automobile; and services like education and tourism to Chinese market. The paper aims at discussing the alternatives of imposing tariffs and addressing the concept of "reasonable trade". The sources of this descriptive paper are the published news, articles and information in web. The authors are hopeful that this paper will come to the help of academicians wishing to investigate more on this issue and the policy makers of the business world who seek better alternatives of trade war.

Keywords: China, US, Trade war, Tariff, Import, Export.

1. Introduction

The US President Donald Trump announced a 25% tariff on unstipulated imports from China worth USD 150 Billion in April, 2018 wishing to reduce the US-China trade deficit by USD 100 Billion. It not clear yet whether the decision is consistent with World Trade Organization (WTO) or how WTO reacts on it. One obvious prediction was the Chinese exports to the US will fall and it already happened. An increased deliberate trade between two countries raises the combined welfare mutually, whereas a decrease in unintentional trade just reduces the collective welfare in both partnering countries creating a lose-lose scenario (Lau, 2018). There is no winner in such game.

In addition, the most probable net conclusion of such country specific trade tariff impose is the switch of imports by other importers from China on behalf of the US importers resulting the decrease of trade deficit of US with China but increase with other countries not changing the overall US trade deficit as well as GDP or employment. However, in the long run, there is at least theoretically a possibility that some existing producers may relocate their production facilities from China to other countries to avoid US imposed tariffs and other restrictions (Lau, 2018). A good example is what the Japanese car manufacturers did in the past though it is very unlikely to occur in labor intensive industries.

Finally, this paper addresses the issue of "reasonable or voluntary trade" that is completely deliberate in nature and non-coercive taking place between the logically willing buyer and logically willing seller. The paper discusses hostile bilateral tariffs between the US and China as well as whether or not the US impose of tariff to China is logical.

2. Literature review

The literature on most favorable trade policy dates back to Johnson (1953) who established that in a one shot game, two large countries would generate a Nash Equilibrium with tariff rates above their social optimum (Balistreri and Hillberry, 2017). In this perspective, a theory projected by Bagwell and Robert (1999) was the key roads through which the economists viewed these issues. In more current times, Ossa (2011) presented a new premise of trade discussions and the framework that guides them. Ossa (2014) has taken this hypothesis to the data and calculated most favorable tariffs. Later, Ossa (2016) carried out a more universal implement incorporating an additional theory of Grossman and Helpman (1994) highlighting a domestic political economy concerns in tariff setting (Balistreri and Hillberry, 2017).

2.1 The US-China trade deficit

We will commence by investigating the size of US-China trade deficit. The US-China trade deficit in goods was USD 375 Billion (Department of Trade, 2017), contrary to official Chinese data of USD 276 Billion (MOFCOM, 2017). There are a number of reasons for the large inconsistency between the official data of two countries. After adjusting the differences in the valuation of experts [free alongside ship (F. A. S.)] in the US versus [free on board (F. O. B.)] in China and imports [customers basis in the US versus {cost, insurance and freight (C. I. F.)}in China] and in the treatment of re-exports through Hong Kong, the discrepancy can be reduced to between USD 325 Billion according to Chinese data and USD 368 Billion according to US data (Fung et al., 2006; Fung and Lau, 2001; Fung and Lau, 1998). If the service trade is considered, where the US has a surplus of USD 38 Billion in 2017 (according to US data) and

included, the 2017 US-China trade deficit can be stood to be in-between USD 286 Billion and USD 330 Billion (Lau, 2018). Still it is not apparent why there is such large difference exists in the two official information sites.

