Research @ Citi Podcast, Episode 21: Trade with China under Trump 2.0

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Transcript:

Johanna Chua (00:00)

I do think China, they would like to find a path to de-escalate and find some sort of deal to de-escalate, because as I said, China wants to— doesn't want too much volatility, does want to reduce some of the risk premium on trade policy.

Brent Robinson (00:14)

Welcome to the Research @ Citi podcast. I'm Brent Robinson. I'm the head of research across the APAC region based in Hong Kong. I have with me Johanna Chua, who's our chief global emerging market economist, also based in Hong Kong. And we're going to discuss the upcoming Trump administration and the relationship around trade between the U.S. and China 2.0, so to speak. And so I'll kick off with the first question, Jo. Welcome, Johanna.

Johanna Chua (00:41)

Hi. Hi, Brent.

Brent Robinson (00:43)

If you could give us real quick background on Trump 1.0, obviously, the first Trump administration had its trade issues with China, and how do those policies potentially differ in the second term?

Johanna Chua (00:55)

Right, no, absolutely. I mean, we all draw parallels. I mean, back in Trump 1.0, I don't think anyone was really expecting Trump to win off the bat in 2016. And obviously, when he won, there were still a lot of kind of institution guys in the Republican Party that were still pretty much entrenched in the bureaucracy of the government. So even though there was a lot of noise from Trump talking about trade and tariff, you would have to say, actually, it was a bit of a slow burn issue. There was a lot of noise. People weren't really sure how much to take it seriously. In fact, even when he got elected in November 2016, I would think actually the real fear of escalation of trade war and tariff war really didn't kind of kick in, especially against China, until about 2018. And actually, initially when he came in, you know, he kind of— he did a lot of other things that were not particularly targeted at China. So, you know, he withdrew from the TPP. He withdrew some cases from the WTO and undermined institution of WTO. And then when he announced the first line of tariffs, in fact, some of them were actually more broad against allies, like the Section 232 national security on steel and aluminum, which wasn't specifically targeted on China. So that was basically launched back in— the investigation started in April 2017 and didn't really kick in until basically March 2018. And then the China investigation started in the fall of 2017, but even there, it was still very targeted to a narrow set of goods, like $50 billion worth of goods. And then so back then when people were thinking about what was happening, they were thinking, Oh, you know, a lot of it is symbolic. It's going to be targeted. But then in the end, Trump delivered a much more hawkish, obviously, much, you know, larger kind of tariff increase in China with a lot of verbal rhetoric. So in the end, I think, on average, tariff increase in China went up about 16%, but it was belated. Like, it started a little bit later. It was ratcheting up. It didn't happen right away. And in the end, we got to kind of an average increase of 16% until we got the Phase One deal, and then that kind of stopped. And it sort of paused.

But this time around, I think, you know, obviously, now Trump is a much more known character, and the rhetoric coming out of trade during the campaign was much harsher, talking about big numbers, like 60% tariff against— across the board in China, you know, and then 10, 20% across everyone else. And so, you know, the headlines kind of come up larger. And because now we kind of know Trump, there was a lot more fear and anticipation of fear that this time it's going to be much more serious. But if you look at what we are assuming, so there's also a couple of conditions now that are quite different from what we were back in 2018–19. You could make an argument because we know more about what Trump could do. We also know that there's a track record now that he could front-load the tariff if he wanted to. We now realize there's a lot of executive power to impose tariffs without having to go through Congress because of existing laws or you have the International Economic Emergency Powers Act. So there's a lot of ammunition that he could do, and then the campaign was very hawkish. But on the flip side, there's also a different macroeconomic situation now in the U.S. relative to where it was back in 2017–18. Clearly, inflation, although it's come off, inflation, inflation expectation is obviously a bit more precarious where we are now in the cycle than back then in 2018–19, where we didn't worry so much about inflation. In fact, we just had Michigan confidence inflation expectation index over one year, actually, it went up 50 basis points in the last survey. So that's one thing that is a constraint.

