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MACROCOSM

China Trade: A Deal Takes Shape

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Donald Luskin

It's only a "framework." But historic tax reform started that way, too.

Treasury Secretary Steven Mnuchin's statements to "Fox News Sunday" yesterday that the US and China "have agreed to put the tariffs on hold" and have "agreed on a framework" are very good news. *But is this a surprise? Not really.* This has never been a trade war, despite scores of news stories that act as though tariffs deferred for months are already in place. This is a peace negotiation conducted under the threat of war, and it's just what we said to expect from the very beginning (see "On the China Tariffs" March 22, 2018).

Also, it's not even close to a done-deal. Just as when last year's historic corporate tax cuts began as a mere "framework," there remains much work to fill in the details and then execute them. But it's now obvious that there is a way forward, and that's a good thing.

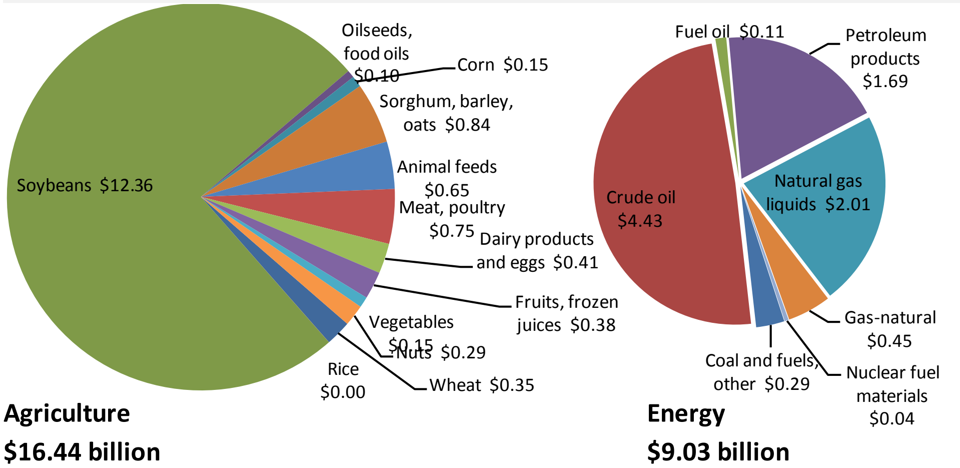
- There's nothing in the US/China joint communique about the "framework" that formally takes either side's tariff threats off the table, Mnuchin's statements to the contrary notwithstanding. But that's not a bad thing at this stage of the game. It keeps the pressure on the negotiators.
- And there's nothing in the communique *specifically* about a widely reported offer by China to close its trade surplus with the US by \$200 billion (which, indeed, China has specifically denied). On the face of it, that would seem to be an absurdly aggressive number – which would not be too far from tripling today's US exports to China of \$130 billion. That said, the communique does cite agreement, *generally*, on

> *"…effective measures to substantially reduce the United States trade deficit in goods with China. To meet the growing consumption needs of the Chinese people and the need for high-quality economic development, China will significantly increase purchases of United States goods and services…*
>
> *"Both sides agreed on meaningful increases in United States agriculture and energy exports… [and] expanding trade in manufactured goods and services."*

Update to strategic view

US MACRO, ASIA MACRO, EM MACRO, EUROPE MACRO, OIL, COMMODITIES: Mnuchin's announced stand-down on tariffs is good news, but not a surprise. It's what we said to expect: a peace negotiation conducted under the threat of war. The US-China communique says nothing officially about a rumored \$200 billion in increased US exports, a highly aggressive stretch-goal. Mnuchin points to undertakings to sharply increase China's purchases of US agriculture and energy commodities. US production can be ramped up, but energy exports are sharply constrained by bottlenecks in pipeline and port capacity. It's a zero-sum game, with the US taking market-share from emerging market commodity producers. It's trickier in non-commodity markets, such as civilian aircraft, for which this deal puts the US on a collision course with Europe. True reform of China's tariff and non-tariff barriers, mentioned in principle in the communique and in speeches by the highest Chinese leaders, would be positive-sum reform that would lift expected growth world-wide.

US exports to China in agriculture and energy 2017, USD billions



Source: Census Bureau, TrendMacro calculations

- *<u>There's some very good news embedded here: no one is talking about reducing the US trade deficit with China by the US importing less, but rather by exporting more. For the optimists among us this has always been implicit in President Donald J. Trump's focus on the trade deficit, but it's good to see it in writing.</u>*
- The communique refutes claims by political rivals and critics that the Trump team has caved to China by getting nothing on reform of non-tariff trade barriers, particularly with respect to intellectual property violations.

> *"Both sides attach paramount importance to intellectual property protections, and agreed to strengthen cooperation. China will advance relevant amendments to its laws and regulations in this area, including the Patent Law."*

<u>While all this confirms our long-standing view that a full-on trade war is only a tail-risk, we are more curious than ever about what the world will look like with some degree of reform of China's trade practices.</u>

- Mnuchin talked on Fox about China increasing its agricultural imports from the US (please see the chart above) by 35% to 45% this year – up as much as $7.4 billion, from $16.4 to $23.8. That is easily achievable, representing only a 2% increase in total US production.
- Mnuchin talks about China doubling its US energy imports (please see the chart above) from $9.3 billion to $18.6. If it all came from crude oil, that would require the US to produce an additional 364,000 barrels per day, or about 3.6% of present production. That's doable – we're on that kind of production growth trajectory anyway. Mnuchin's further claim that China's imports of US energy products could rise to $60 billion in three to five years – its more than a quintuple – is more of a stretch, especially considering that US producers are already sharply constrained by limited pipeline and port facilities (see "Oil's Bullish Bottlenecks" April 24, 2018).