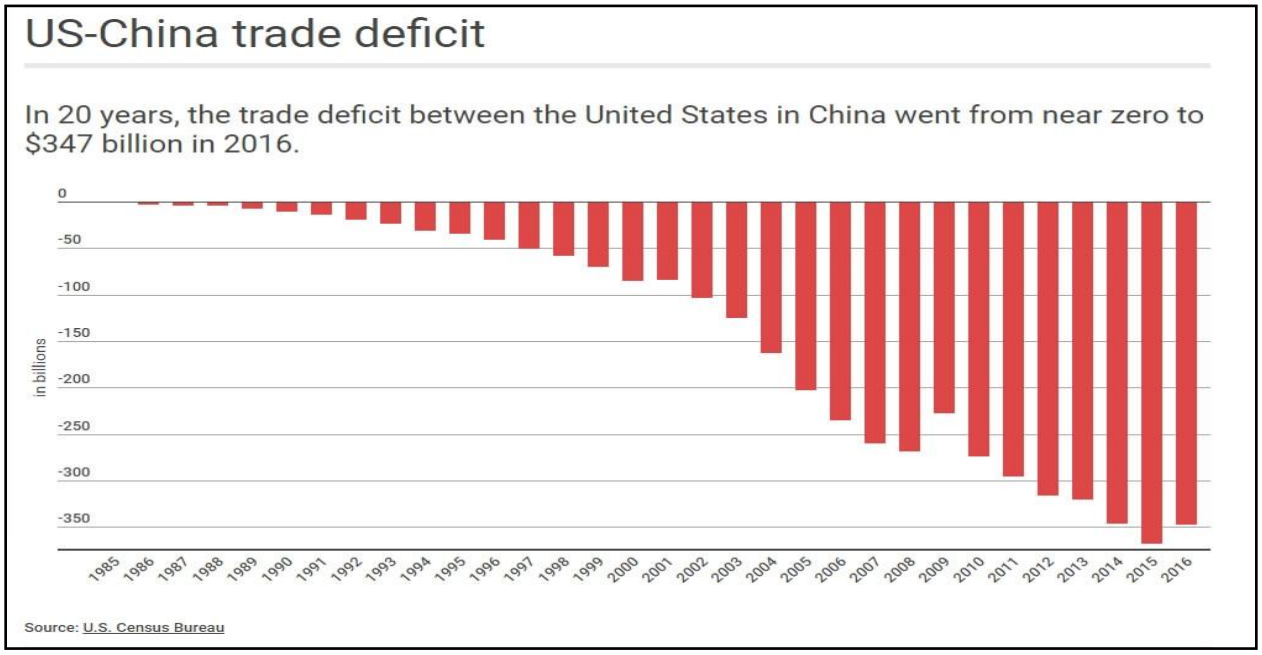

Figure-1: US-China trade deficit from 1985-2016 (Source: US Bureau of Census)

2018: US trade in goods with China

NOTE: All figures are in millions of U.S. dollars on a nominal basis, not seasonally adjusted unless otherwise specified. Details may not equal totals due to rounding. Table-1 reflects only those months for which there was trade:

Table-1: US trade with China in 2018 from January to October (physical goods only)

Month	Exports	Imports	Balance
January 2018	9,835.3	45,788.0	-35,952.8
February 2018	9,806.1	39,067.6	-29,261.5
March 2018	12,382.1	38,256.7	-25,874.6
April 2018	10,268.0	38,230.0	-27,962.0
May 2018	10,610.8	43,797.4	-33,186.6
June 2018	11,115.6	44,599.5	-33,483.8
July 2018	10,261.7	47,096.0	-36,834.3
August 2018	9,294.3	47,863.9	-38,569.6
September 2018	9,789.1	50,032.1	-40,243.0
October 2018	9,130.5	52,233.0	-43,102.5
TOTAL 2018	**102,493.5**	**446,964.2**	**-344,470.7**

Source: US Bureau of Census

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However, a yearly difference of around USD 40 Billion has remained since 2004. It cannot be just explained by the difference in timing of departure of goods from one country and arrival in another. As the Chinese exports to the US have been growing progressively over time, it is possible that in any given year, the recorded Chinese exports to the US will exceed the recorded US imports from China because of transit time. Also, it can be the other way round; recorded US imports have consistently exceeded the recorded Chinese exports. One tentative source of this discrepancy may be the re-exports to the US of Chinese exports via ports other than Hong Kong. Another source might be a methodical valuation difference "customs basis" by the US Customs and F. O. B. as reported by Chinese exporters which reflects perhaps the under invoicing of Chinese exports by Chinese exporters in order to reduce profit and avoid taxes.

