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What is China's Trump card in a trade war?

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On 10 February, US President Donald Trump had a telephone conversation with Chinese leader Xi Jinping. It was characterised by both sides as 'cordial', with President Trump reaffirming the 'One China' policy. This is the first positive sign regarding Sino-US relations since Mr. Trump took office on 20 January. However, given the protectionist comments he has made to date and the hawkish views of his cabinet choices regarding China, the probability of a potential trade war may not be small even though China and the US are mutually dependent in many respects. For a comprehensive review, we count the cost of a trade war to the Chinese economy, the cost to the US as China inevitably retaliates, the lessons learned from trade friction between the US and Japan in the 1970s-1990s, and finally we examine China's best defence—its huge domestic market.

- First, as China runs a significant trade surplus with the US, which accounted for 18% of total Chinese exports and 3.7% of China's GDP in 2015, a potential trade war with the US would represent a demand shock for China's economy. China relies on some key hi-tech products produced only in the US, and many Chinese companies look to tap the US capital markets to raise funds. Subsequent to a trade war, growth in China would slow and the unemployment rate could rise with deflationary pressure. China's government may need to stimulate the economy more aggressively, which could worsen structural problems (see Counting the cost of a potential trade war (I), 25 November 2016).

- Second, the cost to the US would also be hefty when China inevitably retaliates. China accounts for 21.8% of total US imports, especially for labour-intensive products. It would be difficult to replace Chinese products in the short run, and a trade war could mean higher inflation in the US. With extensive connections in the production chain, the US's service export surplus with China, and strong investment from China into the US, we think a trade war would lead to job losses rather than job creation in the US (see Counting the cost of a potential trade war (II), 2 December 2016).

- Third, we think China should refer to Japan's experience with US trade protectionism in the 1970s-1990s by opening its domestic market, shifting some production to the US, and even implementing self-imposed voluntary export quotas. However, the lessons learned from the Plaza Accord suggest that China should avoid relying heavily on exchange rate adjustments to lower its trade surplus, nor should it over-stimulate its economy in reaction, particularly when a housing bubble is already a concern (Counting the cost of a potential trade war (III), 9 December 2016).

- Finally, instead of rushing to react to punitive measures from the US side, we believe China should take stock of its options and identify the possible opportunities that arise from trade sanctions by the US. In our view, China's powerful domestic market is the best defence against a trade war, as it would be difficult for the US to ignore the cost of losing a big market for its products. China could seek to advance its reforms and its opening-up agenda, which could make the economy more efficient and demonstrate a model of 'inclusive globalization' (see Counting the cost of a potential trade war (IV), 27 January 2017).

Contents

Rocky Fan, Michael Luk, Mingming Zhang and Weizhou Yang of Mizuho assisted in the preparation of this report.

1. Introduction

On 9 February, the White House disclosed that US President Donald Trump had sent a letter to President Xi to seek a 'constructive 'relationship' with China. The letter thanked President Xi for his congratulatory note on President Trump's inauguration and wished the Chinese people a prosperous Lunar New Year. The following day, Trump and Xi held a 'lengthy' and 'extremely cordial' phone call, in which 'numerous topics' were discussed. In the phone call, President Trump reaffirmed the US's adherence to the 'one China' policy.

In our view, the phone call is a positive sign for Sino-US relations, which for the past few months have been marred by suspicions. So far, China has adopted a 'wait and see' approach, avoiding confrontation related to the various allegations from the Trump administration. Although it remains unclear whether the recent friendly gesture from President Trump will be a lasting one, we believe it may represent a more cautious stance from the US due to:

First, on 9 February the San Francisco-based 9th US Circuit Court of Appeals declined to block a lower-court ruling that suspended the President's ban on travellers from seven predominantly Muslim nations. This was a sweeping rebuke of the administration's claim that the courts have no role as a check on the president.

Second, on 7 February a panel of bipartisan China specialists said in a report issued by the Asia Society that Sino-US relations are at a 'precarious crossroads' and the two world powers could be on a 'collision course' if the Trump administration continues to abandon the long-standing US policy on China.

Together, the reactions to Trump's policies show that President Trump may soon find that his hands are tied by his administration's lack of experience in governmental affairs, as well as a lack of popular support. He may have to re-assess the possible reverberations as he launches his planned sanctions against China.

We think President Trump's change in attitude on the call is certain to ease the tension between China and the US. In our view, this was the result of a cautious, restrained stance in China's diplomacy. However, it remains unclear whether it represents a genuine change in attitude. It is too early to dismiss the threat of a trade war:

First, although the call confirmed the US's adherence to the 'one China' policy, it did not touch on the trade-related issues that have been the focus of the disputes. With President Trump apparently holding nothing back in implementing his campaign pledges, we believe it is too early and too easy to conclude that he has abandoned his threats against China.

Second, President Trump has a trade team in his cabinet that is filled with China hawks, including Peter Navarro as trade adviser, Matt Pottinger, the National Security Council's Senior Director for Asia, and Robert Lighthizer, his pick for US trade representative; this demonstrates the administration's negative tendencies with regard to China.

Third, bipartisan mainstream think tanks in the US have also turned more cautious on China. In the Asia Society's report, while the panel of specialists made clear that the US government should return to the 'one China' policy, it also suggested that the administration should be prepared to launch new policies, including trade sanctions and litigation in international platforms to mitigate the US's trade deficit with China.

A good relationship between China and US is important for a stable world economic order. It is also a powerful counterattack to the anti-globalization trend around the world. However, as the Trump administration remains unpredictable, we are cautious on the outlook of Sino-US trade relationship. Nevertheless, as China benefits from a sizeable domestic market and rapidly rising household income and assets, we believe these are China's best defence in the face of the threat from the US. China could seek to advance its reform and opening up agenda, which could make the economy more efficient, and also show in action a model of "inclusive globalization".

2. Potential impact on the Chinese economy from US trade protectionism

Rise of hawkish US stance on international trade

With Mr. Trump taking office on 20 January, his China policy is about to be unveiled. Given the protectionist comments he has made to date and his hawkish cabinet choices, the outlook for smooth trade relations between the US and China appears increasingly uncertain.

While China and the US are mutually dependent economically in many respects, we believe that a full-blown trade war with the US is unlikely as that would badly hurt both economies. However, the possibility of a large-scale trade war cannot be ruled out. In the following sections, we count the cost to the Chinese economy, the cost to the US as China inevitably retaliates, the lessons learned from trade friction between the US and Japan in the 1970s-1990s, and finally we examine China's best defence, which we believe comes from its sizeable domestic market.

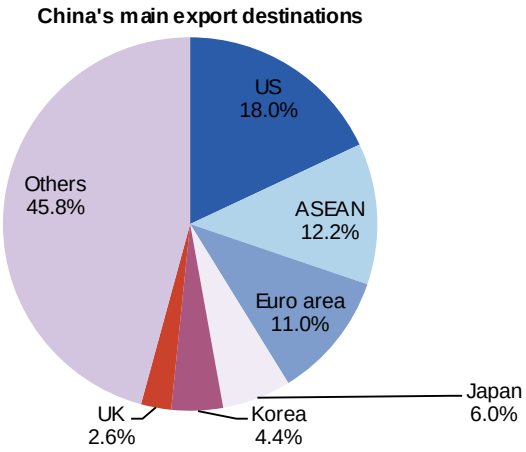
First, we look into the cost to China. On President Trump's election platform, he singled out China as his main target for 'unfair trade practices' and efforts to 'bring jobs back to the US'. Specifically, he pledged to get tough on China-US bilateral trade relations, by: 1) labelling China a currency manipulator; and 2) imposing a high tariff on Chinese imports (see *Why a Trump victory could be an opportunity rather than a risk for China,* 17 November 2016). We think a trade war could severely dampen China's growth and employment, bring deflationary and RMB depreciation pressure, and cause China's structural problems to worsen.

Significance of US exports to China's economy

Merchandise exports to the US constitute 3.7% of China's GDP

The US is China's largest export market, ahead of ASEAN countries, the Euro area, and Japan. China's merchandise exports to the US reached USD410.8b, 18% of total Chinese exports, or 3.7% of China's GDP, in 2015[1]. Exports to the US are not only strong among labour-intensive industries, representing nearly one-third of toys, furniture, and textiles exported by China, but also for capital intensive industries such as electrical equipment and mechanical appliances.

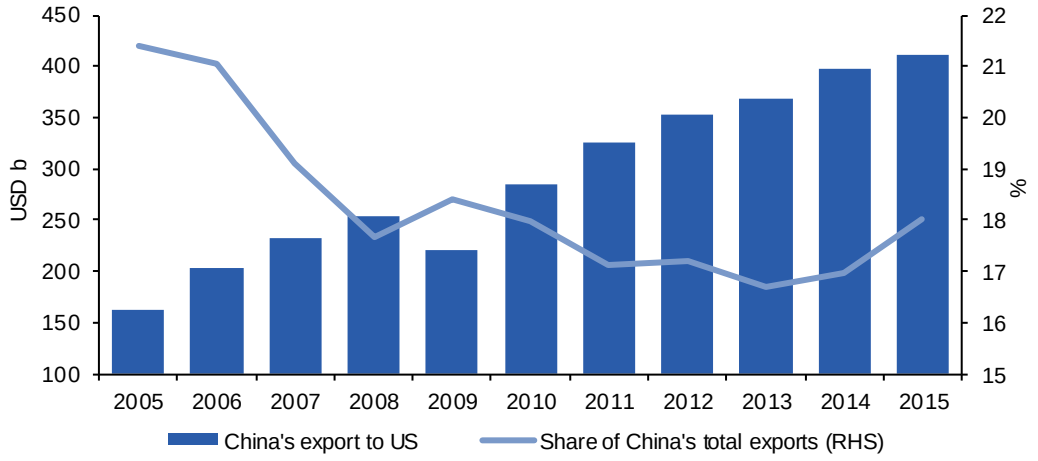
Fig 1 China's top merchandise export destinations



Source: UNComtrade, Mizuho research

[1] The data from this report is derived from the UNContrade database. However, statistics from China are different from those on the US side. The difference between the trade data reported by China and the US is mainly due to the following three reasons: 1) exports to the US via Hong Kong are not recorded as exports to the US by China customs; 2) different quotations; and 3) different data processing methods. We use UNContrade data reported by China when we count the cost for China's economy, and use UNContrade data reported by the US when we count the cost for the US economy.

Fig 2 China's merchandise exports to the US



Source: UNComtrade, Mizuho research

Fig 3 Top 10 Chinese exports to the US by value (based on China data)

	Value (USD b)	Share of China exports (%)
Electrical machinery and equipment	95.6	15.9
Machinery and mechanical appliances	84.5	23.2
Furniture	29.2	29.5
Apparel, knitted or crocheted	17.6	21.0
Toys	15.2	35.5
Apparel, not knitted or crocheted	15.1	19.3
Footwear	14.1	26.3
Plastic articles	14.1	21.4
Vehicles other than railway or tramway	13.3	21.2
Iron or steel article	10.5	17.4

Source: UNComtrade, Mizuho research

Fig 4 Top Chinese exports to the US by share (based on China data)

	Value (USD b)	Share of exports (%)
Feathers and down	2.7	38.9
Cork	0.01	36.5
Toys	15.2	35.5
Explosives	0.3	35.4
Printed books	1.2	30.4
Furniture	29.2	29.5
Musical instruments	0.5	29.0
Textiles	7.7	28.5
Headgear	1.3	26.8

Source: UNComtrade, Mizuho research

Merchandise exports to the US account for 20m jobs in China

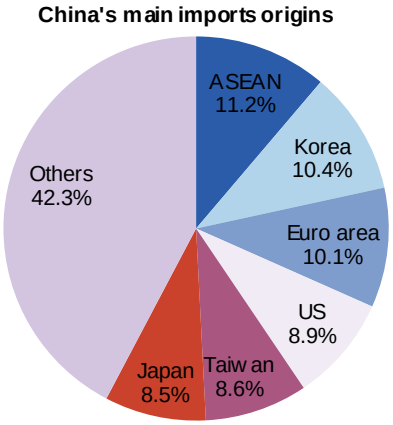
Given the size of China's exports to the US, the US market is of great importance to China's labour market. According to joint research by the Ministry of Commerce, the Customs office, the National Bureau of Statistics (NBS), and the State Administration of Foreign Exchange (SAFE), USD1m in merchandise exports were able to create 59 jobs in China in 2012. The export sector created a total of 120.9m jobs in China that year. We estimate that total exports to the US created around 20m jobs in 2015, around 6% of the total urban employed population in China.