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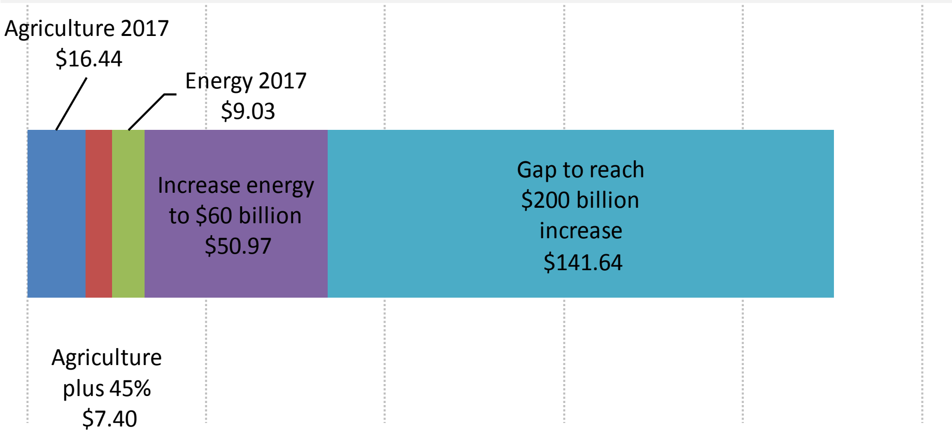
- Mnuchin's numbers for this year leave $183.6 billion to get to the rumored $200 billion. Taking energy to $60 billion still leaves $141.7 billion to go (please see the chart below). Unrealistic, maybe, but it's no surprise that Mnuchin would emphasize these particular US winners from increased Chinese buying – it marks a 180-degree reversal of the risk that Trump's "trade war" would most harm his own political base in the Midwest and the South.

Proposed increases in US ag and energy exports to China USD billions



Source: Census Bureau, TrendMacro calculations

- Let's say China *does* increase its imports from the US as a result of the eventual conclusion of the present negotiation. Whatever the amount turns out to be, to the extent that it's about commodity products like agriculture and energy, *as a first approximation it's just a zero-sum transfer of wealth to the US from whatever nation is exporting to China now.* That's hardly a "reform" – it's just an exercise of bargaining power that, until now, the US had chosen to abjure. *To that extent, this is a blow to emerging markets whose exports will be arbitrarily displaced.*
- In one particular case, the blow to emerging markets may be deliberately aimed. China is a major importer of Iranian oil, and the Trump administration could kill two birds with one stone by displacing it with US oil – winning a trade victory for US producers at the same time as effectively getting China to boycott Iran, increasing the pressure to renegotiate the nuclear deal from which the US has just withdrawn (see "Iran Deal: More Fire, More Fury, Pure Trump" May 9, 2018).
- *Because China's reallocation of its sourcing decisions doesn't change the global equilibrium of supply and demand for commodities, we don't see why this should have an impact on expected inflation.*
- *It gets more interesting when we think about non-commodity markets with fewer producers and no global benchmark-prices.* Consider large civilian aircraft, for example, the single largest US export to China, and a global market in which the US's Boeing and Europe's Airbus are effectively a duopoly. *What happens under a deal that effectively mandates China to buy Boeing aircraft only?*

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- That would hardly be a move in the direction of free trade – it would make China's buy-decision as between Boeing and Airbus a political mandate, not an economic choice, and it would leave Boeing a monopoly seller with respect to China. As a first approximation this should lead to gains for Boeing equal to losses borne by Airbus (in lost business with China) and China (in higher prices). China may be happy with its share of the losses if bearing them averts a trade war with the US – but *Brussels might feel that the US's deal with China, in this respect, was tantamount to a trade war between the US and Europe.*
- But that may not really be the equilibrium outcome. To the extent that Boeing is production-constrained, its customers crowded out by China's mandated purchases would have to buy from Airbus, which would be able to charge higher prices. US airlines would be among the displaced buyers, in which case *narrowing the US trade deficit with China would result in widening the US trade deficit with Europe. And unlike in more diverse commodity markets, the end effect in narrow technology-driven markets would be higher prices for everyone.*
- *On the other hand, true reform – lowering China's tariff and non-tariff trade barriers – would be a positive-sum game that would increase economic growth in China and in every nation that trades with China. It would expand global demand, making everyone a winner.*
- Such reforms are hard for China to execute, because they implicate its command-and-control economic and political structure. So we have some sympathy with skeptics who fear that China will buy off the US with some commodity imports, but avoid true reform. But if the US is to get anything like the $200 billion reduction in the trade deficit that it seeks, it's going to have to entail exports of intellectual property, and that intellectual property is going to have to have some protection. Communist Party Chair Xi Jinping and Premier Li Keqiang have already both promised it in very public statements, and it is called out in the communique. At least some steps in that direction will be taken, and any step at all will be in the direction of goodness.

Bottom line

Mnuchin's announced stand-down on tariffs is good news, but not a surprise. It's what we said to expect: a peace negotiation conducted under the threat of war. The US-China communique says nothing officially about a rumored $200 billion in increased US exports, a highly aggressive stretch-goal. Mnuchin points to undertakings to sharply increase China's purchases of US agriculture and energy commodities. US production can be ramped up, but energy exports are sharply constrained by bottlenecks in pipeline and port capacity. It's a zero-sum game, with the US taking market-share from emerging market commodity producers. It's trickier in non-commodity markets, such as civilian aircraft, for which this deal puts the US on a collision course with Europe. True reform of China's tariff and non-tariff barriers, mentioned in principle in the communique and in speeches by the highest Chinese leaders, would be positive-sum reform that would lift expected growth world-wide.