And as you know, you know, China, despite some of the de-risking that U.S. has achieved in terms of reducing its import reliance, it's still very embedded and very reliant on China. And in a lot of our notes, we've been saying that actually, if you look at the details of the composition of China's exports to the U.S., 40% of those goods that China exports to the U.S., they have a market share of at least 70%. So it's not going to be very easy to substitute. So there's obviously going to be a little bit more sensitivity on inflation. And let's not forget probably a big reason why the Democrats, maybe, and Harris, Kamala Harris didn't do well in the last election was because of this backlash on inflation and cost of living. So that's one thing that's a little bit different, which should make some sensitivity around what you're going to do in terms of the timing and severity of tariffs.

And then the second thing that's a bit different now than what it was in 2018–19 is ironically, China has actually further gained global market share and manufacturing value-added, gained more global export value-added. Even though maybe the share to U.S. bilaterally has gone down, China's share in the rest of the world has gotten larger. And as you know, China has become arguably even more entrenched in some of the kind of global supply chains and intermediate goods and some of the critical products. So the tricky thing with this is that if U.S. goes very harsh on like clamping down, imposing very harsh tariffs on China, including intermediate goods from China, but China continues to trade with everyone else with very large kind of market share and a lot of, you know, a lot of, you know — obviously, it's very hard to displace — it could also backfire on the U.S. in terms of making U.S. industrial base even less competitive, which is part of— which is the thing that U.S.,Trump is going to kind of, is trying to aim at. So therefore, you know, you can make an argument, you compare 1.0, 2.0, you think, Oh, my God, I know more about Trump. He could do something bigger. He threatens bigger. He could do a lot of big stick. But actually—

Brent Robinson (06:04)

Sorry, just to interrupt you to that point, there's been an awful lot of volatility and how much of this is priced into the dollar and RMB and all these things?

Johanna Chua (06:12)

No, no absolutely, but just wanted to follow up point. So just to lay out the difference. Actually, in the end, when you look at what our assumption is that we've embedded or what we think — I mean, who knows what will happen — but our assumption is we are expecting the effective tariff rate that U.S. will increase on China this time around will be about 15%, eventually. I mean, 60%, maybe in some goods, maybe there'll be some exemptions, but overall, it'll be 15%, which actually is pretty much similar to what we already saw in the 2018–19. So it's going to be similar, and also our assumption is it will actually also be gradually phased in. So the end result of our assumption is not too different, partly because the background is obviously a little bit different.

And then now the question you have about DXY and Reminbi and how much it's priced in, you know, obviously, it's quite difficult to kind of factor that in because there's a lot of things that are driving the stronger dollar. It's not just tariff, although tariff risk premium is a big part of it. I mean, part of it is also the fact that, you know, U.S.— no one's really expecting US recession now. We've had a bit of extended U.S. exceptionalism. People are repricing expectation about the Fed. So part of it is also driven by interest rate differential. But at the moment, you know, we have seen a bit of a pare back of gains of DXY. I mean, DXY rallied over 6% since Trump won, and then we've kind of given up maybe half a percent from here. And our strategist is saying, you know, even though in the end, we may not get the draconian outcome that we were expecting that was being kind of campaigned, we could still have a lot of verbal rhetoric and noise. So I think we're still factoring in maybe another maybe 1–2% upside on DXY at this point. So we're kind of close to the peak of that adjustment. And even though it comes off after that, you know, we have to factor in that because of this rhetoric, I don't think we're going to go back kind of the lowest previous range. We're going to be in a new kind of higher range, but probably a little bit off the peak after maybe another few run after, you know, inauguration as well.

Brent Robinson (08:00)

And back to your comment about a gradual increase. There's an awful lot of talk about these gradual month-by-month increase in tariffs. How does that work? And why would that be advantageous? Or is that just a negotiating tool?

Johanna Chua (08:13)

Yeah, so I mean, at the moment, first of all, we don't know if the noise around month to month, kind of, you know, 2% a month average tariff increase, something that Steve Miran, the nominee of the chair of the Council of Economic Advisors had mentioned in one of his essays before he got nominated. First of all, we don't know if that's exactly going to happen. But I think it's the first tangible kind of evidence that the approach for tariff will be very gradual. You know, because there was a little bit of tail risk, we kind of don't know exactly what Trump's going to do. So the extent that there was a tail risk, he might do something draconian up front, in a way, some of these noise coming out is kind of validation of the fact that they're going to be a little bit more careful. As I mentioned to you, not only because of the inflation, inflation expectation, but if you do a big adjustment and you make U.S. even less competitive, it can also have financial market implications. So I think that's partly what the market cheered about. But the other thing we need to know is it's one thing if it gradually kicks in, but then what's the endpoint? I mean, it wouldn't be great. If it's 2% every month, but it goes all the way to 100%, that's not good. So, but I think that leaves room for some negotiation.