Hi-tech products and supply chains

If the US starts a trade war, it is likely that China would retaliate and impose high tariffs on imported US goods as well. This could have significant repercussions on China as the US is also one of the top countries of origin for China's imports. In particular, we believe such

retaliation could damage Chinese technology companies' supply chains. In some key areas, China still relies on hi-tech products from the US. Even if China designates special treatment for these products, it is possible that the US could restrict such products' export to China to escalate the trade war.

Fig 5 China's top merchandise exports destinations



Source: UNComtrade, Mizuho research

For example, Intel and AMD are dominant producers of CPUs for personal computers around the world, and Microsoft's windows operating system is widely used in these computers as well. GPS systems are installed in most mobile devices in China too. It may cost Chinese companies and consumers a lot of time and resources to replace American products if a trade war breaks out.

Fig 6 China's top 10 imports from US (based on Chinese data)

	Value (USD b)	Share of imports (%)
Electrical machinery and equipment	19.8	4.6
Aircraft	17.6	62.9
Machinery and mechanical appliance	15.9	10.1
Vehicles other than railway	13.2	19.0
Oil seeds and oleaginous fruits	13.0	32.7
Optical, photographic	11.3	11.4
Plastics	6.3	9.6
Commodities not specified to kind	5.8	7.2
Pulp of wood	3.9	21.8
Pharmaceutical products	3.3	17.1

Source: UNComtrade, Mizuho research

Service trade with the US and FDI from the US

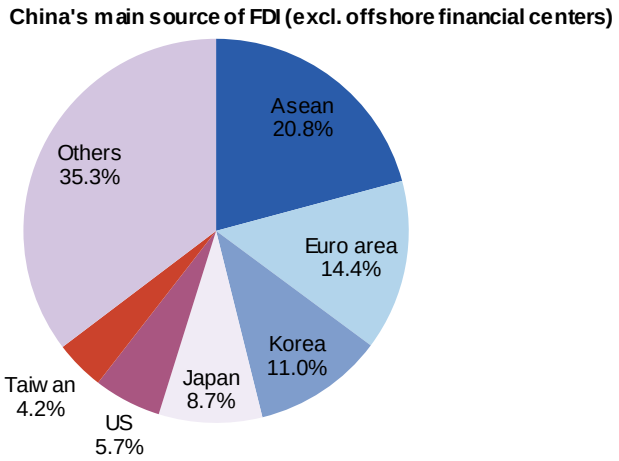
The US runs a significant service trade surplus with China. In the event of a trade war, more restricted access to service industries (such as financial services) could bring additional costs to China. Meanwhile, US companies in China would also suffer, with implications for direct investment into China as well as Chinese employees in US companies.

For example, many hi-tech companies in China have tapped the NASDAQ market to raise capital. In China, capital markets are heavily regulated, and it may take a company several years to be listed on the A-share market. Moreover, many hi-tech companies suffer losses in the early stages, and Chinese regulations do not allow loss-making companies to launch IPOs. As such, a trade war could affect China's innovation via the loss of ready access to funding.

Moreover, a trade war may affect Chinese employees at American companies. According to the NBS, a total of 27.9m Chinese were employed by foreign companies in 2015, including companies from Hong Kong, Macau, and Taiwan. In 2015, FDI from the US accounted for

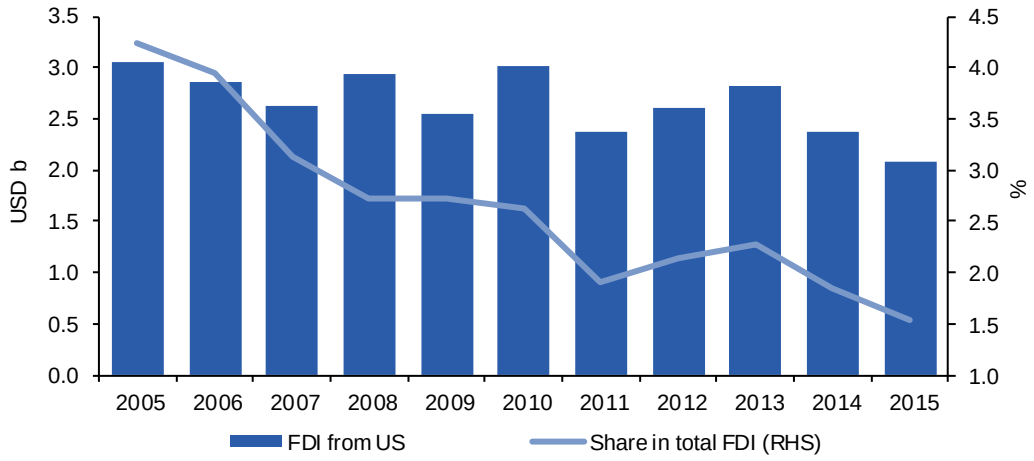
around 1.5% of overall FDI in China, or 5.7% of total excluding FDI from offshore financial centres such as Hong Kong. That makes the US the fifth largest source of FDI for China. We roughly estimate that close to 1m workers are employed by American companies in China. A trade war between China and the US may affect the operations of American companies in China as well as the employees of those companies.

Fig 7 Main origins of FDI in China



Source: CEIC, Mizuho research

Fig 8 China's FDI from the US



Source: CEIC, Mizuho research

Limited scope for substitutions to replace the US economy

In theory, if the US raises tariffs on Chinese goods, China could potentially export more to other countries to replace the US market. However, given the size of the US economy, we believe China's choices are limited.

Technically, the Euro area, ASEAN countries, Japan, and Korea are the next largest export markets for China, just behind the US. However, we found that for major goods exported to the US, China's share of these other countries' import markets are already high. For example, electrical machinery and equipment is the most important exported good to the US by value, but China already accounts for 49.6% of electrical machinery imports by Japan and 40.7% of imports by Korea. The potential for China to substantially increase its shares to the aforementioned non-US export markets is limited.

Fig 9 China's share of import market of major trading partners (based on Chinese data)

%	Electrical machinery and equipment	Furniture	Toys	Nuclear reactors, boilers	Textiles
US	40.8	50.4	82.4	32.4	54.7
Japan	49.6	59.9	78.1	45.8	77.4
Korea	40.7	65.6	55.0	22.0	58.9
Germany	23.0	21.6	48.8	17.6	30.0
UK	22.7	38.8	63.8	13.0	37.0

Source: Wind, Mizuho research

Overall impact on China's economy

As China runs a large trade surplus (USD365.7b in 2015, per US census data) with the US, the initial impact of a China-US trade war on China would likely be a demand shock: aggregate demand in China could decline significantly. Considering the multiplier effect of the export sector, a trade war would likely put pressure on both economic growth and labour market stability in China. Deflation could appear, as many products for export would have to be redirected to the domestic market with price cuts; in addition, unemployment could dampen consumer confidence as well.

In 1930, US President Herbert Hoover signed the Smoot-Hawley Tariff Act, which raised tariffs on thousands of imported goods. President Hoover's protectionist justification was similar to Trump's today. In the end, the Smoot-Hawley Tariff Act also brought significant repercussions back onto the US. Other nations retaliated with their own trade barriers, contributing to the severity of the Great Depression.

The situation seems to be different today. Most countries around the world agree that free trade is good for economic growth and social welfare. It is unlikely that trade protectionism would expand globally. However, given the importance of China-US trade, if a trade war does break out between the two countries, its impact on China would also merit attention.

3. Hefty toll on the US as China retaliates

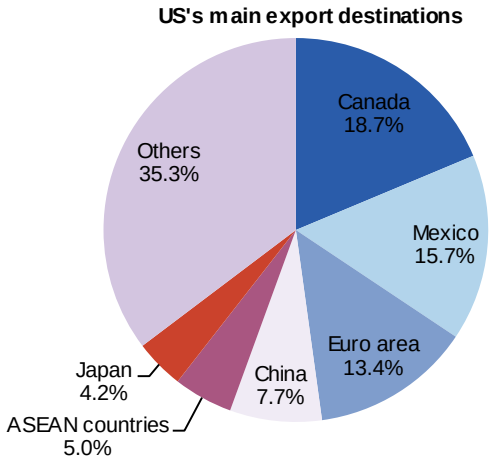
In the case of a trade war, we believe retaliation by China would be inevitable. As such, although significant damage can be expected in China from US protectionist policies, the US economy could be hurt too.

US exports to China and associated employment

Merchandise exports to China constitute 7.7% of total US exports

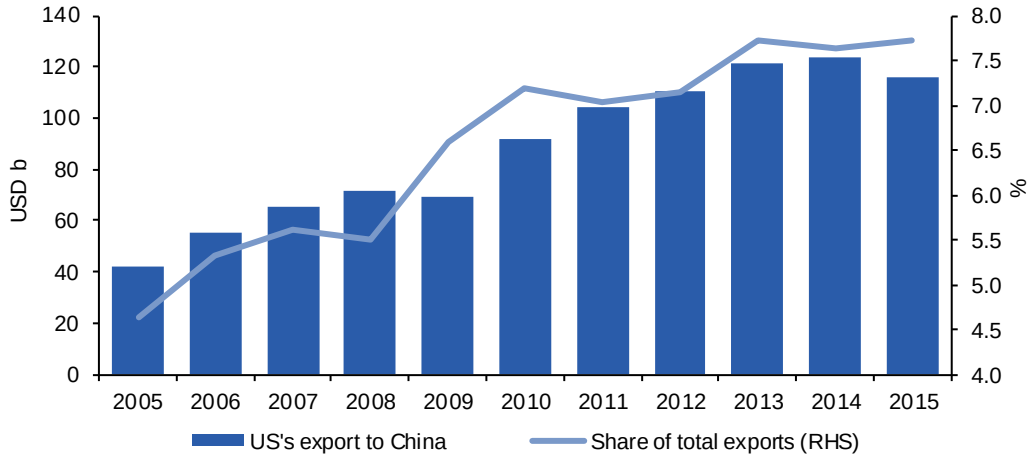
China is the US's fourth-largest export market, behind Canada, Mexico, and the Euro area. According to the US Census Bureau, in 2015 merchandise exports from the US to China reached USD116.1b, or 7.7% of total US exports and 0.7% of US GDP. Exports to China comprise not only high-tech equipment, such as aircraft and electrical machinery, but also natural resources, such as wood pulp and cereals.

Fig 10 Main destinations for US exports



Source: UNComtrade, Mizuho research

Fig 11 US's merchandise exports to China (based on US data)



Source: UNComtrade, Mizuho research

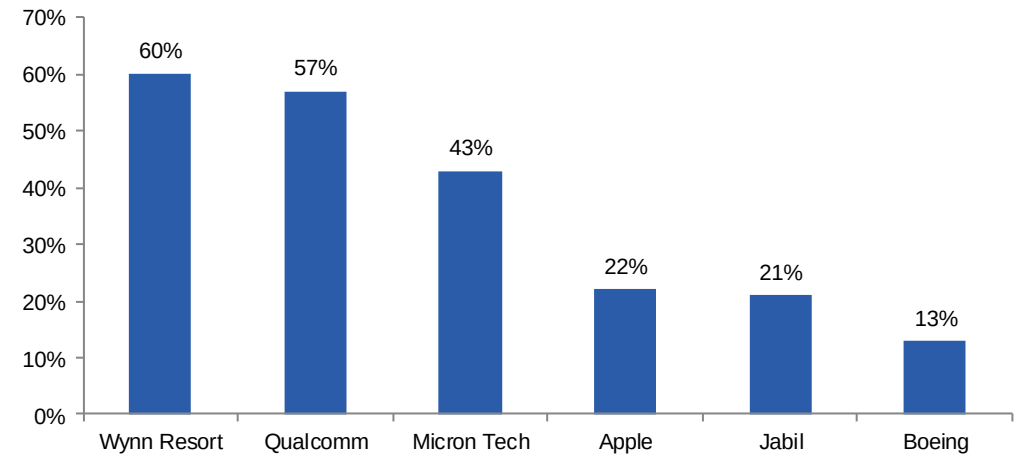
Fig 12 Top 10 US exports to China by value in 2015 (based on US data)

	Value (USD b)	Share of US exports (%)
Aircraft	15.4	11.8
Electrical machinery and equipment	12.8	7.5
Machinery and mechanical appliances	12.3	6
Oil seeds	11.1	47
Vehicles	10.9	8.6
Photographic and cinematographic equipment	7.9	9.5
Plastic articles	4.9	8.2
Wood pulp; recovered paper	3.4	39.1
Organic chemicals	2.5	6.4
Cereals	2.4	12.9

Source: UNComtrade, Mizuho research

China is one of the most important markets for many US multinational companies. According to Bloomberg, citing a joint report between the Rhodium Group and the National Committee on US-China Relations, total investment by these US multinationals in China has reached USD228b.

