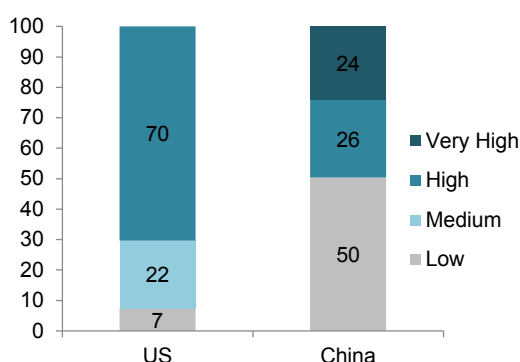


CHINA HOT TOPICS

06 April 2018



Value of targeted products by technological content (%)



Source: Natixis

US-CHINA TRADE WAR: BARRAGE OF ARROWS SHOOTING FROM BOTH SIDES, BUT AT DIFFERENT TARGETS

The US-China trade war is escalating faster than expected but the real question is what the ultimate targets are for the two contenders. To answer this question, we analyze the 1,333 products covered by the US latest action targeting China's breach of intellectual property rights and classify them based on two criteria: the technological content and the weight in China's total exports to the US. We apply the same methodology to China's second round of export tariffs announced this week and compare the two.

We find that more than 70% of the US tariff package is high-end exports while the low-end ones only constitute 7% of total value. As for China's list of targeted imports from the US (106 in total), our estimated value is almost the same to the one announced by China's administration (USD 50 billion). However, 50% of the products on China's list are at the lower end of value chain.

Our interpretation of the findings above is that the US is not really targeting the bilateral trade deficit with China, but trying to constraint China from climbing up the technological ladder. The sheer size of China's retaliation, in terms of the share of total imports from the US, is understandable as the US is hitting China where it hurts the most. This sore point is technological modernization and this is officially enshrined in China Manufacturing 2025. Despite the size of China's response, it seems clear that China is trying to minimize the self-inflicted cost of retaliation by focusing, to the extent possible, on lower-end products.

In other words, both the US and China are targeting the weakest point for each other. While the US is targeting China's future technological capacity, China is responding by targeting US exporters' present revenues. Such immediate response with instantaneous consequences on US exporters can well explain Trump's immediate response with an even larger package of import tariffs. It is hard to think of a way to negotiate in such circumstances.



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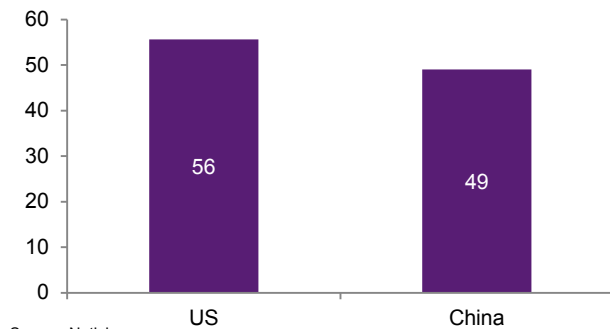
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Barrage of arrows, but where are the targets?

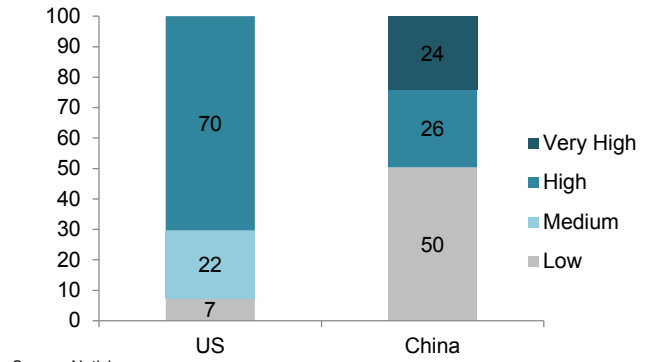
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Chart 1
Natixis estimate: maximum value of targeted imports (USD bn)



Source: Natixis

Chart 2
Value of targeted products by technological content (%)



Source: Natixis

For US, it is not only about trade balance but technology

Among all products, there are three key targets. Nuclear reactors, machinery and mechanical appliances are the most affected products and equal to 7.2% of China exports into the US (Table 1). Electrical machinery and equipment, and optical, measuring and medical instruments constitute 3.2% and 1.9% respectively.

More importantly, **70% of the total value of the 1333 products is high-end exports while the low-end ones only constitute 7% of total value (Chart 2)**. High-tech categories tend to have a higher proportion of products subjected to import tariffs, varying from 66% to as high as 100%. The key focuses of the list are aircraft, machineries and mechanical appliances. For example, 72% of optical, measuring and medical instruments will be affected. 66% of aircraft and 67% ships exports will also be subjected to additional tariffs, which are the sectors that China is trying to grow both in global market share and technological advancement level. **The list also includes projects that China is still struggling along the technological ladder, in particular arms and aircrafts.** We have discussed in our [previous report](#) that "Manufacturing 2025" is the key target instead. Trade balance is not the key focus of a trade war but technological advancement.

