FOR PROFESSIONAL INVESTORS – 10 January 2025

Chi Time

US tariffs and China – A potential surprise

What does not kill you makes you stronger.

Friedrich Nietzsche

The conventional wisdom that US tariffs would hurt China's economy and world trade has missed some important facts that could create a potential positive surprise for markets and risk assets in 2025 and beyond. Or is this just wishful thinking?

The timing for another tariff war under Donald Trump's new presidency could hardly be worse. China's economy is now much weaker than it was in 2018 when the Sino-US trade war started. Inflation is a greater challenge for the US than six years ago. In the grand scheme of things, weaker economic linkages between China and the US could increase risks to global stability by reducing the cost of conflicts. A renewed tariff war could create a lose-lose situation for global markets.

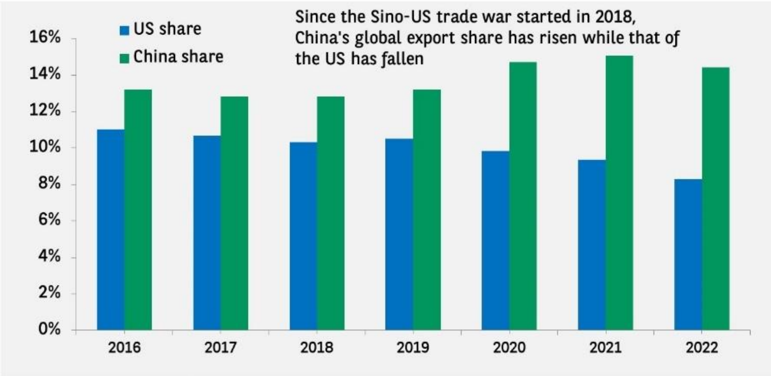
What's new?

Donald Trump's 'America First' policy aims at reducing US dependence on Chinese goods, reshoring manufacturing and protecting domestic industries, and containing a threat to national security that the US believes China's global expansion poses. Trump sees imposing punitive tariffs on China's exports to the US as an effective way to achieve these aims.

However, his 2018-19 tariff strategy did not work as intended. Far from isolating China, the US tariffs (many of which were either kept or raised by the Biden administration) have forced Chinese firms to diversify, innovate and expand in other countries, enlarging China's global footprints.

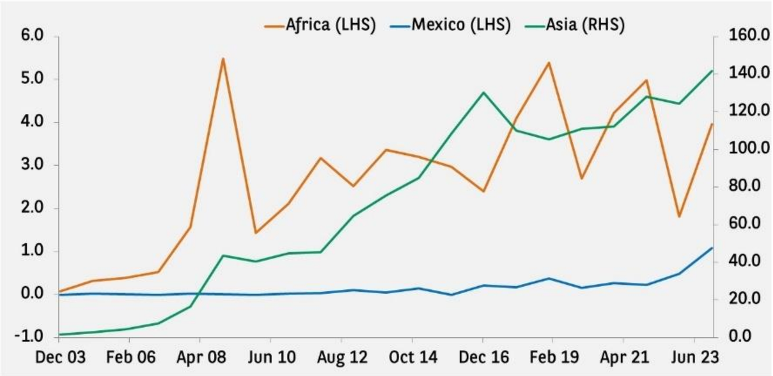
Notably, China's global share of exports has risen since 2018 while that of the US has fallen (Exhibit 1) as Chinese firms shifted production and trade to other countries, notably in ASEAN, Africa, and Latin America (Mexico in particular) to skirt US tariffs and trade restrictions (Exhibits 2 and 3).

Exhibit 1
Share of world exports



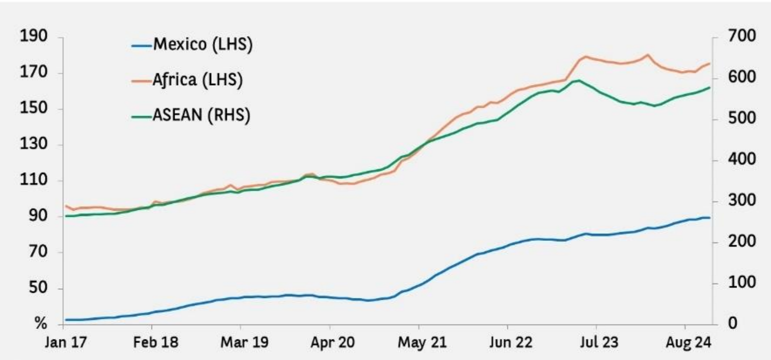
sources: Statista, The World Bank 20 December 2024

Exhibit 2
China has increased investment (USD bn) in new markets, esp. Asia, significantly since 2018



sources: CEIC, BNP Paribas Asset Management 23 December 2024

Exhibit 3
Rising Chinese exports (USD bn)* to ASEAN, Africa and Mexico since the trade war in 2018

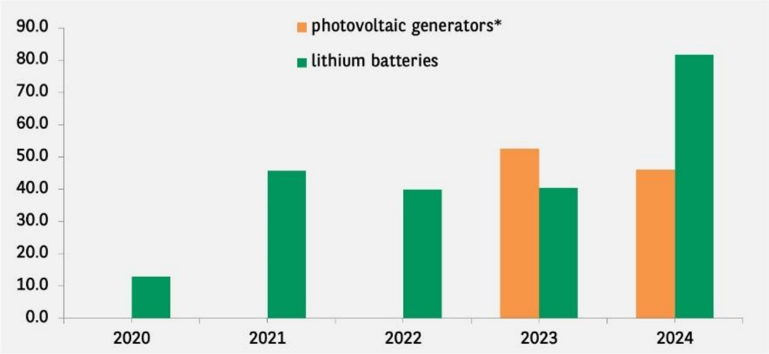


* 12-month rolling sums
sources: CEIC, BNP Paribas Asset Management 20 December 2024