Fig 13 China accounts for a vital slice of sales for many US companies



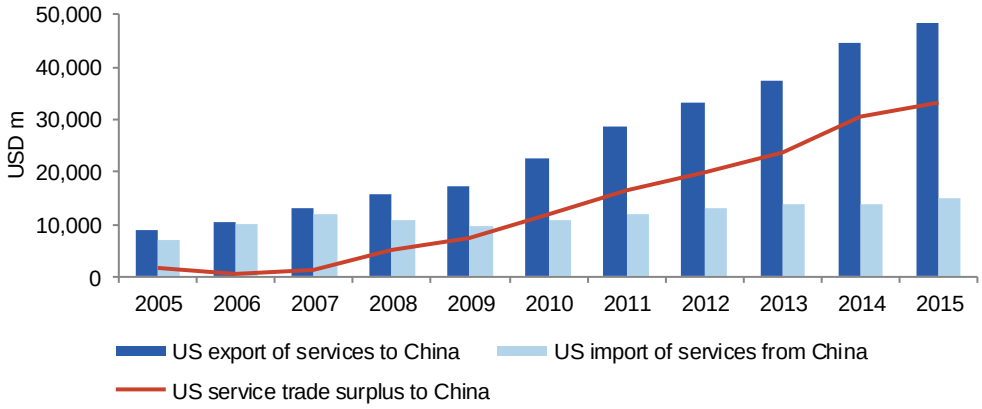
Source: Bloomberg, Mizuho research

According to the US Department of Commerce, 678,000 people are directly employed in the production of goods sold to China. This accounted for 10% of all US jobs supported by exports in 2014.

The US's service exports to China and China's ODI in the US

As discussed, an important development in China-US trade relations has been the fast-growing service trade. Service exports to China, which include tourism services offered to Chinese travellers in the US and IPO underwriting for Chinese companies listing in the US, among others, grew six-fold from 2005 to 2015. In 2015, total service exports from the US to China reached USD48.4b, and the US ran a trade surplus of USD33.3b.

Fig 14 US's service trade with China

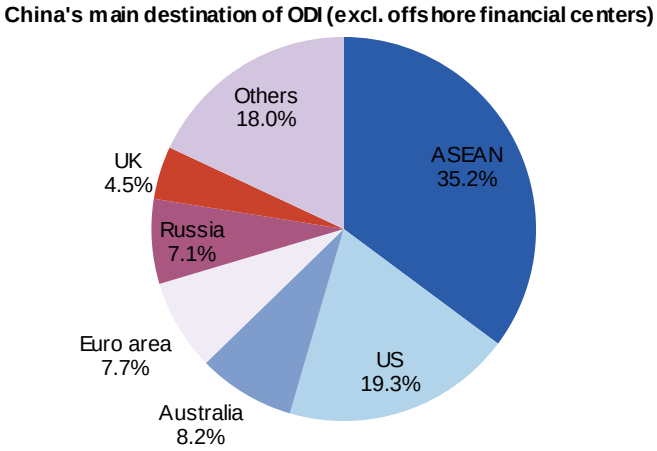


Source: CEIC, Mizuho research

Data from the US Department of Commerce suggests that service exports to China created 273,000 jobs in the US in 2014.

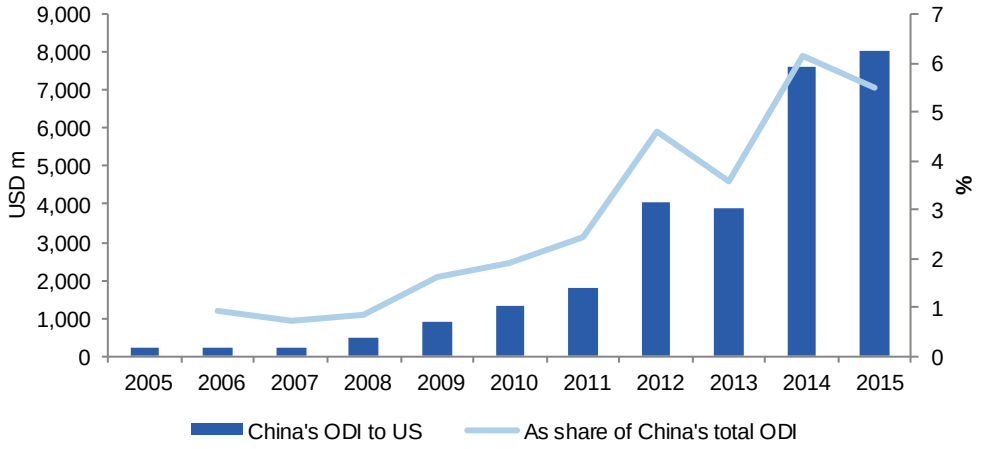
China's outbound direct investment (ODI) has increased substantially in recent years as well, and the US is an important destination. In 2015, China's ODI to the US reached USD8b, below only the ASEAN countries. According to the Chinese Ministry of Commerce, China's direct investment in the US generated 13,000 jobs in 2015, and overall Chinese investment in the US was supporting nearly 90,000 jobs by 2015.

Fig 15 China's ODI by destination



Source: CEIC, Mizuho research

Fig 16 China's ODI to the US



Source: Wind, Mizuho research

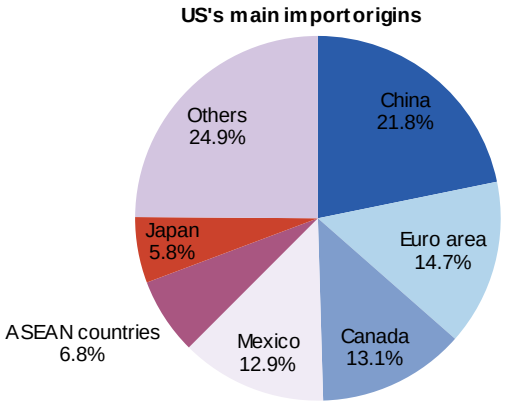
Consolidating employment in the merchandise and service export sectors as well as Americans working for Chinese companies, we estimate that trade with and investment by China supports more than 1 million jobs in the US. A trade war with China would directly affect 0.7% of the overall non-farm working population in the US. Considering the multiplier effect, we believe the actual impact could be much larger.

US imports from China

Merchandise imports from China account for 21.8% of total US imports

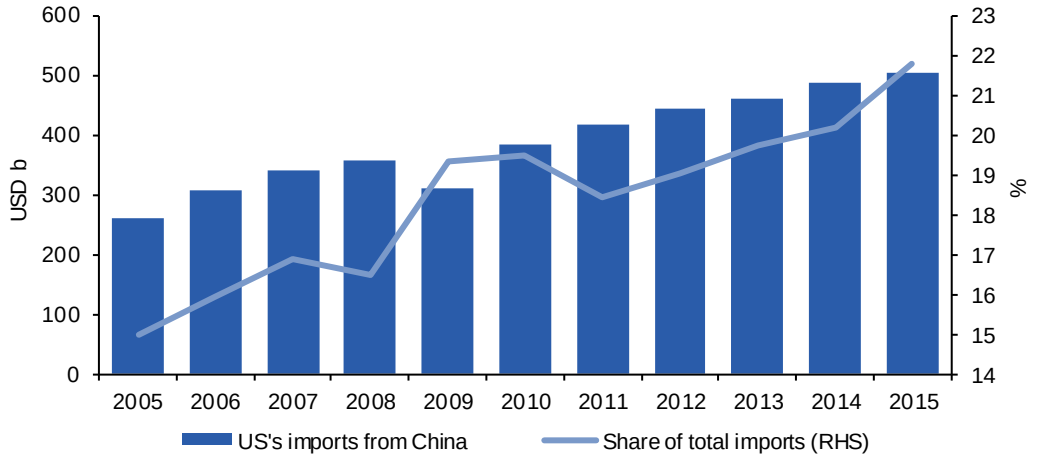
According to UNComtrade, total merchandise imports from China reached USD504.0b in 2015, or 21.8% of total US imports and 2.8% of US GDP. That makes China the top country of origin for US imports ahead of the Euro area (14.7% of total imports), Canada (13.1%), and Mexico (12.9%).

Fig 17 Origin of the US's top imported goods



Source: UNComtrade, Mizuho research

Fig 18 US merchandise imports from China (based on US data)



Source: UNComtrade, Mizuho research

A trade war and inflation pressure

In 2015, 40.8% of US imports of electrical machinery and equipment came from China, and 32.4% of machinery and mechanical appliance imports came from China as well. By comparison, Mexico's share is less than half of China's, and other countries' shares are even smaller for these two types of products.

Fig 19 US's top 10 imports from China by value in 2015 (based on US data)

	Value (USD b)	Share of imports (%)
Electrical machinery and equipment	135.9	40.8
Machinery and mechanical appliances	106.9	32.4
Apparel	32.3	36.4
Furniture	30.9	50.4
Toys	25.7	82.4
Footwear	18	62.5
Plastic articles	15.5	30.8
Vehicles other than railway or tramway	13.8	4.9
Photographic and cinematographic equipment	11.4	14.5
Iron or steel articles	11.3	29.3

Source: UNComtrade, Mizuho research

For many labour-intensive products, China is actually a dominate supplier. 93.1% of imported umbrellas in the US come from China, and the ratios for toys and footwear have reached 82.4% and 62.5%, respectively. As the US produces very little of these products, imports largely represent the overall market supply in the US.

Fig 20 US's top 10 imports from China by share in 2015 (based on US data)

	Value (USD b)	Share of imports (%)
Umbrellas	0.6	93.1
Toys	25.7	82.4
Artificial flowers	1.7	78.1
Headgear	1.7	67.6
Luggage	9.2	63.3
Footwear	18	62.5
Basket-ware and wickerwork	0.4	62
Textile articles	8.2	54.7
Furniture	30.9	50.4
Railway or tramway locomotives	1.1	48.4

Source: UNComtrade, Mizuho research

Given China's large share of the US import market and its status as the dominate supplier for many labour-intensive products, if a trade war were to break out between China and the US, it would be rather difficult for the US to make these products itself or find other suppliers in the short term. A trade war with China would therefore represent a supply-side shock for the US, and could bring inflationary pressure to the US economy.

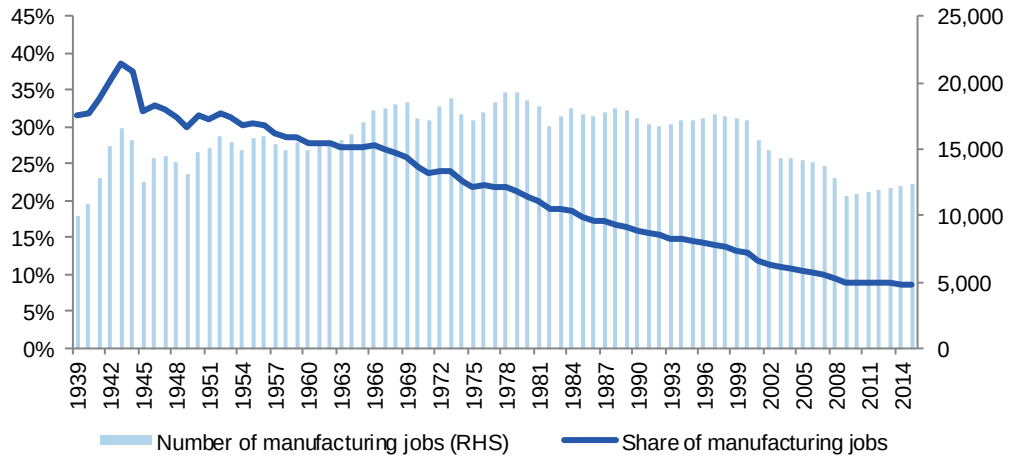
Would the labour market benefit from a China-US trade war?