Table 1: Analysis of US' Tariffs by Product

Tech Level	Product Category	No Tariff (USD m)	Tariff (USD m)	Total (USD m)	% Products subjected to tariff within the category	% China Exports into US
Very High	Arms and ammunition	0	1,112	1,112	100	0.3
	Aircraft and spacecraft	30	59	88	66	0.0
High	Optical, measuring and medical instruments	2,814	7,219	10,033	72	1.9
	Vehicles	12,348	1,562	13,911	11	0.4
	Railway, locomotives and traffic signalling equipments	1,248	230	1,478	16	0.1
	Nuclear reactors, machinery and mechanical appliances	51,532	27,930	79,462	35	7.2
	Pharmaceutical products	2,292	758	3,051	25	0.2
Medium	Ships, boats and floating structures	105	213	318	67	0.1
	Electrical machinery and equipment	1,216	12,444	13,661	91	3.2
Low	Furniture	26,596	797	27,393	3	0.2
	Aluminium	2,017	1,078	3,096	35	0.3
	Iron and steel	393	145	538	27	0.0
	Organic chemicals	4,208	1,617	5,824	28	0.4
	Rubber	2,988	244	3,232	8	0.1
	Inorganic chemicals	1,035	1	1,036	0	0.0
	Metal	2,986	215	3,201	7	0.1
	Clocks and watches	602	1	603	0	0.0
	Chemical products	974	0	974	0	0.0
All		113,384	55,627	169,011	-	14.4

Source: Natixis N.B. HS2 category used for illustration and HS6 category used for calculation. Categories not included in the tariff list are not included in the table. 2016 Data used.

For China, it is about scale even at a cost of hurting itself

As for China’s list of targeted imports from the US (106 in total), our estimated value is almost the same to the one announced by China’s administration (USD 50 billion). More importantly, as much as 50% of the products on China’s list are at the lower end of the value chain.

For China’s retaliation announced so far, it aims at hurting US exports in terms of scale, and this includes large items such as soybeans, aircraft and vehicles that amount to 29% of US exports into China. The main targeted agricultural products (including soybeans and cereals) account for 11.6% of China’s imports from the US, followed by 9.4% in aircrafts and 8.9% in vehicles. More than 50% of mineral fuels and plastics articles, which are also of some importance in imports, are also subjected to tariffs. Semiconductors, the fourth largest item in China’s imports from the US, have been exempted probably due to the irreplaceable nature and the urgent need of such technologies. **In contrast to the US, China’s list covers more primary products than high-tech products, and therefore the impact will be more direct but short-lived.**

Table 2: Analysis of China's Tariffs by Product

Tech Level	Product Category	No Tariff (USD m)	Tariff (USD m)	Total (USD m)	% Products subjected to tariff within the category	% US Exports into China
Very High	Aircraft and spacecraft	1,268	12,700	13,968	91	9.4
High	Vehicles	884	12,000	12,884	93	8.9
Low	Tobacco and manufactured tobacco substitutes	0	183	183	100	0.1
	Cereals	1	1,561	1,562	100	1.2
	Vegetable plaiting materials and vegetable products	0	4	5	97	0.0
	Oil seeds and oleaginous fruits (soybeans)	673	14,000	14,673	95	10.4
	Cotton	114	510	624	82	0.4
	Food industries, residues and wastes	399	680	1,079	63	0.5
	Plastics	2,284	3,796	6,080	62	2.8
	Soap and washing preparations	381	450	831	54	0.3
	Mineral fuels and oils	1,105	1,300	2,405	54	1.0
	Albuminoidal substances	242	180	422	43	0.1
	Chemical products	1,623	1,186	2,809	42	0.9
	Preparations of vegetables, fruit, nuts	228	38	266	14	0.0
	Rubber	923	150	1,073	14	0.1
	Organic chemicals	2,719	305	3,024	10	0.2
	Beverages, spirits and vinegar	496	8	504	2	0.0
	Products of the milling industry; w heat gluten	23	0	23	0	0.0
Meat	1,357	0	1,357	0	0.0	
All		14,720	49,051	63,771	-	42

Source: Natixis N.B. HS2 category used for illustration and HS6 category used for calculation. Categories not included in the tariff list are not included in the table. 2016 Data used.

The fact that China has high reliance on the above products also mean tariffs could hurt Chinese producers and consumers. Beyond semiconductors, automobile makers who export about 30% of their products into China will be subjected to another 25% tariff on top of the existing 25%. However, at the same time, 28% of China’s imported vehicles are originated from the US. Interestingly, Li Keqiang just promised to cut the tariff on automobiles during the People’s Congress. Hence, in the long run, the tariff on vehicles is clearly not desirable for China.

The same can be said for soybeans and aircrafts as China buys 41% of imported soybeans and 63% of imported aircraft from the US. The recent fall in pork prices could offer room for China to retaliate through soybeans, a key source of piglet feed, and China could also switch to non-US companies to meet the demand in aircraft, but whether this is sustainable is another question. Due to the large scale of purchases by China, it may not be that easy to substitute with new sources based on constraints in infrastructure and productivity in a short run. Higher inflation and the lack of competition on mechanizing could also mean higher costs for China.

Arrows targeting the weakest point of each other

Our interpretation of the findings above is that the US is not really targeting the bilateral trade deficit with China, but trying to constraint China from climbing up the technological ladder. The sheer size of China’s retaliation, in terms of the share of total imports from the US, is understandable as the US is hitting China where it hurts the most. This sore point is technological modernization and this is officially enshrined in China Manufacturing 2025. Despite the size of China’s response, it seems clear that China is trying to minimize the self-inflicted cost of retaliation by focusing, to the extent possible, on lower-end products.

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