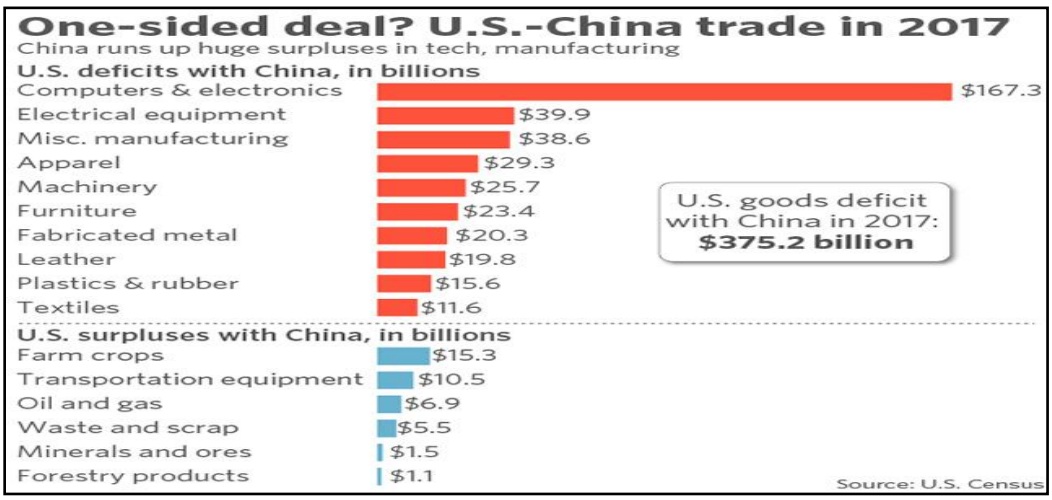

Figure-2: US-China trade in 2017 (Source: US Bureau of Census)

In this regard, it should be noted that, royalties and license fee payments to third country subsidiaries and affiliations of US corporations like apple, Google and Qualcomm are not fully recorded in these figures. These are genuinely service revenues received by US entities but accredited to third countries such as Netherlands, UK and Ireland. The exact value of these payments is not entirely published anytime, though they are assumed to be considerably large. Therefore, the real value of the US-China trade deficit in goods and services, before adjusting to a value-added basis, is possibly not larger than USD 300 Billion yearly, still it is agreeably a larger number.

Thus, so far, the debate of the US-China trade war is based on the gross value of exports rather than value added figures. Value added measures the GDP actually created by exports in the exporting country and can considerably vary from gross value. For example, while the Apple iPhone is made in China, the domestic value added in China is less than 5 percent of the gross value (Lau, 2018). If the US-China trade deficit could be calculated on the basis of value-added rather than gross value, considering the service trade within the value-added framework, the deficit can be reduced by roughly a half, based on an earlier analysis of the 2015 bilateral trade data

close to USD 150 Billion a year (Lau et al., 2017). The gap could be possibly narrowed down or even closed in a few years time if both China and the US work together.

2.2 Trade war: A lose-lose scenario?

Imposing tariffs to reduce the trade deficit on Chinese exports to the US is unlikely to be successful due to the possibility of retaliative actions from Chinese part thus reducing the US exports to China as well. The basic drawback of a trade war is that there are no ultimate winners in this game, both countries rather lose as their natural, logical or feasible consumptions are forcefully controlled and condensed. Exporters not only in China but also in US will also be shocked due to the reduction in their expected volume as well as importers in both countries will observe their business to decline. The end consequences will go to the final consumers who will have to pay more in prices and may have to compromise in quality as well.

Importers, on the other hand can keep the inflation lower by importing and supplying the goods from abroad in a reasonable price. Research indicates that between 1994 to 2017, a 1% point increase in Chinese share of US non oil imports reduced the annual rate of growth of the US non oil price index by 1% point (Lau, 2018). The Chinese share of total US non-oil imports rose more or less continuously from 2.7% in 1989 to almost 22% in 2009, more or remaining unchanged through 2017. Between 1989 and 2017, the average annual growth rate of US non-oil price index was 2.5% dropping a 2.6% from 5.1% in previous 28 years period of 1961-1989 (Lau, 2018). The slowdown in the core rate of inflation since 1989 can be at least partially attributed to the increase in Chinese imports which permitted a lower US rate of interest (Lau and Tang, 2018). Imposing tariffs on Chinese imports from the US part will obviously lower the share of US non oil imports and might raise the US core inflation rate.