Problems in the US labour market

President Trump and his team attribute the polarization of the US labour market to globalization and trade with China. Indeed, academic research suggests that job opportunities in the US have diverged over the past two decades, with expanding job opportunities in high-skilled occupations (technical and managerial, etc) and low-skilled occupations (food service, personal care, etc)[2].

While intrinsic problems with US labour, such as the slowing rate of four-year college degree attainment, are partly to blame, international trade does play a role in the problem[3]. We note that the share of manufacturing jobs in total US non-farm jobs has declined significantly over the past few decades. Workers laid-off by plant downsizings due to globalization could be caught up in structural unemployment. Some had to take lower-skilled positions, while many had to leave the labour force permanently.

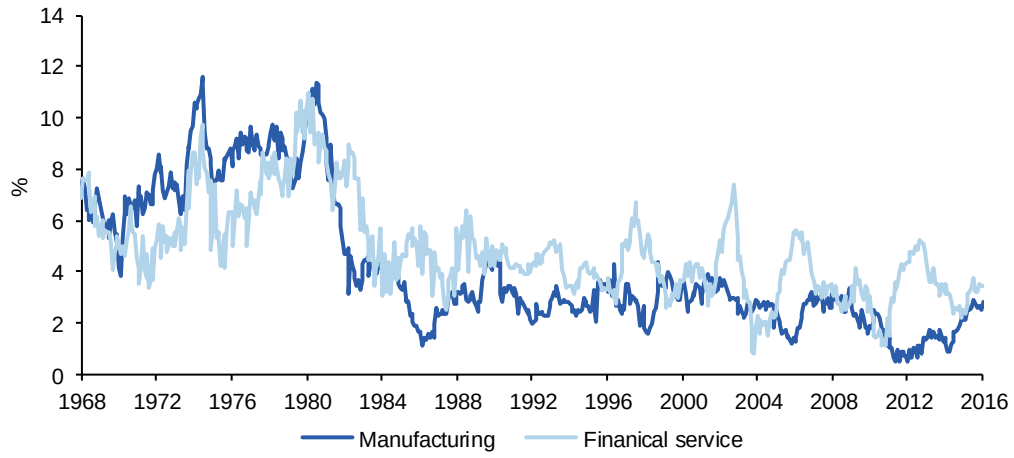
Fig 21 Manufacturing jobs in the US



Source: Wind, Mizuho research

[2] David H. Autor and David Dorn, "The growth of low skill service jobs and polarization of the US labour market", *American Economic Review*, 2013, 103(5)
[3] David Autor "The Polarization of Job opportunities in the US labour Market", April 2010

Fig 22 Wage growth YoY in the US



Source: Wind, Mizuho research

A trade war with China cannot solve this problem

However, a trade war with China may not solve this problem. Although electrical machinery and mechanical appliances are now major exports from China to the US, much of it remains relatively low-end, low-value-added products. For example, in 2015, 45% of US electrical machinery imports from China were telephone sets, and 48% of US mechanical appliance imports from China were computers and accessories (automatic data processing machines)[4]. By comparison, US imports in these two categories from Japan and Germany are much more diversified and include many high-end products, such as electronic integrated circuits, photosensitive semiconductor devices, and gas turbines, etc.

Fig 23 US imports of electrical machinery from China by value

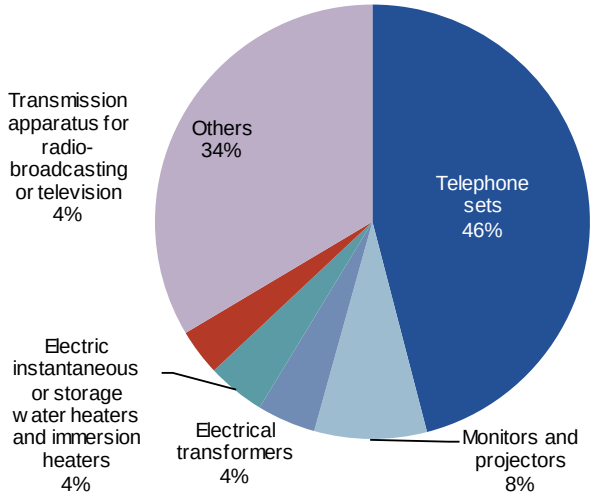
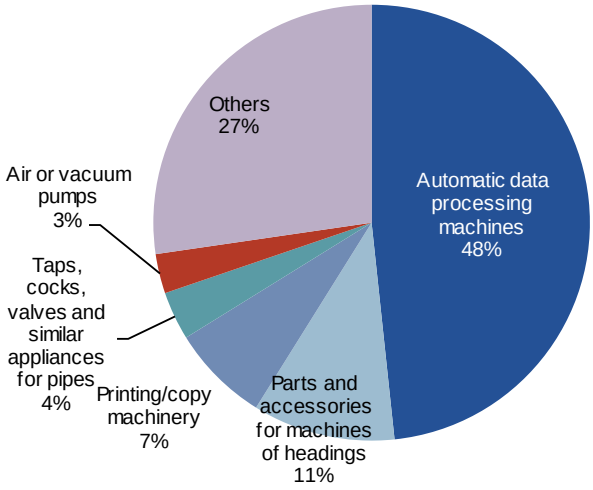


Fig 24 US imports of mechanical appliances from China by value

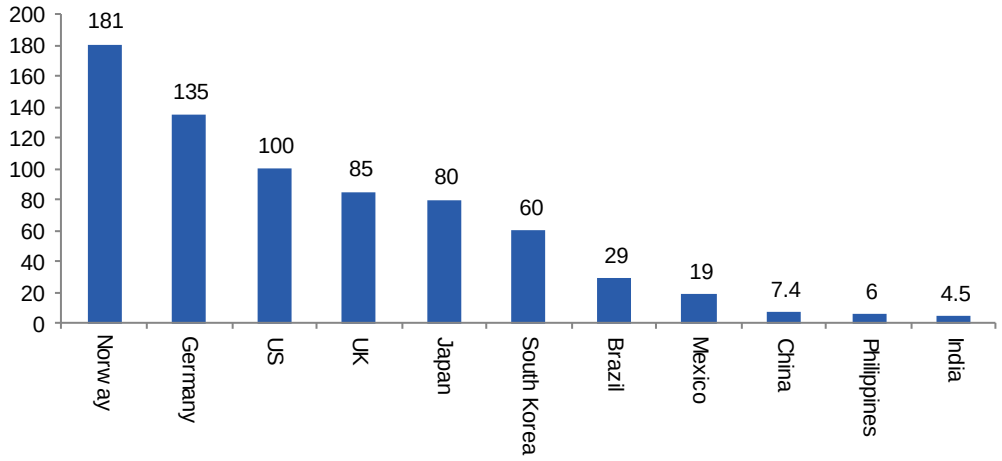


Source: UNComtrade, Mizuho research

The Conference Board estimated that hourly compensation costs in manufacturing in the US reached USD35.3 in 2013. China's cost was only 7.4% of the US's. As such, it seems unlikely that the manufacture of labour-intensive, relatively low-end products will return to the US after the US raises tariffs on Chinese goods. Rather, production will likely just move to other low-cost countries like India, ASEAN countries, and Mexico.

[4] Given that China imports most of its electronic integrated circuits from the US and other advanced economies, computer exports to the US are likely to concentrate on relatively low-end parts of the value chain.

Fig 25 Hourly compensation costs in manufacturing as a percentage of US costs (US=100)



Note: China is based on statistics of 2012; other countries' data is based on statistics of 2013 Source: The Conference Board, Mizuho research

If China is unable to export to the US in a trade war, Chinese manufacturers may cut prices and redirect exports to other countries. This could indirectly boost exports from those countries to the US as their production costs are lowered thanks to cheaper imported components from China as well as lower overall living costs. Consequently, in the long run, a trade war would likely only shift the US trade deficit from China to other low-cost countries. If the US does want to create more manufacturing jobs, the Trump administration should target high-end manufactured products, in our view.

Overall impact on the US economy

As the US runs a large trade deficit (USD365.7b in 2015) with China, the initial impact of a China-US trade war on the US would likely be a supply shock: it would be difficult to replace Chinese suppliers in the near term, and inflationary pressure could appear in the US. That could increase the need for monetary tightening while the growth rate slows.

Over the long run, production facilities could be transferred from China to other low-cost countries if the trade war drags on. However, unless the US expands the trade war to other low income countries, it is unlikely that low-end manufacturing jobs would return to the US. Therefore, Mexico, India, and other low-cost countries would likely benefit most, while the trade war would do little to solve the polarization problem in the US labour market, in our view.

China's likely retaliation would affect American jobs tied to the export of goods and services to the Chinese market, as well as US multinational corporations that invest in China. High-end job opportunities in the US would therefore be cut. Overall, we think the US would suffer a net loss in terms of employment, even in the long run.

4. Lessons from US trade friction with Japan in the 1970s-1990s

The fast-growing Japanese economy and the US trade deficit with Japan in the 1970s-1990s share many similarities with the Chinese economy and the US's trade deficit with China today. To better understand the impact of a potential trade war between China and the US, we look back at the trade friction between the US and Japan in the 1970s-1990s and draw some implications for China today. In addition, our analysis suggests that if a trade war between China and the US breaks out, electronic products and machinery would most likely to be targeted by the Trump administration for high tariffs.

Trade friction between Japan and the US

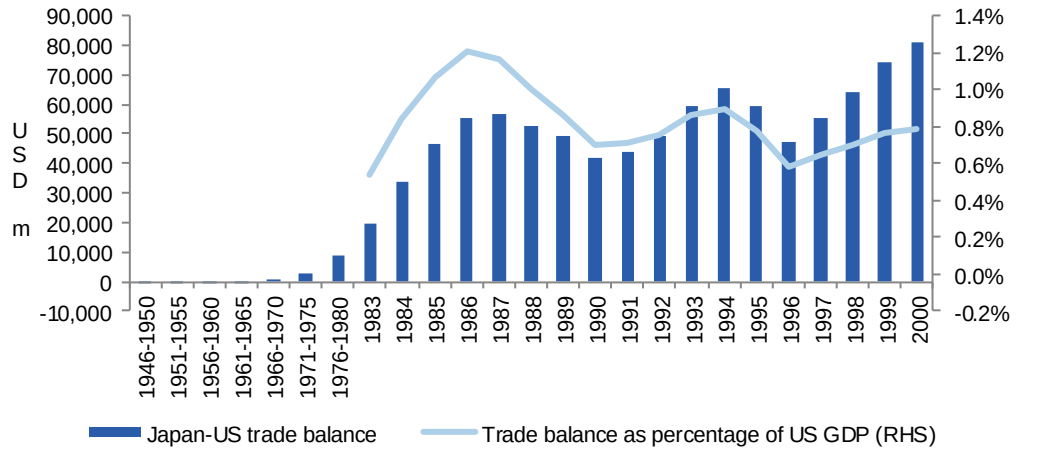
US Japan trade friction: from textiles to autos

Japan joined the General Agreement on Tariffs and Trade (GATT) in 1955 and gradually liberalized its trade with other countries. As the competitiveness of Japanese products improved, from the mid-1960s the US began to run significant trade deficits with Japan.

