A Blessing in Disguise: A Game Theory Analysis of the US-China Trade Dispute

The growth in world trade would have reached a decade high in 2018 had it not been for the trade war with China instigated by Donald Trump, the US President. Although the damage wrought to date has yet to reverse the underlying global economic recovery, a huge number of businesses engaged in US-China trade are suddenly finding themselves under untoward pressure. As a sign of this, at some of the Californian ports that traditionally process US agricultural exports to China, throughput has dropped by 60% in recent months.

With the trade war seemingly set to only escalate, assessment of its ultimate impact also has to be continually recalibrated to factor in three particular variables:

1. Time Frame
   Until earlier this year, many assumed Trump’s ruminations with regard to China-origin imports were simply his characteristic bluster. Indeed, the tariff-related sabre-rattling that followed a series of Section 301 investigations led many to assume it was largely political chicanery, related more to winning votes in the midterm elections than to any likelihood of actual action being taken. Following the more recent actions taken by the White House to cultivate the support of Europe and Japan in its anti-China trade position, as well as the rush to conclude a new trade agreement with Mexico and Canada (the United States-Mexico-Canada Agreement (USMCA), which replaces the old North American Free Trade Agreement (NAFTA)), it now looks certain, however, that the US-China trade war will persist well beyond the recently concluded midterms.

2. Scope
   While the opening salvos of the trade war impacted on a wide range of US trade partners, of late the escalating deployment of tariffs has become far more focussed. More specifically, back in February, the Section 201 action applied equally to large household washing machines and solar cells/modules whatever their origin, supposedly as a means of protecting domestic US manufacturers in the corresponding sectors. For its part, the Section 232 action, effective as of March this year, affected steel and aluminium products from all suppliers, with protecting US national security the given justification. The Section 301 action, the first stage of which was enacted in July, however, solely had China in its sights.

Supposedly adopted as a response to the mainland’s allegedly inadequate intellectual property protection regime, the scope of this action has progressively widened, with the value of the goods affected rising in tandem. Indeed, from a supposed starting point of below US$10 billion, the current estimate puts the total worth of the circumscribed goods at well in excess of $100 billion. In fact, as the situation has escalated, almost every item traded between the two countries has been caught in the crossfire.

3. Nature
In light of the two developments detailed above, it should be more than apparent that the dispute has evolved into something that has implications well beyond trade, with its ramifications already clear on the wider economic front and within the political sphere. In line with this, the fact that the US government has specifically excluded every product with any relevance to the *Made in China 2025* strategy from the *Section 301* tariff exemption has been seen as a tacit admission that the White House is actually looking to curb China’s continued economic growth rather than merely regulate its trade with the US. In corroboration of this, apart from introducing the aforementioned punitive trade measures, the US has also formally adopted *The Foreign Investment Risk Review Modernisation Act (FIRRMA)*, legislation that strengthens the hand of *The Committee on Foreign Investment in the United States (CFIUS)* when it comes to regulating or vetoing overseas investments in the country. Although, in theory, *FIRRMA* is not solely focused on China-sourced investments, few have any real doubts as to the covert agenda that drove its implementation.

From this then, it should be apparent that, far from being embroiled in just a short-term trade dispute, China and the US are actually locked into a very real political and economic confrontation, one that has every sign of enduring long into the future. Put simply, unfair trade is just a pretext, while the real target is China itself.

What, then, does the US government really hope to achieve? For some, the objective seems to be, at best, the disruption of China’s economy or, at worst, its wholesale regression. With the hawks very much holding the upper hand within the White House at present, it is not surprising that many subscribe to this particular view.

There is, though, the question as to just how long such hawkish elements will continue to hold sway and as to whether or not the more moderate elements within the US will ultimately act to constrain such peremptory action. Given Trump’s volatile and autocratic character, the diverse interest groups wielding various levels of influence within the US and the country’s constitutionally-enshrined separation of powers, it will not be easy for such an objective to be pursued unwaveringly and without amelioration. A more widely held conviction is that the punitive trade and investment measures are merely being deployed by the US as a means of circumscribing China’s economic development and ensuring that the country does not threaten the US domination of the global agenda. Indeed, among those who prefer not to see the current trading contretemps as the prelude to a new Cold War, Trump is seen as merely taking steps to oblige China to accelerate the opening up of its domestic market, while addressing the long-standing imbalance in US-China trade.

**Two Erroneous Perceptions**

Given the overall level of obfuscation, not to mention the inconsistency, it is all but impossible to gauge the true intent of the current generation of US policy makers. For China’s part, when it comes to preparing for the worst, it should first of all look to maintain steady growth on the domestic front. Above all, it should do so by...
eradicating any systemic risks, particularly with regard to finance and employment. Secondly, in the case of external issues, the central government should be more proactive, especially when it comes to turning risks into opportunities. While domestic economic strategy is not the focus here, it is important to clarify two misperceptions on the external front:

1. China Accounts for the Largest Proportion of the Overall US Trade Deficit

According to US Customs statistics, the country’s trade deficit with China totalled $376 billion in 2017. It should be noted, however, that this figure represents the difference in the value of goods originating from the two countries imported into each other’s territory. This is not the gap in revenues generated by the people and businesses in the two countries from bilateral trade. This key distinction reflects the fact that the exporters of China-origin goods could well be US companies operating on the mainland. At the same time, not all the goods originating from China and imported by the US are 100% mainland-manufactured.