Therefore, if a trade war becomes apparent between China and the US, both nations will lose significantly. While the threat of a higher tariff and anti-tariff leading to a trade war may make sense from technical point of view, understandably, no one actually want to see it in reality.

2.3 A better alternative of trade war?

However, there is always a better alternative or alternatives. The US trade deficit with China can also be reduced by US trying to increase its exports to China which is the largest single market for all kinds of goods and services in the world. It can be done in two ways: the first is rerouting the existing exports to other countries to China as a replacement and the second one is to produce new outputs to export in China using the current resources that are still underutilized. The first way is mostly aesthetic. US GDP and employment that two reasons argued by Mr. Trump for imposing tariff, will not

necessarily rise even if the US-China trade deficit will fall down. There is very insignificant net short term economic benefit on the part of the US, apart from to claim that the trade deficit has been effectively reduced. This is more political benefit for the US rather than long term economic one. The second option, however, has a strong possibility to genuinely increase in sustainable economic welfare gain for two parties. US producers will be happy and the Chinese importers and consumers can have a taste of newer, quality products.

Additionally, tariffs against China may not even lower the overall US trade deficit with the rest of the world as the US importers may substitute for Chinese products by importing from other countries. In this regard, we can put forward an example from the US apparel trade history. Between 1989 to 2017, the combined apparel imports from Hong Kong, Taiwan and South Korea to the US declined from 36.9% to only 1.7% which was replaced by Chinese imports rising from 11.7% to 36.6% (Lau, 2018). The new tariffs will force the US apparel importers to refrain importing from China sharply and the gap will be replace by importing from India, Bangladesh, Vietnam and Cambodia. The interesting fact is that due to the same demand remaining, the overall US apparel import will remain the same even after imposing new tariff.

3. Increasing the export for the US to China:

The creation of new output which results from new independent export demands generates new GDP and creates new employment opportunity for the US by utilizing the untouched and less used creative potential. The underutilization of resources may have been the consequence of imperfectness of market mechanisms, particularly prospective markets; or collapse of synchronization. Two key sourcing areas of impending US exports that can be enormous and are comparatively uncontroversial are agriculture and energy. Due to the huge population, China has a vast demand for agricultural commodities like soybean oil or different types of meats. On the other hand, there is a immense possibility for the US to boost the value-added content of agricultural exports like beef, pork and poultry as well as food grains like corn or soybeans to the Chinese market. For example, in 2017, China imported agro products valuing more than USD 115 Billion out of which only 20% came from the US exporters (Lau, 2018). The Chinese imports of agricultural products have been increasing at a rate of more than 10% a year (MOFCOM, 2019). Therefore, a huge potential is there for the US exporters of agricultural commodities to export to China that can be raised from the existing USD 20 Billion to USD 50 Billion a year in coming 3 to 5 years based on innovative and superior value-added production. The US has surplus unutilized production capacity like abundant land, water and other natural resources for producing more agro goods on the condition of assuring long term demand.

Next, there is gigantic and ever growing demand for energy in inland China that can be satisfied by the exporters of liquid gas from Alaska and crude oil from Texas and New Mexico. For example, in 2016, China imported crude oil worth a total of USD 117 Billion and natural gas worth total of USD 9 Billion but the imports from the US was only USD 0.2 Billion and 0.08 Billion for oil and gas respectively (MOFCOM, 2019) which is a very small fraction of the total amount of oil and gas import. Considering the enormous and growing demand for energy in China, particularly environment friendly energy source like natural gas and solar power; and the US being converting itself into a leading energy exporter due to the rising shale oil production, it is totally possible for the US to become a top energy exporter to China that can be topped to USD 50 Billion yearly (Lau, 2018).