Brent Robinson (09:19)

Yeah, and so if you look at your point around Trump himself has gone a bit quiet on China, and China's also not really been that proactive. They've been kind of waiting, right? So whatever happens, how do you see China domestically responding?

Johanna Chua (09:37)

Well, first of all, I mean, the fact that Trump has so far been relatively quiet, I mean, he's made a lot more noise on allies — like 25% tariff in Canada and Mexico, or even going after Denmark. But the fact that he's a little bit quiet in China, there's two theories around that, right? So on the one hand, you can make an argument. Similar to Trump 1.0, he went after broad-based tariff before he really went after China later on. So you could make an argument: maybe this could be the calm before the storm, because if Trump is looking for some quick win of negotiation and using tariff as a tool for negotiation, it's probably easier to get some sort of concessions from allies than it is to kind of find a deal with China. So one theory says: okay, maybe it's a sequencing thing. This is just kind of calm before the storm. You want to tee up some negotiation with allies to get some sort of concession and win, and then you go hard on China later on. So that's one theory.

But the other theory is that, you know, maybe, again, because of China's— you know, we're at a point in the cycle where the situation has changed. Maybe there's a lot of backdoor communication that's going on between U.S. and China. I mean Trump had said publicly that there is some communication. And so we don't know to what extent that because China is not going to cave in that easily the way maybe allies might be more willing to adjust, that maybe part of the reason why it's been a bit more quieter is, again, you don't want to create a lot of volatility. Maybe China has a little bit more bargaining negotiation and maybe it will really not be as draconian as people expect. Now, at the moment, because the track record of Trump is that his strategy’s— negotiating strategy tends to escalate before you de-escalate. And even in Trump 1.0, he kind of went after broad-based kind of trade policies that didn't specifically target China before he went for China. I think it's too premature to say, you know: oh, you know, then China will be immune. I mean, I really think this is still a little bit of calm before the storm and there's still a lot of risk of noise coming out of the U.S., even though in the end, it will not be implemented. Just the noise itself could create enough volatility for the market.

Brent Robinson (11:37)

China's global manufacturing dominance and exports have actually increased its share. Do you see any risks of a hollowing out of China's economy when these trade barriers continue over the Trump administration and what kind of response would China have? And does that include the diversification into the Southern Asia Pacific region?

Johanna Chua (11:59)

Right. I mean, obviously, China already sees that we're going through a period of strategic rivalry between the U.S. and China that, you know, it's not really going to end anytime soon. And so there's definitely been a lot of protectionism backlash coming from the developed markets, including more restriction and technology transfers, et cetera. So obviously, from China's perspective, China benefits a lot from globalization. They gain a lot from maintaining, you know, global supply chain and access to free markets. But the U.S. has become a little bit more antagonistic. I think China's part of the logical response to that is you want to make sure that you still stay integrated with other markets. Or you further entrench yourself with the supply chain. And if anything, because of this national security imperative, because under Biden, we even had more— aside from tariff, we even had more stringent export control. I think then China obviously has to double down on a lot of its supply-side industrial policy so that they can gain some level of technology self-sufficiency in critical— or even gain a lead in technology, like in clean tech. So, in a way, part of the diversification we're seeing in Global South maybe partly a kind of a deliberate strategy to find new markets because you've got a lot more restrictions and barriers coming from developed markets. But part of it is also a response to the fact that because you've been doubling down on supply-side industrial policy at a time when domestic demand has been weakening and further weakening because of what's happening in the real estate and other things that have been happening to China since the COVID pandemic, this unbalanced policy of supply relative to demand is creating even more competitiveness in terms of your goods export that is further, you know, allowing you to gain more export market share in other of the Global South. So there's multiple factors that's driving this, partly that unbalanced policy. It's partly your desire to kind of diversify. And also, actually, a lot of the gains that China has been making in clean tech products like EV, et cetera, some of that was a kind of a bet that China made like a decade ago. And over time, through economies of scale, you just become more and more competitive. And economies of scale creates a lot of price competition and more efficiencies and productivity growth. And that— actually that price decline basically created a new demand for the Global South that you didn't think was going to be there. Like, Brazil would not have adopted EV as fast as it did, if not for the fact that it became so competitive, that the price became so. So there was multiple things.