Arguably, these shifts are imbedded in the 'dual circulation' strategy that Beijing put together in 2020 to counter Trump's 'America first' policy that he put together in his first presidential term. Beijing's strategy aims at sustaining China's growth through expanding demand and reducing reliance on exports (see Chi on China: "China's Dual Circulation Strategic Pivot to Counter External Exigencies and Global Demand Shift", 16 September 2020). Beijing's new strategic thinking has changed from cooperating with the US to preparing for 'struggle', as many senior leaders put it, under intense geopolitical tension.

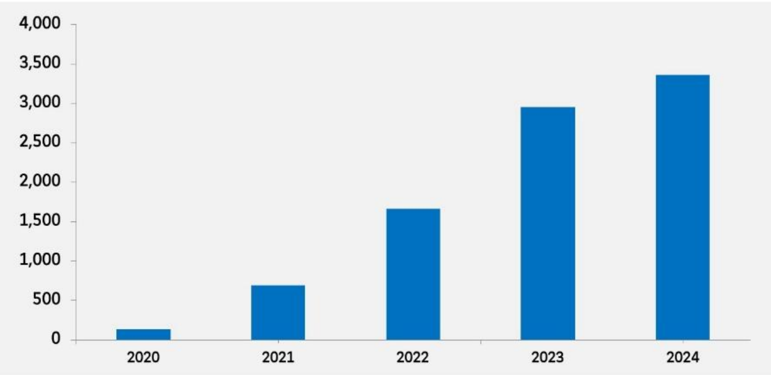
Demonstrating its 'struggle', with some success, Chinese exports grew by an average of 10% a year between 2019 and 2022, despite the US trade obstacles. Exports of some sectors, such as lithium batteries, electric vehicles and photovoltaic generators have grown exponentially in recent years (Exhibits 4 and 5).

Exhibit 4
Export growth (%YoY) of photovoltaic generators & lithium batteries since Covid-19



* data only starts in 2022
sources: CEIC, BNP Paribas Asset Management 23 December 24

Exhibit 5
Export growth (%YoY) of electric vehicles since Covid-19



sources: CEIC, BNP Paribas Asset Management 23 December 2024

Chinese companies seem to have embraced a survival strategy that reflects the adage of 'what does not kill you makes you stronger'. Recent surveys and research indicate that 90% of Chinese companies are considering expanding overseas.

Such attitude is a complete change in China's corporate mindset from a decade ago, when Chinese companies sought strong government protection for survival. China's export competitiveness and speedy technological progress in the face of US policy obstacles stand in defiance of the so-called 'Galapagos Island Syndrome' – which refers to isolated business development that will only survive in the home market but not outside – that the world saw infect Chinese companies in the early to mid-2000s.

So?

These developments raise questions about whether a trade war would serve American interests. While Chinese companies upgrade their supply chains and adapt to the global demand shift and rising geopolitical tension, American manufacturers have had to deal with higher input costs and disrupted supply networks because of their government's China-containment policies.

Ironically, by forcing China to decouple from the US, US tariffs and trade restriction policies seem to have eroded America's global influence, albeit slowly. This can be seen in the increase in the usage of the renminbi in international payments, which has ranked consistently fourth and fifth most-widely used currency for global payments in the SWIFT system, and the creeping progress of renminbi internationalisation (for the latest development, see Chi on China: "The Renminbi's Creeping Internationalisation (V): A Dollar For Dollar Strategy", 18 December 2024).

Furthermore, by diverting trade and investment from the US to other parts of the world, China has created growth opportunities both for itself and partner countries. This reflects China's 'external circulation' tactic under its 'dual circulation' strategy by boosting regionalism to counter de-globalisation and the rise of geopolitical risks (see Chi on China: "China Decoupling or the Rise of Regionalism", 17 November 2023 and Chi on China: "From US Tariffs to China Decoupling – Evidence and Implications", 7 June 2024). A new tariff war could force China to open up even more to position itself as the world's opportunity at a time when the US is turning inward under the new Trump administration.

It's a double-edged sword

While this strategy could help China expand its global influence, it could also focus more attention on its domestic problems. Much will depend on its resolve and ability to restructure the economy. In particular, for sustained economic resilience, domestic consumption must grow and its global trade and investment networks expand, i.e. China will need to implement its 'dual circulation' strategy effectively.

All these are medium- to long- term strategies. In the short term, Beijing's response to the looming US tariffs will likely include retaliatory tariffs (although not tit-for-tat) and exchange rate depreciation. Note that the renminbi depreciated by a total of about 14% in 2018 and 2019 when Trump imposed tariffs on Chinese imports last time. And in anticipation of a tough US stance this time, the renminbi and the CSI 300 stock index have already fallen since late last year.

Cutting export prices may not be effective to offset tariffs because China's export price index has already dropped by 13% from its peak in 2022, and profits of Chinese industrial companies have declined for three years in a row. Chinese exporters did not rely on cutting prices to fight tariffs in 2018-19. It is unlikely they will do so this time. Instead, they will likely focus on new markets.

Chi Lo BNP Paribas Asset Management

DISCLAIMER