Therefore, it is uncomplicated to foresee added exports in the agricultural and energy sectors that alone can be stood for USD 100 Billion a year with almost 100% of US value-added content. In addition, it is meaningless to say that such amplified exports are expected to be sustainable. The beauty of such solution is that no one will lose anything and there will be a long term mutual benefit. Another point is to mention here that new exports will consist of new domestic supply for already committed export demand which will not rise up or rise down the prices or otherwise influence the internal market in the US. Again, in China, the price of imported goods will be less than the cost of domestic production price margin and serve the important purpose of meeting the expanding extra domestic demand without adversely affecting the domestic production. Considering everything, it is mostly be a win-win situation for both. Yet, for both US producers/exporters and Chinese importers, long term agreement with trustworthy enforcement mechanisms is obligatory in order to ensure that the demands in China are imminent, sustainable and are not the subject matter to any arbitrary interruptions.

The other rapidly growing sector of US exporters' destination can be the services market in China, that is also 100% value-added content, especially demand in education and tourism (Lau, 2018). In the last one decade or more, the number of Chinese students and tourists as well as their expenditures in the US has been increased significantly. They are taking part of consumption goods and services in the US actively. In this regard, actions like imposing severe tourist visa requirements for Chinese tourists and making the visa requirement stricter for the Chinese students will produce counterproductive results for the US as such measures generally contribute to widening rather than narrowing the deficit between the US and China. In addition, having more tourists will help in exchanging the culture and views between the two countries that might even help to create business relationships. Again, the competent student exchange between the two countries will help to create more demand in the both internal markets as well as help to contribute in developing competent valuable human resources in the future.

The above mentioned three tentative sectors- energy, agriculture and services in tourism and education can attribute to reduce substantially and even level the trade deficit between China and US.

Last but not the least, trying to promote high-tech goods to China can be also a potential opportunity for the US exporters as China is becoming a global customer for high quality technological products with the increasing income power of Chinese citizens. Although, there is risk remains from the US part for national security concerns and competitive considerations. An example for these concerns is the discouraging US consumers to use Huawei products and discouraging the Chinese to use US technological goods. However, this common stand-offs is more likely to generate inherent or even overt protectionist barriers for both economies, to assist their monopolistic producers and the loss of their consumers (Lau, 2018).

4. The concept of "Reasonable or voluntary trade":

Is there anything called "reasonable or voluntary" trade? When a trade or trades are considered mutually reasonable or voluntary? The traditional theory of comparative advantage indicates both trading parties (and say countries) gain if they trade as one country is comparatively weaker in producing a good than the other country. In such ways, every country has some comparative weaknesses and comparative advantages in producing goods or rendering services. Therefore, according to the theory of comparative advantage, the country which has comparative weaknesses or disadvantages in producing a product will buy from the country or countries which have or have the comparative advantages in producing that product. But it does not explain how the gains are calculated or distributed between the two trading countries. Well, the virtual allocation of gains normally relies on their original positioning, comparative advantages and comparative market control. The absence of commonly established straightforward pointer or measurement for the extent of reasonableness or voluntariness is still a matter of debate.

One likely concept of reasonableness could be a mutual trade balance starting from nil. However, this conception does not create a great deal economic logic. An example is a major oil exporter like Saudi Arabia or Iran to have a balanced trade with all the other big and small countries which is impossible in practice. Another possible notion might be a nil or zero trade balance with the rest of the world which may appear to be more logical. But this will in fact take away the prospect from the US to advantage from acting as a global means of exchange, while if it runs a big trade deficit with the rest of the world, it is still be able to pay for the surplus imports with US dollars, cash or bonds, both of which can be printed more or less at will of federal

government. In fact, though it sounds peculiar, the capability to preserve a constant trade deficit with the rest of the world can be considered as a benefit rather than a shortcoming, as long as the rest of the world is ready to expand credit to the country providing the global liquidity for an indefinite period (Lau, 2018). Yet, another view of reasonableness or voluntariness is that the trading partnering countries should be treated in an equal manner, same tariffs and quotas, no-non trade barriers- in short, there should not be any discriminatory regulations. However, in reality, it is largely absent as the discriminatory treatment is evident all over various bilateral or multilateral agreements (Lau, 2018).