But I have to say, I have to warn you that this is not a panacea. This is not a solution to China insulating itself from the protectionism from the West, because obviously, U.S. is still a very, very important market. It's still the largest consumer market, very profitable market. So they can’t— you know, there's a big cost to forgoing that. And second, that a lot of these Global South countries, you know, they also want to develop their own domestic industrial base. And so the risk here is that if too much cheap goods come from China — and again, China's competitiveness is not just in the high end, you know, high tech EV industrial goods — it actually is broadening out even to lower-skill manufactured goods. Like even Indonesian footwear manufacturers have to worry. So because of the unbalanced policy, it's even creating a lot more pressure for some of those countries on the receiving end to then also be worried about protecting their domestic industries. And if there's either tariff or non-tariff barriers that would pose a constraint— and then again, a lot of companies also want to diversify. As I said, U.S. is still a very important market, and you don't want to forego that. So then you will try to find ways to use other third-party rerouting countries to access the U.S. market, to the extent that that pressure is going to be continuing and continuing, and we will see to what extent Trump will use policy to clamp down on that. That also does induce more hollowing out of your economy. And more so if you're not successfully able to reflate domestic demand in China, then profitability in operation in China, relative to opportunities elsewhere, will make it more attractive for companies to go overseas.

Brent Robinson (15:56)

Well, and if you stay on that China competitiveness on exports, even in Trump 1.0, China struggled to export the kind of numbers that they agreed to with the Trump administration — I think, 200 billion or whatever — they never even got close. So if China does try to bridge that gap, what type of exports is it? Because Xi and the Trump administration are more sensitive to EVs. Is it pork and beef and raw commodities, and what is it they export?

Johanna Chua (16:23)

Yeah. So I actually think at this point, I really don't think a shopping list of purchases from the U.S. is really going to be enough for Trump. Because, like as you said, Phase One trade deal, there was a lot of hoopla about that, but in the end, they significantly massively underdelivered their commitments to that Phase One trade deal. So when you come back to a negotiation to avert tariff escalation, China's starting point is already from deficit. So there needs to be something else offered to the table. And I think again, I think— it's not clear to me if there's going to be one item. It may have to be multiple items. And, you know, I think we listed down some of the possible things that can be up for negotiation.

So aside from a shopping list of buying agri products or energy, again, another avenue could be market access. Because you can make an argument that, you know, obviously with national security issues, there's still a lot of potential regulatory restrictions that China could ease up on for market access. So, for example, people look a lot to the fact that the relationship of Elon Musk and Donald Trump. And Elon Musk, as you know, Tesla has a lot of business in China. 21% of revenues come from China. So there's a lot of car sales in China. And as you know, Tesla has a lot of ambition for autonomous vehicles in China. So, you know, could you get some regulatory access there? Could you get something on Apple being able to sell their iPhones or something related to market access could be part of the negotiation.

The third question is whether it is possible— because China has now, you know, kind of exceeded in terms of becoming the most competitive in a lot of clean tech products. If Trump is really serious about revitalizing domestic industrial manufacturing base in the US, is it possible to open up the opportunity for greenfield investment from China to U.S. to create jobs like factories? The challenge here is that although Trump has mentioned it, he seems to be open about it in the campaign. There's obviously a lot of more Sinophobic, hawkish people in the Republican camp that might see that more as a national security— I mean, they will welcome factories from Germany and Japan. It might be a little bit more complicated. So I don't know whether that will fly.

The fourth possibility is obviously fentanyl and money laundering related to that, because obviously Trump wants to go hard on crime and drugs, so that's possible. Maybe there's some cooperation. The fifth thing, maybe there could be something security related. I mean, you could make an argument if Trump really wants to basically, you know, broker a Russia–Ukraine ceasefire, you know, in six months, there could be something on the back door related security. Again, we don't know. The other thing that people—

Brent Robinson (18:44)

There are a lot of possibilities.