In the late 1960s, textiles was a leading industry in Japan, and textile exports to the US became a threat to the US. In 1971, after a two-year negotiation, the Nixon administration made a voluntary agreement with Japan to curtail excessive textile imports. Textile imports from Japan were assigned specific import quotas, which were based on imports from Japan in 1969 plus a reasonable growth factor.

However, an increasing number of Japanese manufactured products became competitive in the US market, and the US trade deficit with Japan continued to expand in the 1970s. In 1974, the US government signed another deal with Japan to put a voluntary cap on its steel exports to the US. In 1976, the countries reached further agreement on restricting special steel exports to the US. Even so, in 1977, a US steel manufacturer filed a claim asking for an investigation of possible dumping by five Japanese steelmakers. It was not until 1979 when the US introduced the Trigger Price Mechanism (TPM)[5] that the trade friction between the US and the Japanese steel industry started to cool down[6].

Fig 26 Japan's trade balance with the US (1946-2000)



Source: Bank of Japan, US Census Bureau, etc, Mizuho research

[5] The mechanism allows the US government to start an anti-dumping investigation when the price of imported steel is below a certain level. See Garry P McCormack, "The Reinstated Steel Trigger Price Mechanism: Reinforced Barrier to Import Competition" , Fordham International Law Journal, Volume 4, Issue 2, 1980

[6] Jiang Ruxia, "Study on Trade Frictions between USA and Japan after the Second World War", 2011, Jilin University

The most intense trade friction between the US and Japan was in the auto industry. In 1978, auto exports from Japan to the US exceeded 1.5m units, before reaching 1.92m units in 1980. Japanese cars contributed 80% of US auto imports and took 20% of the overall US auto market. The US government had to set aside USD1b to subsidize the US auto industry.

Consequently, in 1979 the US government required that Japan open its domestic auto market, set up automobile factories in the US, and adopt voluntary quotas for auto exports. In May 1980, the Japanese government agreed to reduce tariffs on auto parts from the US and limit auto exports to the US to 1.68m units by 1983. Later, the quota was gradually expanded to 2.3m units by 1991.

Moreover, to reduce the US's huge trade deficit, five major industrialized countries including the US and Japan negotiated to allow the USD to depreciate in the Plaza Accord in 1985. (see ***Why a new Plaza Accord would be good for China and the global economy***, 25 February 2016). The JPY appreciated significantly against the USD.

However, except for the first few years, such efforts were not effective in reducing the trade deficit between the US and Japan in the auto sector. In the early 1990s, the auto industry's trade deficit accounted for three-fourths of the US-Japan trade deficit and one-half of the overall US trade deficit. After President Bush's visit to Japan, the Japanese government decided to lower the auto export quota to the US from 2.3m units to 1.65m units in 1992. But in 1993, the Clinton administration required Japan to further open its domestic auto market. In 1995, the two countries reached agreement on autos and auto parts.

In addition to these major frictions, the US conducted dumping investigations on imported televisions from Japan in the late 1970s and signed an agreement with Japan covering semiconductor materials exports in the late 1980s. Other electronic products such as computers and telecom equipment were involved in the trade friction as well. In response, although Japan ran trade surpluses with the US in general, the Japanese government put restrictions on US agricultural product imports, including beef and oranges.

Fig 27 Major trade frictions between the US and Japan

Time	Industry	Event
1957	Cotton goods	The Voluntary Export Restraint agreement with the US called for Japan to restrain its textiles exports to approximately 1.5% of U.S. domestic production of textiles, with a one-time 5.2% increase in exports permitted in 1959
1969	Steel	Steel manufacturers in Japan agreed to restrict their exports to the US voluntarily.
1971	Textile	Japan-US textile negotiations
1974	Automobiles	The US automobile industry sought 'import relief' to protect it against Japan's rising share of the US car market.
1977	Steel	A request by the US steel industry led to the implementation of the steel Trigger Price Mechanism (TPM) in 1977. The TPM established a minimum price for steel and treated any price below the minimum as dumping.
1977	Color TVs	Orderly Marketing Arrangement limited Japanese color television exports to the United States.
1981	Automobiles	In 1981-84, Japan began to limit exports of passenger cars to the US to 1.68m units a year. In 1984 and 1985, the quota was extended to 1.85m passenger cars. In 1986, Japan's Ministry of International Trade and Industry assumed unilateral responsibility for limiting the quota to under 2.3m units a year, which lasted until 1991.
1986	Semiconductors	In the 1986 US-Japan semiconductor trade agreement, Japan agreed to end the 'dumping' of semiconductors in world markets (not just the United States) and to help secure 20% of its domestic semiconductor market for foreign producers within five years
1987	Electronic products	The US imposed punitive tariffs on four types of electronic products from Japan.
1992	Automobiles	Japan cut its auto export quota to 1.68m units.
1995	Automobiles	US-Japan auto parts agreement: allow US car and auto parts to enter the Japanese market more effectively.

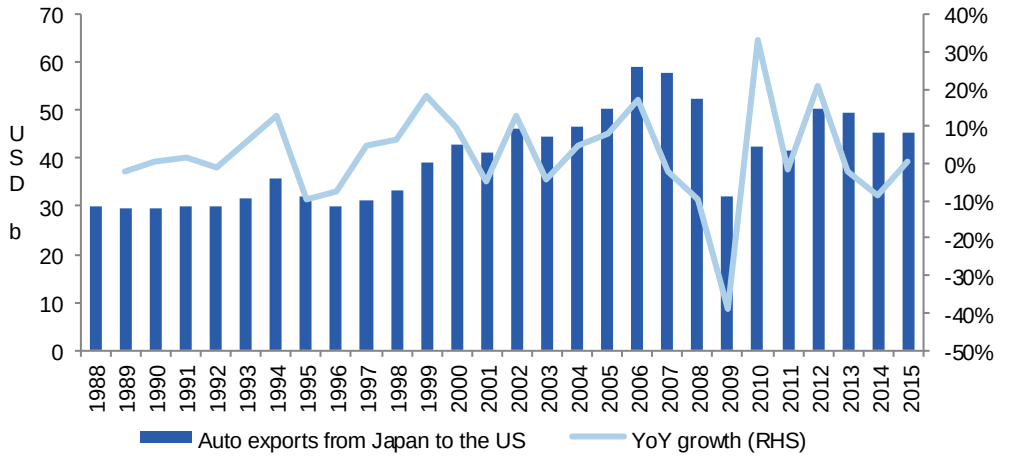
Source: Mizuho research

It was not until the mid-1990s that economic relations between the US and Japan began to improve. The US's trade deficit as a percentage of US GDP declined. Most trade frictions were settled under the World Trade Organization (WTO) framework from the 2000s.

Impact on Japan's economy

We believe the direct impact of high tariffs and export quotas on the Japanese economy was limited as the trade friction was concentrated on only a few sectors. The situation was different from the 1930s, when the US's Smoot-Hawley Tariff Act raised tariffs on thousands of imported goods. For example, when Japan cut its auto export quota to the US from 2.3m units per year to 1.68m in 1992, the value of Japanese auto exports to the US declined by only 1% that year. The impact on the overall economy was even less.

Fig 28 Japanese auto exports to the US

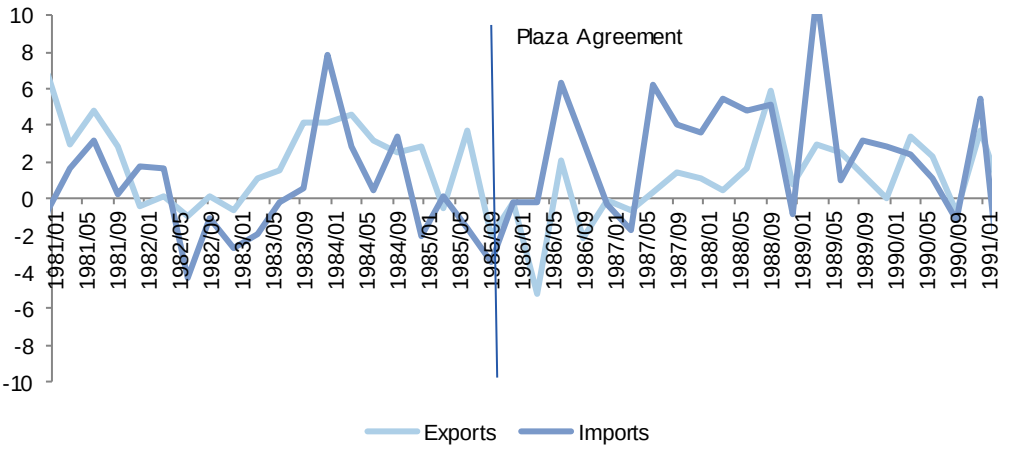


Source: Wind, Mizuho research

But trade friction did affect the industries involved; Japanese auto makers invested in the US and made Japanese brand cars in the US due to government intervention. Export quotas also encouraged Japanese manufacturers to export high-end products to the US.

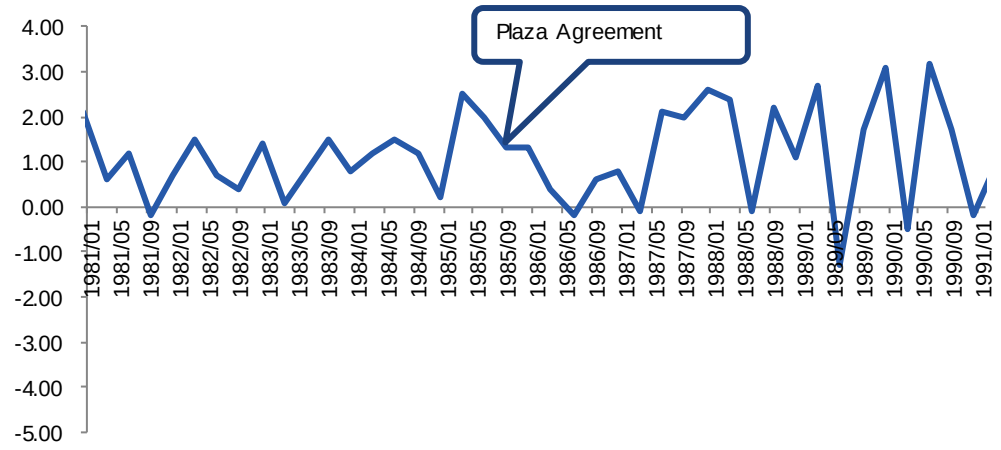
Nevertheless, the exchange rate adjustment after the Plaza Accord looks to have been very costly for Japan. Sharp JPY appreciation dampened Japanese exports and triggered a recession in 1986; the Bank of Japan had to lower its policy rate to stimulate the economy. Massive liquidity injections together with capital inflows caused by continued JPY appreciation created bubbles in asset markets. The collapse of these bubbles was a major cause of Japan's extended recession from the 1990s.

Fig 29 Goods and service trade of Japan (1981-1990) (%)



Source: Wind, Mizuho research

Fig 30 GDP growth QoQ after seasonal adjustments (%)



Source: Wind, Mizuho research

Though exchange rate adjustments were costly for Japan, we note that such adjustments were still not effective in reducing the trade deficit. Compared with the early 1980s, the JPY has appreciated significantly against the USD. However, Japan's trade surplus expanded further and remained at a relatively high level until recently.