It cannot be ignored as a fact that China has been benefitted as from its opening and reform and becoming a member of WTO. Recently, it has successfully managed to secure the position of second largest economy. Over the past 40 years, it has managed to lift out 600 million people from poverty. Such tremendous achievement would be impossible to achieve for China without economic reform and participating in the world economic forum Like WTO in 1978. There are feelings from the US counterpart that China has been benefitted much more than the US with inequitable upshot. It is, consequently, not easy to compute and contrast the benefits that each one country gets from the trade, in particular, as the supposed benefits and costs may be dissimilar for various countries. There is no convincing economic judgment why the benefits should be equal, even quantifiable.

There are few other reasons for US to think China to be unreasonable, but such reasons do not have much to do with the trade. The first is the Chinese restrictions on foreign investment in certain sectors like IT and education. We can provide a typical example in this case. To invest in automobile industry in China, an international automobile firm has to form a joint venture a local firm as a partner and the foreign firm can own only up to 50% partnership of the joint venture. But the scenario is going to alter in near future as the Chinese government is opening up more of its economic door to others both in new sectors and expanding the partnership size for the existing ones. In some areas like insurance companies, a foreign investor is already allowed to own 51% share in the first three years and 100% in five years. The liberalization is likely to expand further extend as after 40 years of economic reform, the firms in China are already bigger and stronger enough, and there is no justified argument to protect such firms as "infant" for protection (Lau, 2018).

It should be noted that limiting the ownership on overseas possession is not quite uncommon even outside China. If we take the example of even US, it does not allow an international investor to own more than 25% on its airline firms. Again, Japan and South Korea both refused to permit fully foreign owned firms for automobile manufacturing industry. A matter of fact is that, in these two countries, a very few international joint ventures or alliances are existing for automobile firms. Moreover,

foreign investments in the US are needed to be approved by the Committee on Foreign Investment in the United States (CFIUS), having a wide discretionary power (CFIUS, 2019). An absolute openness of foreign direct invest (FDI) is perhaps difficult at present but it not likely to last long as China is planning for more opening up it economy to the foreigners just as it also wants to invest outside China.

Another issue of concern for the US is the supposed theft of intellectual property by the Chinese firms. The Chinese government does not overlook the theft of intellectual property or any kind of theft as well as it does not engage in cyber theft itself. Moreover, the intention is quite clear from the part of the government by establishing a special intellectual property court system that has country wide jurisdiction (Lau, 2018). It might be possible that few Chinese firms are engaged in such activities that are quite common for some other countries also. For this issue, a well accepted, understandable and clear-cut answer is to make believable complains, collect evidence and submit them to the Chinese court and ask for support in inquiry from the part of victims. In this case, without evidence, nothing much can be done even a state owned enterprise is involved.

Still, involvement of a state owned firm in such activity does not mean that the central government is involved itself with such deeds or procedures. As the state is merely one of the stakeholders, it cannot be simply blamed for the deeds of another stakeholder. As an example, the US government is not responsible for what Uber does or the British government cannot be held responsible for what British Petroleum did in the Gulf of Mexico. But indeed, the board of directors and top management of Uber and BP can be held responsible for the firms' wrong-doing.

Lastly, it should be accepted that the market does not worry itself with "reasonableness". Any deliberate or non-coercive trade between a willing buyer and a willing seller at the current (or negotiated) market price can and should be considered reasonable and voluntary.

5. Concluding remarks

Whether the tariffs the US and China have imposed on each other will direct to a full blown trade war between these two largest economies is yet to be seen. The business environment would be more challenging for the producers of agricultural, automobiles, aircraft and chemical products if China really impose relaliative tariffs (in fact, China already imposed on a few items already). However, at least in the near future, the US economy will not be that much affected due to the small portion of its value-added exports to China. But there could be other knock-on effects, difficult to quantify in numbers that could raise the pain for US exporters. For example, the stock

market is obviously going to be weak (that happened already several times) that would reduce the net wealth of American households and bond yields could rise if China started to unload some of its sizable holdings of US Treasury securities.

In summary, a full blown trade war between the US and China will not benefit any party but both parties might risk of losing in a substantial manner. In this paper, some alternatives have been suggested that would narrow the trade deficit between the two largest economies and would have positive brim over effects for the rest of the world. The policy makers should think of long run welfare effects rather than thinking with short sighted vision.

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