Don’t Forget About the Trade War

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Before coronavirus and impeachment, the Sino- American trade war stubbornly remained on the mainstream news circuit while largely governing the direction of financial markets. With each rumor of concession or tweet of condemnation, stocks gyrated and bonds jittered. Each round of negotiation was been matched by salvos of tariffs, export controls, lawsuits, complaints, declarations, and threats. At its peak, the U.S. imposed tariffs on $550 billion of Chinese imports while China retaliated with tariffs on $185 billion of U.S. goods.[1]

With its early 2018 inception, many mainstream pundits and commentators agreed with President Trump that the trade war would be beneficial (or at least benign) and short (otherwise it would not be “easy to win”).2 But the trade war, albeit in fits and starts, continued, escalated, and now largely sits in stalemate – despite the “Phase One” agreement – with no clear visibility of resolution. Even with a recent reprieve, the trade war will likely continue for the foreseeable future with great risk to economies and financial markets.

Why Trump Will Likely Continue the Trade War

Some argue that President Trump is actually in favor of free trade but wishes to renegotiate various trade treaties. That is, by embracing protectionist policies, free trade can later be broadened on more “appropriate” terms. For example, some of the stated NAFTA renegotiation objectives included the elimination of "unfair subsidies, market-distorting practices by state owned enterprises, and burdensome restrictions on intellectual property." But this interpretation is contrary to significant evidence which indicts Trump as a devoted protectionist.

Trump's overall political philosophy is revealed by his pre-Presidential talk show confessions. The future President hit the talk show circuit extensively in the 1980's and 1990's by appearing on such shows as David Letterman, Oprah Winfrey, Phil Donahue, and Larry King. These interviews provide an insightful look into his core beliefs. Consistently, the most passionate commentary concerned foreign nations "taking advantage" of the U.S. – either by failing to contribute more to their own national defense or by running significant trade surpluses (U.S. trade deficits). In these interviews, the ire from the latter of these was usually directed (given the time) at Japan. Today it is China.

Trump clearly views trade in a zero-sum, mercantilist manner with the country possessing a deficit as "losing" and "down." In mid-2019, the President tweeted the following:

When a country . . . is losing many billions of dollars on trade with virtually every country it does business with, trade wars are good when we are down $100 billion with a certain country and they get cute, don't trade anymore-we win big. It's easy.[3]

Four other facts buttress Trump's position as an ardent protectionist. First, protectionism is theoretically consistent with President Trump's immigration position. If one believes immigrants take away American jobs, then logically one would also fear cheaper foreign goods which destroy the profitability of American companies – and by extension, cost U.S. workers their jobs.

Second, while the protectionist measures enacted so far have been focused on China, they have also, to a lesser extent, been levied against allies (e.g., Canada, Europe, etc.). This is why, when signing the new U.S.-Mexico- Canada Agreement in January, President Trump noted the agreement was "finally ending the NAFTA nightmare."[4]

Third, President Trump, almost immediately upon taking office, pulled out of the Trans-Pacific Partnership negotiations. While one could easily argue this agreement actually hindered free trade given its excessively burdensome and complex rules and regulations, the rationale given for withdrawing was a protectionist argument: the preservation of American manufacturing.[5]

Fourth, he has surrounded himself with advisors notorious for their protectionist policy advocacy. Most notable among them are economist Peter Navarro who authored the book Death by China and Commerce Secretary Wilbur Ross.

Today's political climate only serves to facilitate Trump's protectionist philosophy. In addition to this year's election and the likely need to secure Rust Belt electoral votes, anti-China rhetoric and positioning are popular with both political parties and the deep state.

Why China May Wait for the 2020 – or 2024 – Election

As any future trade agreement will decrease free trade (at least compared to the pre-trade war environment), any likely agreement will be, by definition and on the whole, deleterious to both countries to the advantage of certain industries, businesses, and/or occupations (including political offices). China singularly understands the benefits of free trade and stands to lose its prosperities as well as be burdened by any ancillary labor, intellectual property, or environmental provisions. It is in their interest to delay and forestall any agreement.

This strategy coincides nicely with two Chinese concepts: “saving face” and a “holistic” negotiating style. The concept of “face” refers, loosely, to the Sino- cultural understanding of respect, honor, and social standing. President Trump, with bombastic boasts and brash bargaining, only forces President Xi and Chinese leadership into steadfast positions.

It is culturally, and thus politically, difficult for the prospects of any agreement if it appears to be an American victory. This applies to both intra-regime circles (leadership struggles) and with the government vis-à-vis the populace. The former is exacerbated by the pageantry and intrigue of next year’s Communist party centenary. The latter of which is intensified by leadership’s keen sensitivity to Chinese society’s long- held belief in the “Mandate from Heaven” (the loss of which is frequently signaled by Heaven through such natural disasters as epidemics – especially untimely given both the onset of coronavirus and the perception of an inept government response).

Holistic negotiating style, or *zhengti guannian*, is a well-known and often frustrating exercise for any westerner having done business in China. As described in a Harvard Business Review article:

. . . the Chinese think in terms of the whole while Americans think sequentially and individualistically, breaking up complex negotiation tasks into a series of smaller issues: price, quantity, warranty, delivery, and so forth. Chinese negotiators tend to talk about those issues all at once, skipping among them, and, from the Americans’ point of view, seemingly never settling anything.[6]

This concept has already manifested itself in the trade war; it is not uncommon for U.S. to believe an agreement has been reached only to be met by silence or denials from the Chinese.

Will the Trade War Cause a Recession?

If the trade war escalates, can it *directly* cause a U.S. economic recession? Many mainstream pundits, citing the infamous Smoot-Hawley Act of 1930, warn as such (which is odd, especially since the Great Depression was well underway before it was enacted let alone took effect).

But tariffs may *indirectly* cause a recession. As recessions are caused by malinvestment (investments unjustified by the natural level of interest rates) created through artificially suppressed interest rates, then rising rates may serve to expose this malinvestment and force its liquidation (e.g., business closures, layoffs, bankruptcies, etc.) – also known as a recession.

Currently, U.S. Treasury debt held by China approximates $1.1 trillion.7 Curtailing future purchases and/or programmatically selling these holdings may increase interest rates dramatically (from where they would otherwise be, all things being equal). Many pundits cite the unlikelihood of this by noting such sales would decrease bond prices and thus the value of China's U.S. Treasury holdings. But the impact on U.S. interest rates need not result from a "liquidation" by China; rather, since all prices are determined at the margin, decreased demand or increased supply (sales) by China – evenly seemingly insignificant, may raise rates.

If the trade war turns to financial warfare tactics, both sides are more likely to receive recession than resolution.

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