The Apple iPhone is a good example of the complexity of the situation. Research has shown that the assembly of iPhones in China amounts to less than 4% in value-added terms, less than half the added value attributable to South Korea for the same product – and even that only amounts to a fraction of the profit receivable by California-headquartered Apple [1]. From this, it can be inferred that if all mainland exports to the US were iPhones, then the more Chinese products that entered the US, the greater the profits accrued within the US.

According to the 2011 trade in value statistics [2] (the latest data available) compiled by the World Trade Organisation (WTO), on average the domestic value-added content of Chinese products exported to the US was 65.3%, while that of US products exported to China was 85%. As such, of the $506 billion worth of goods exported to the US by China last year, China’s domestic value-added accounted for just $330.4 billion, whereas of the $130 billion worth of US exports to China, the US domestic value-added was $110.5 billion. In other words, the difference between the two was $219.9 billion – 42% less than the $376 billion trade deficit registered by US Customs statistics.

According to figures from the US-China Business Council [3], in 2017 the China market absorbed $550 billion worth of products made by US-owned companies operating around the world, including those in the US and many based in China (see the figure). However, since the value of products made and sold by Chinese companies in the US was not substantial, the value of Chinese products absorbed by the US market roughly equates to the $506 billion worth of goods directly imported into the US from China within the same year. As such, even though China is the largest single source of the US trade deficit, taking into consideration the value of products made and sold by companies of the two countries in each other’s markets, China may also be the largest net income source for US companies.

2. Trade is Not a Zero-Sum Game

This common-sense concept seems to be one that is entirely alien to Trump’s way of thinking. Clearly, if he had been able to conceptualise trade as a complementary, mutually beneficial exercise, then he would not be able to or have initiated the trade war. In fact, the difference between trade deficit and surplus is determined by whether one ends up with more goods or currencies on hand after settling all the trade transactions – there is no net gain or loss for either side of the trade. In order for trade to genuinely be a zero-sum game, the transaction in question must have
been conducted on an unfair basis. To support such an argument, the Trump administration designated the “non-market” nature of China’s economy as the unfair factor that disadvantaged the US.

However, neither US legislation nor WTO regulations [4] have ever clearly defined what constitutes a “non-market” economy. In addition, given that the post-war global trade framework and rules were largely established by an informal US-led consortium of developed nations, any inherent structural bias in the current global trade system would more likely act in favour of the industrial economies rather than in the interests of the developing countries. For instance, the developed nations have long resisted pressure to end their protectionist measures in agricultural and textile trades.

Bearing this in mind then, it can be seen that the current US-China trade dispute is not about fairness. It is actually about competitiveness. As China has become more and more competitive across an ever-widening array of sectors, the US has become increasingly concerned that it is to lose its dominant role within the global economy. This has seen it resort to increasingly desperate – and often excessively unfair – means of stalling China’s growth.

Two Strategies

With the above two points borne firmly in mind, China should consider the following strategic approaches as it evaluates its future options:

1. Act Proactively
   As the US stake in the current trade war is clearly far in excess of the official customs figure, it is all but guaranteed that US businesses will suffer hugely as a consequence of the dispute. In light of this, beyond its current “tit for tat” countermeasures, China should also consider adopting another venerable tactic – “piercing the enemy’s shield with its own spear”. This would include encouraging affected US companies to stand up for themselves and oppose the measures adopted by the Trump administration. At the same time, beyond the borders of the US, every effort should be made to unite all the countries caught up in the dispute and to collectively channel all their protests to the appropriate bodies. This would then see all of the relevant regional and international platforms deployed to jointly protect and promote the existing multilateral trade system.

2. Turning Crisis into Opportunity
   Overall, the current trade dispute is attributable to a number of disparate elements – the wayward nature of the Trump administration, the anti-globalisation movement and the impact of China’s growth on the global stature, and self-image, of the US. It has also highlighted the fact that, following the emergence of several rapidly developing nations, the post-World War II international economic infrastructure looks increasingly obsolete and in need of reform. This has been further highlighted by many of the actions undertaken by the Trump administration – including the TPP withdrawal, the NAFTA re-negotiation and the use of Sections 201, 232 and 301 of its Trade Act to unilaterally imposed tariffs – which have seriously disrupted an international trade order of which the US was once the key architect. Beyond that, such actions have also seriously undermined the country’s credibility in the international arena, particularly among many of its traditional allies.
These actions, though, may have also created an opportunity to reform the international economic and trade regime. Apart from setting out to mitigate the consequences of the trade dispute via a number of short-term countermeasures, China should, over the longer term, leverage on its stature as the world’s largest and most promising market, as well as its commitment to expanding its open-door policy, in order to secure the support of the developing and the developed nations. It should also seek to increase its level of influence in the international arena as means of driving the reform of the global trade system. With such adept handling then, China might not only weather the trade war, but might also turn it to its own – and the world’s – advantage, rendering it, ultimately, a blessing in disguise.

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[1] CBS News
[2] WTO - trade in value statistics


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