Fig 31 Japan's trade balance with the US and JPY exchange rate

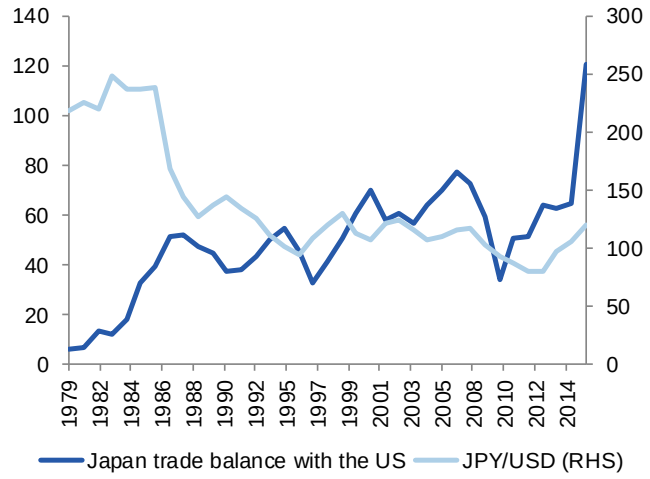
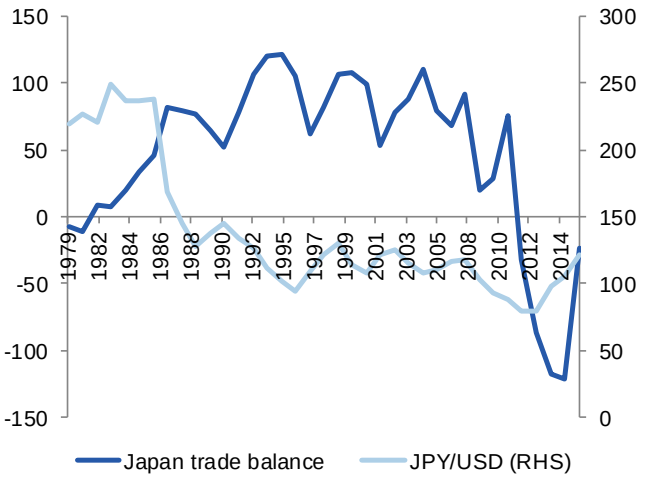


Fig 32 Japan's overall trade balance and JPY exchange rate



Source: Wind, Mizuho research

Implications for the Chinese economy

A review of Japan-US trade friction suggests that China should consider opening its domestic market further and even implement self-imposed voluntary export quotas for some products to avoid the high tariffs that come with a full-blown trade war. In this case, high-tech companies, service companies, such as US financial companies, as well as relatively high-end Chinese exporters could benefit. In fact, further opening domestic markets may help China to advance its market entry reforms in sectors dominated by state-owned monopolies.

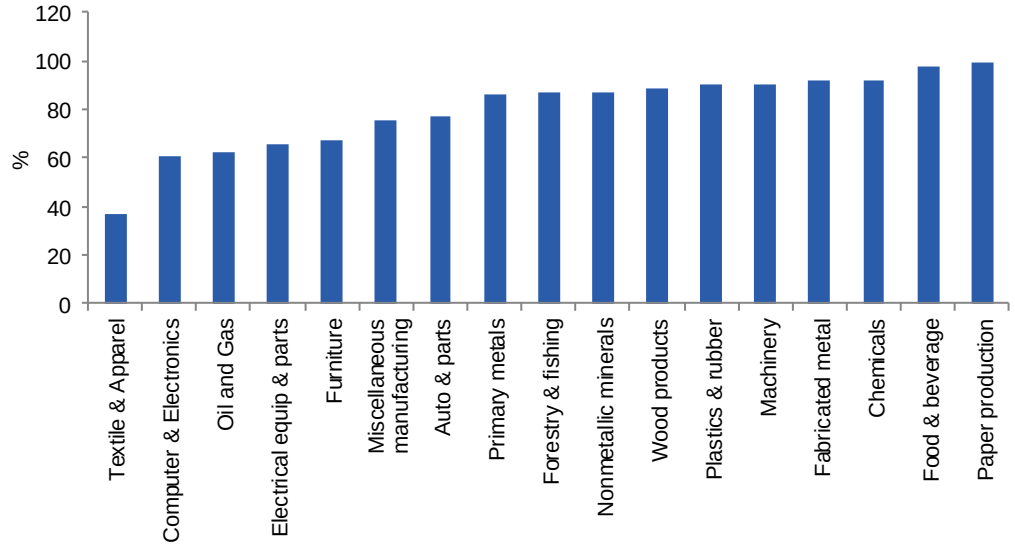
History also seems to suggest that China should avoid relying heavily on exchange rate adjustments to ease a trade imbalance. Sharp appreciation of the RMB could dampen the export sector significantly in the short run but seemed to have limited impact on the trade balance over the long run. Moreover, even if the export sector is affected by a China-US trade war, Japan's experience seems to suggest that China should avoid over-stimulating the economy, particularly when a housing bubble is already a concern for policy makers today (see ***China's monetary policy dilemma under a strong US dollar***, 6 December).

Sectors in which the US may start a trade war

While President Trump has suggested that he may impose high tariffs on imported goods from China, it is more likely that the new US administration would choose to shortlist some products for tariff hikes if a trade war does break out. We believe three criteria could be used to determine what sectors are most likely to be affected: 1) domestic production in the US as a percentage of total US consumption is low; 2) sectors for which the US still has some production advantages; and 3) sectors for which China exports massively to the US.

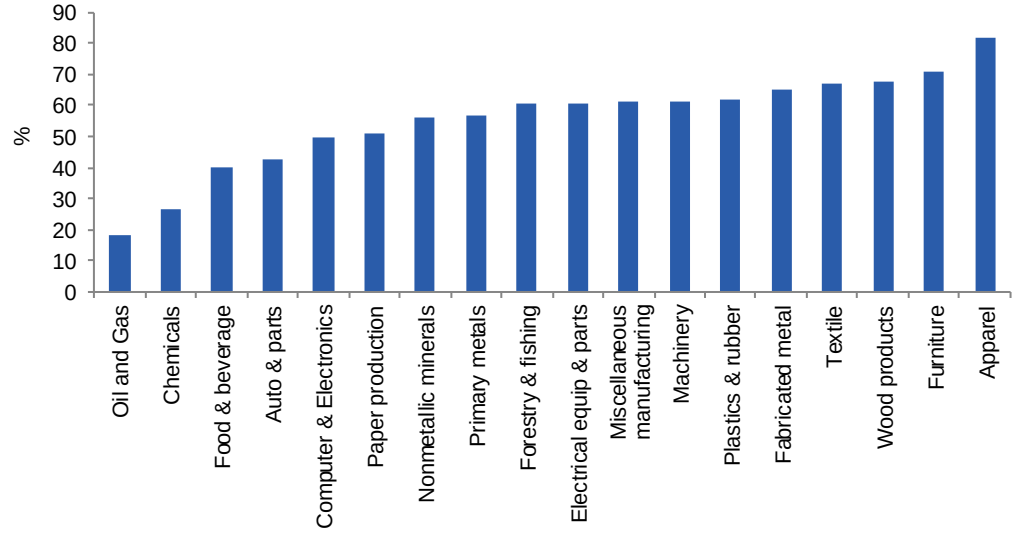
Our conclusion is that if the US is going to start a trade war, most likely the new administration would impose tariffs on computers & electronics, electrical equipment, and machinery exported by China.

Fig 33 Domestic production as a percentage of total consumption for major industrial goods in the US



Source: BEA, Mizuho research

Fig 34 Labour's share of total value added in major industrial sectors in the US



Source: BEA, Mizuho research

5. China's best defence against a trade war

We maintain our view that China could experience a demand shock if the US really starts to impose barriers against Chinese products, given the significant trade surplus that China currently runs with the US. While much remains unclear, it is important for China to take stock of its available options in case the trade environment does deteriorate soon.

For the US, China's powerful consumption market is too big to miss

Specifically, we believe China's domestic demand arising from its massive population and rapidly growing spending power may be China's best defence against the threat of a trade war. In our view, given the size of the market that the US may have to forgo when China retaliates, the cost of a trade war with China could potentially be even more formidable than the trade war with Japan during its heyday in the 1980s.

Fig 35 A trade war between China and the US would come at a huge cost to both economies

Source: CEIC, Mizuho research

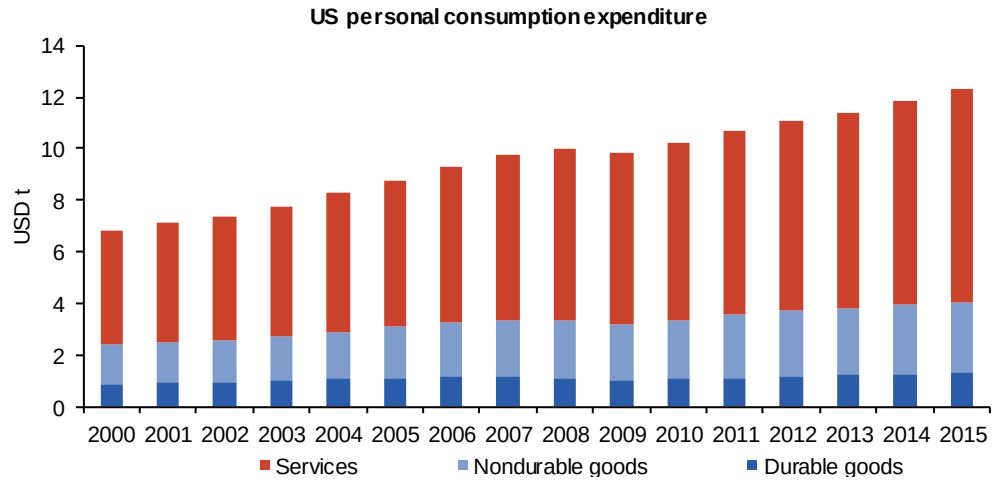
China's market will soon be larger than the US's

Devoting a high percentage of expenditure to merchandise

China's domestic market for merchandise is about to exceed that of the US, given China's much higher weighting of household expenditure on merchandise and the rapid increase in consumption.

In 2015, the latest year for which data is available, personal consumption expenditure (PCE) in the US came to USD12.3t, more than double that in China, whose spending was equivalent to USD5,773.3b. However, within the US, around two-thirds of PCE went for services, with the actual amount spent on merchandise coming in at USD4,012.1b. While a comparable breakdown is not available from China's official data, China PCE's notable resemblance to retail sales growth implies that the weighting of merchandise consumption in China is much higher.

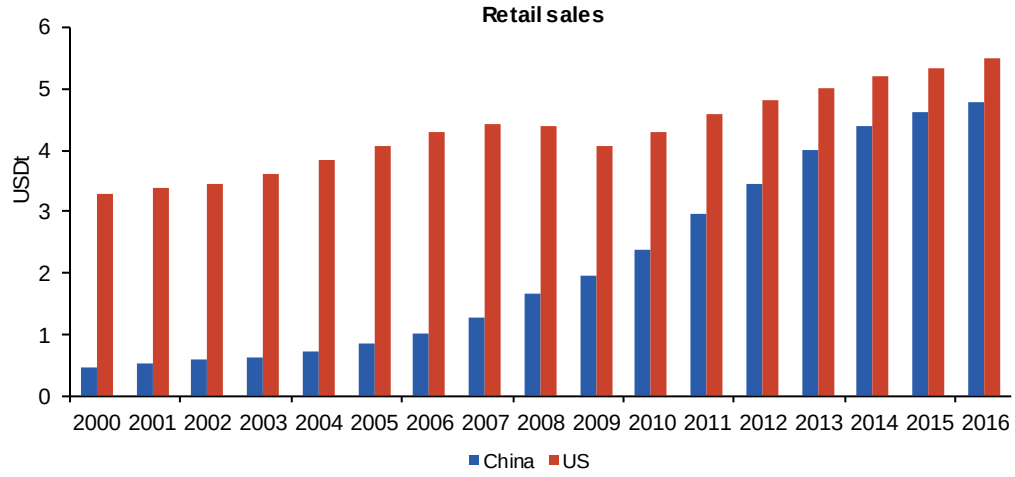
Fig 36 Merchandise only accounts for around one-third of US personal consumption expenditure



Source: CEIC, Mizuho research

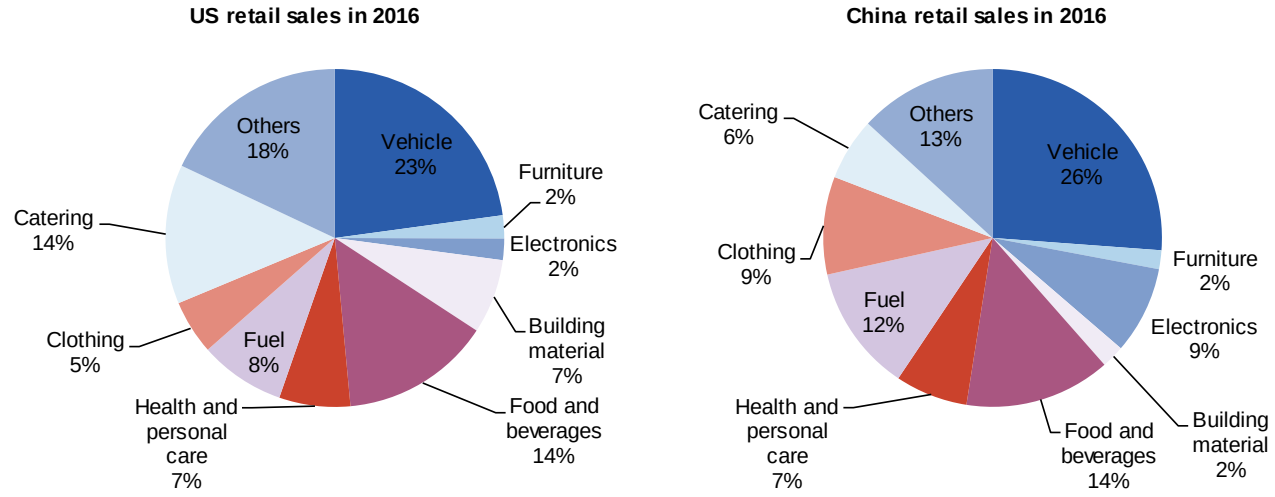
In 2016 China's total retail sales reached CNY33.2t, the equivalent of USD5,000.9b, broadly comparable to the USD5,504.1b figure in the US; this was the result of a sustained period of rapid growth in China. During 2007-16, China's retail sales increased by 15.4% YoY on average compared to 2.5% YoY in the US. In terms of tradable goods in the retail sales basket (removing the contribution from food services and fuel), the gap between China and the US narrowed even further.