Johanna Chua (18:45)

A lot of possibilities, but— and then the other thing is people raised the issue about FX. Could there something be related to FX. But I find this much more difficult. Again, because, you know, people kind of draw analogies with like Plaza Accord and maybe we'll have a Mar-a-Lago Accord. But the difference now is it's easier to coordinate kind of a multilateral kind of agreement on currency between allies. It's kind of harder to do that with China when there's— and obviously a bilateral FX deal doesn't really— you need something more multilateral. Even though we can all make an argument that Renminbi does not look expensive, I mean, Chinese goods are super competitive. But the issue is because of this, you know, lack of confidence in China, weak demand, you now have deflationary pressures.

So China doesn't look like Japan in the mid-80s when the Plaza Accord was negotiated. China looks like Japan in the 90s when the real estate bubble already burst and you have a real estate deflation. So the worry there is that, you know, to what extent, kind of an FX deal, how do you negotiate that and not worsen deflationary expectations? So it really needs to come alongside a very large stimulus coming out of China on the fiscal side. And I think those things are very, very hard. So I'm not particularly optimistic that it will happen anytime soon.

Brent Robinson (19:57)

So other than a Mar-a-Lago, you know, currency-type accord, you know, Trump is obviously a deal maker. So is there a grand broad bargain that they would come to some free trade agreement on certain items or is that just silly?

Johanna Chua (20:14)

Look, I think, obviously, he wants to, right? You know, as you know, Trump, you know, the art of the deal, right? I mean, there's a debate that this is his last term. He doesn't have to run for re-election. If he really wants, you know, legacy, then maybe he might want the grand bargain. But the problem with the grand bargain is you're making an assumption that just by dangling the tariff stick, on people, on other countries, that that's enough to get everybody to, you know, toe the line of whatever objective you want to do. And I think again, it's a challenge because, you know, maybe if you're dealing with another smaller country who's dependent on you on security, on energy, you know, you can impose a little bit more influence. But when you come with China where there's a lot of moving parts, there's a lot of distrust and not to mention that, you know, Trump is only there for four years. And from Xi Jinping’s perspective, he has a much more longer horizon with different objective.

Like I said, I do think China, they would like to find a path to de-escalate and find some sort of deal to de-escalate because as I said, China wants to— doesn't want too much volatility, does want to reduce some of the risk premium on trade policy. But the path for there is complicated and uncertain. And that's part of the reason why when we look at our assumption of tariffs and what U.S. will do for the rest of the world, we are assuming that China will still get a higher tariff than everyone else. It may not be as high as 60%, but it's still going to be higher. And it's partly because there's a lot of strategic objective of why you'd want to impose a higher tariff on China from the U.S. side, but also just the path of negotiation to reach a detente on tariff just looks more complicated. So therefore, if we assume it's going to be 2% every month, this may keep going because it takes a little bit longer. I think that's—

Brent Robinson (21:58)

The problem with— as we know, the problem with 60% is it's a lose–lose situation. So it can't really be the outcome, I would imagine.

Johanna Chua (22:06)

I mean, I mean, I think at this point and especially now we're getting signed, I mean, I don't think in my personal view, I don't think it's a credible threat. But you don't need 60% to have enough stick to incite a negotiation. So even though it's not 60%, I mean, I mean, at this point in China's economy, I mean, there's also obviously a lot of challenges and weakness, and we like to talk about stimulus coming out of China to offset the tariff risk. And again, we are expecting some stimulus. But again, I think our concern at the moment is given the size of the confidence shocks already existing in China, not even related to Trump, but just, you know, real estate, the whole regulatory uncertainty. This just adds to it. And so our worry is that the stimulus coming out of China is just not going to be sufficient to really stabilize growth. So that's really a valid concern.

Brent Robinson (22:53)

Okay. Well, thank you very much, Johanna. Johanna Chua, our global chief emerging market economist at Citi. Thank you very much for your time. This episode of Research @ Citi was recorded on Thursday, the 16th of January 2025. I'm your host Brent Robinson. Join us next time as we discuss securing the future of the European auto industry.

[Disclaimer] (23:16)