Fig 37 China's retail market is about to overtake the US to become the world's largest



Source: CEIC, Bloomberg, CE Mizuho research

Fig 38 Retail sales portfolios in 2016

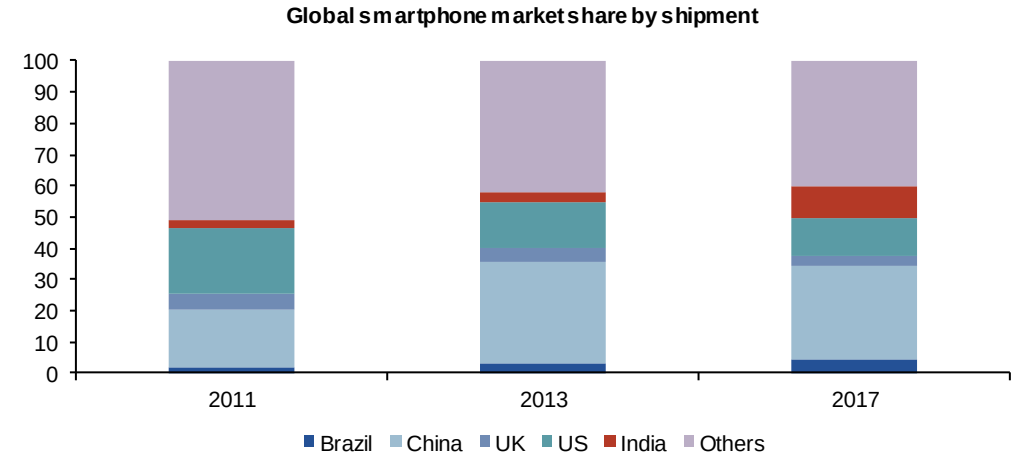


Source: CEIC, US Census Department, Mizuho research

Smartphones

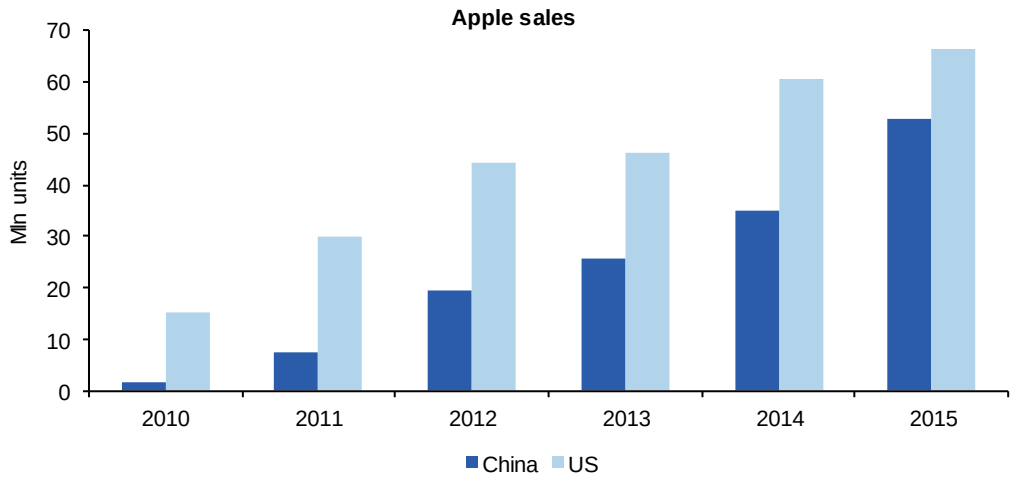
China overtook the US as the world's largest market for smartphones in 2012; now the size of the Chinese smartphone market is more than double that of the US. In the case of iPhones, sales in China are fast approaching the US level.

Fig 39 China's smartphone market overtook the US's as the largest market in 2012



Source: CEIC, Mizuho research

Fig 40 Even for Apple, Chinese sales are approaching that of the US



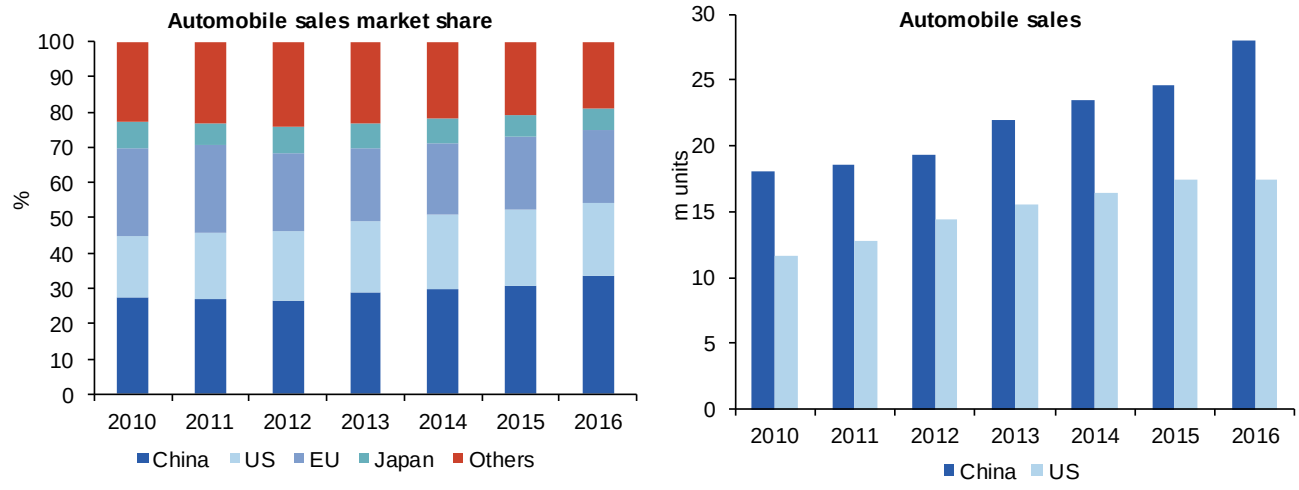
Source: Gartner, Mizuho research

Automobiles

In 2016, 24.3m passenger cars were sold in China, 60% more than in the US. The lead was widened by a buying frenzy triggered by a tax cut on small cars, but China has long since surpassed the US to become the world's largest passenger car market, reaching the top spot in 2009. Among passenger cars sold, 98.8% are made domestically, but 56.8% are foreign brands.

US auto makers' market share is over 20% in China, with imports from the US focused primarily on trucks and luxury cars. These are market segments that are discouraged by the Chinese government, partly out of concern for rational energy use and emissions. Luxury imported cars in particular were targeted with an extra 10% tax hike in December 2016 to discourage unreasonable consumption. A trade war could compress this market for the US even further.

Fig 41 China became the world's largest passenger car market in 2009

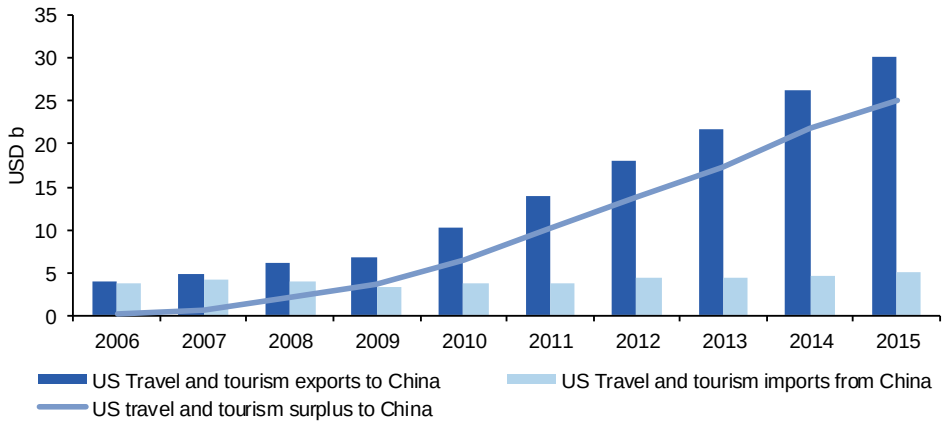


Source: Bloomberg, Mizuho research

Tourism

One area in particular where we believe the US would incur a significant net loss is the travel industry. Not only is China the world's largest outbound tourism market, Chinese tourists also spend heavily. In 2015, 2.6m tourists from China went to the US, while 2.1m US tourists travelled to China. Given the much higher average spending from Chinese travellers, the US enjoyed a USD25.2b surplus vis-a-vis China from tourism in 2015.

Fig 42 The US runs a surplus against China in the tourism sector



Source: CEIC, Mizuho research

Ensuring steady, healthy growth of the consumer market

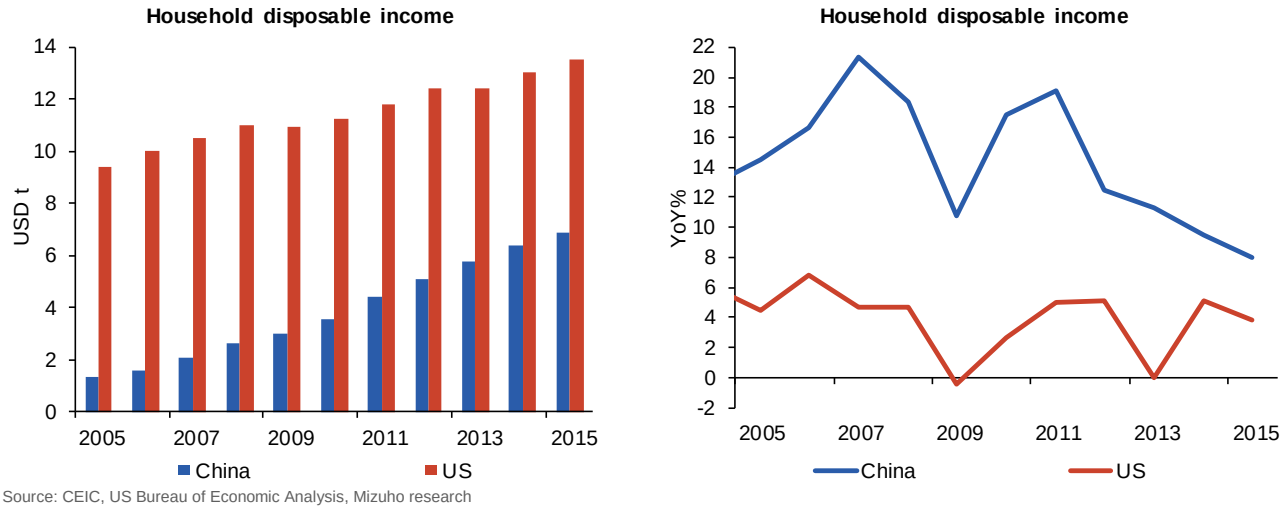
Maintaining steady, healthy growth in China's consumer market is critical. The Ministry of Finance has confirmed that personal income tax will break new ground in 2017, with the overall tax burden to be lowered by reducing tax receipts from lower income groups and expanding the size of the middle class. Meanwhile, as part of a more proactive fiscal policy, transfer payments will also increase for healthcare, elderly care, pensions, and civil servants. These measures should further increase the incentive to spend (see *The case for stable growth outlook in 2017,* 18 January).

Rapid growth in both income and assets

Robust income growth supports the rise of personal consumption

China's consumer market continues to hold substantial untapped potential. The Chinese Academy of Social Sciences (CASS) published a report on 17 January, in which it revealed that between 2004 and 2015, the average salary in China nearly tripled, while actual income increased even more thanks to contributions from rising business profits and investments. As a result, between 2005 and 2016, the contribution of wage-based savings in the wealth management market increased 9.6-fold, significantly more than the actual increase in wages. The CASS's finding tallies with the robust increase in household disposable income. Total household disposable income in China (USD6,366.9b in 2014) was around half that of the US. Yet household disposable income in China rose 18.6% YoY on average in 2005-14, much faster than the 3.8% YoY growth in the US. Per *Forbes*, while the US continues to be home to more billionaires than any other country, at 540 in 2016 (down from 563 in 2015), the number of billionaires in China increased to 400 in 2016, up from 335 in 2015.

Fig 43 Rapidly rising household disposable income in China



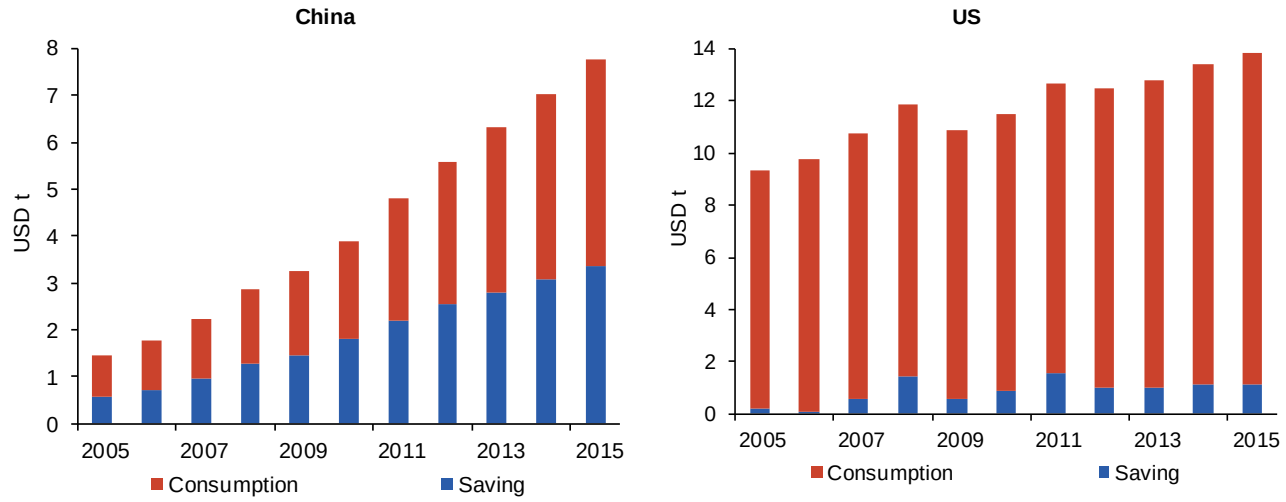
Source: CEIC, US Bureau of Economic Analysis, Mizuho research

Strong propensity to save boosts China's wealth accumulation

Despite the lower disposable income, China's household savings reached USD2,418.6b in 2014, more than double the savings in the US that year, thanks to a savings rate that is as high as 38% of total disposable income. China's savings remain larger than the US even after contributions to institutional savings plans, such as pension funds and social insurance, are factored in.

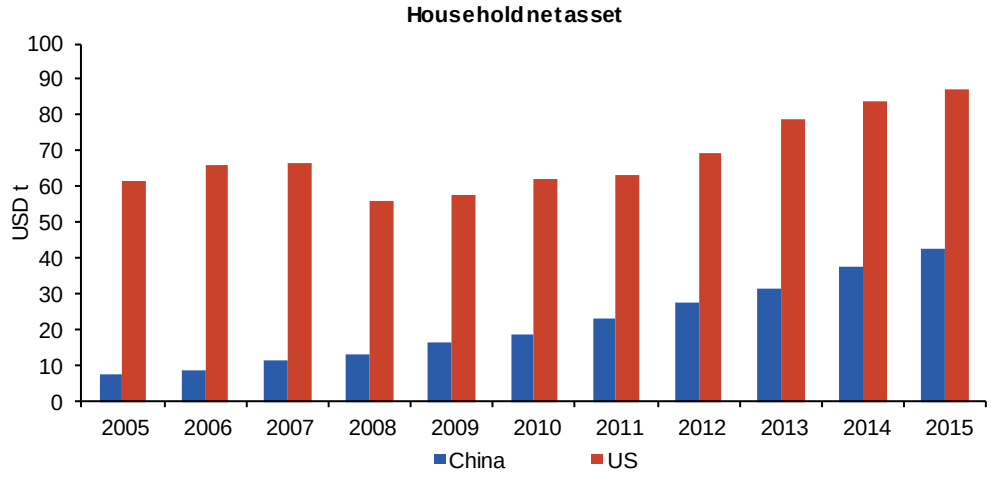
This has also translated into a rapid increase in total household wealth. Based on Professor Li Yang's studies on China's national balance sheet, we estimate that total assets in the household sector reached CNY265.2.6t in 2015, or roughly 48.9% of net household assets in the US. Following this wealth accumulation, especially after the substantial growth in property prices since 2015, positive wealth effects may entice Chinese households to consume more and cut their propensity to save.

Fig 44 Savings are much higher in China



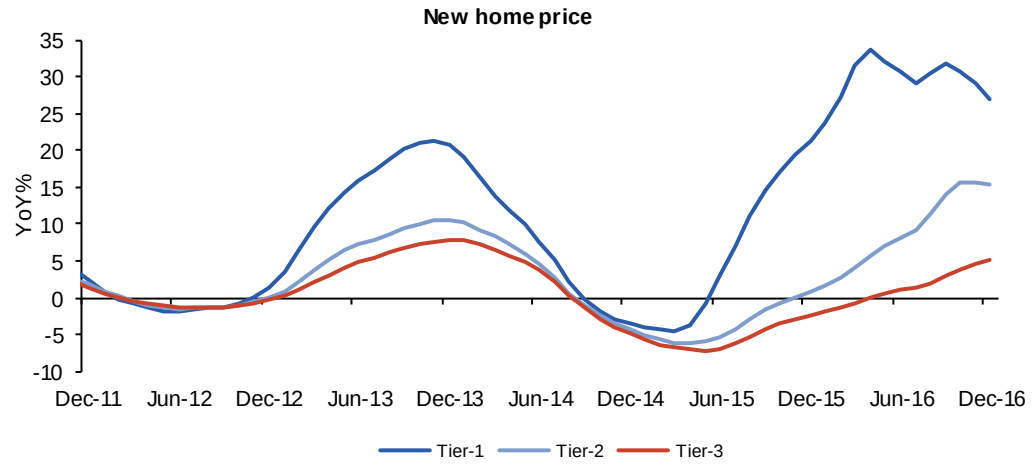
Note: Savings includes pension and social insurance reserve
Source: CEIC, US Bureau of Economic Analysis, Mizuho research

Fig 45 China also has a faster pace of wealth accumulation



Source: CASS, US Bureau of Economic Analysis, Mizuho research

Fig 46 Positive wealth effect comes from rising asset prices

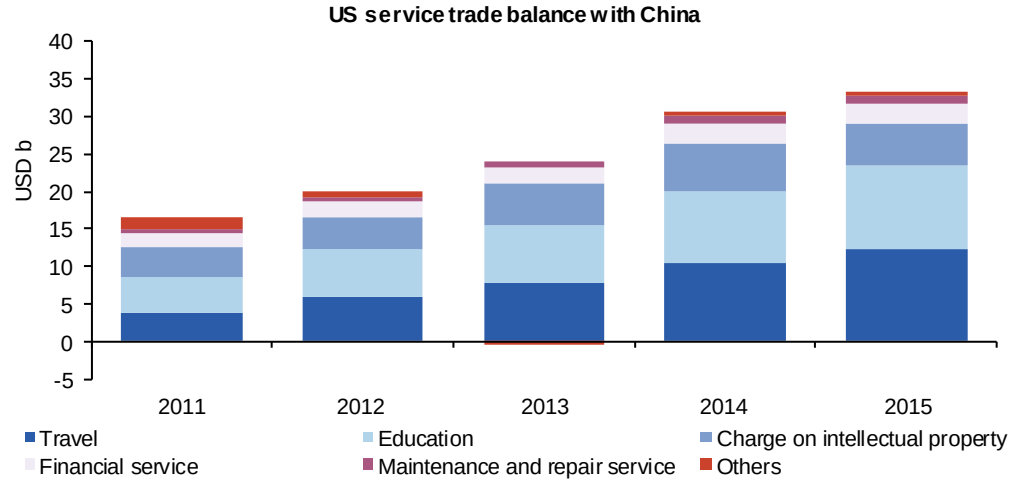


Source: CEIC, Mizuho research

Service industry could open further to the US

We believe China could stand ready to open its service sector further, especially in the technology-related portion of the service sector, if a trade war cannot be avoided. As discussed, the sizeable service trade surplus that the US maintains on China suggests that the potential for US companies in China is strong. According to the US Department of Commerce, US service exports to China created 273,000 American jobs in 2014. In particular, by re-opening China's market to US tech giants such as Google and Facebook, China could receive a boost in the quality of its service industry and make more powerful, friendly connections in the US.

Fig 47 Potential for expansion of service trade between the US and China, especially in technology



Source: Bureau of Economic Analysis, Mizuho research

6. Further liberalisation of the Chinese economy to showcase 'inclusive globalization'

During the World Economic Forum (WEF) in January, President Xi Jinping's speech on 'inclusive globalization' made a deep impression in a forum that was otherwise dominated by concerns about a surge in protectionism. In our view, the change of tide represents an opportunity for China to take on the role as a global leader.

As discussed, the executive orders signed by the White House since President Trump took office on 20 January have shocked some of the US's closest allies and led to widespread protests at home. Together with the ban on travellers from seven (predominately Muslim) nations, criticism of Germany for manipulating the Euro, and the "America First" foreign policy slogan, we believe the world will soon be ready for new international agreements and a re-ordering of the status quo, with China in a position to play a more important role.

As such, China's best strategy against an increasingly strident US may be to continue avoiding confrontation. Instead, China should garner support from other countries that also consider international collaboration to be an important principle.

Against this backdrop, we believe it is important for the PBoC to keep the RMB stable, rather than allow further depreciation by increasing the flexibility of the exchange rate regime. While this may appear to be contrary to our long-standing belief in reform and market liberalization, we think it is necessary because the PBoC will need to be cautious about potential US allegations that the RMB is being artificially weakened.

In our view, China's policymakers should also prepare for the worst, for example if the US decides to unilaterally impose trade sanctions on Chinese products. This would include – as a last resort – preparations to allow the RMB exchange rate to move freely, which could imply a massive one-off depreciation against the USD.

All in all, though uncertainties loom in the China-US trade relationship due to the Trump administration's aggressive posturing, China still has substantial bargaining power. We maintain that China's powerful domestic market, along with its sharply rising income and wealth, cannot be easily ignored by the US as it weighs the potential consequences of starting a trade war. With the right preparation, such as further reforms and market liberalization, a new world order could actually be a window for China to take on a new global leadership role.

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