

# PERSPECTIVE

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**Singapore** | 16 October 2018

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## **U.S. – China Trade War: Opportunities & Risks for Southeast Asia**

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### **EXECUTIVE SUMMARY**

- Trade wars disrupt global supply chains casting doubt over the future of economic globalization.
- Economic growth in the U.S. and China will fall marginally. Escalation of the trade war or turning it into a permanent phenomenon will suppress global growth visibly.
- Southeast Asian exports of intermediate goods to China will be hit, but the trade war may lead to U.S. demand for Southeast Asian goods replacing imports from China.
- The indirect, long-term positive effect will be a stronger and faster switch from global to a regional supply chains auguring a more self-sustaining Asian economy.

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## **INTRODUCTION**

Prior to his election President Trump made it clear that he thought the U.S. suffered from bad trade deals entered into by his predecessors. He wanted fair trade instead of free trade without specifying exactly what he meant by that.

Since his inauguration, initiatives have been launched to renegotiate trade agreements, and after some hesitation the U.S. has started to impose tariffs on imports from China, which has in turn retaliated. The two parties mix threats and negotiations blurring the picture, and for the first time in more than 30 years, free trade between the U.S. and China is rolled back. The question is how fast and how deep this will be and whether the rollback will be permanent or revoked at a later day. For Southeast Asian countries it is of paramount importance to form a picture of how they will be involved; how much they will suffer and will opportunities open up for them.

## **WHY A TRADE WAR?**

In the beginning of the 1980s China reformed its economy and the U.S. controlled its inflation. These two policy steps are inextricably intertwined. Conventional economics teaches that inflation targeting monetary policy introduced by the U.S. Federal Reserve System brought inflation down. The real reason was that China gradually emerged as the global manufacturing nation using its large work force to lower prices on labour intensive, low cost goods, which the U.S. started to import. This was good for both the U.S. and China. Purchasing power rose for the American consumer, underpinning a fairly high economic growth. Jobs were created in China demonstrating to the Chinese citizens that economic reforms worked. It was a plus-plus game.

Gradually apprehension surfaced in the U.S. about the trade with China being unbalanced. Several administrations and voices in the Congress sought rebalancing without getting much to show for their travails.

The Trump administration's arguments for a trade war with China fall into three categories: The U.S. has lost its position as a manufacturing nation; a large number of jobs have gone; and the trade balance is one-sided in China's favour.

A Congressional study<sup>1</sup> has concluded that the U.S. share of global manufacturing value added has declined from 29% in the early 1980s to 18.1% in 2016. China's share of global manufacturing output, which was negligible in 1980, surpassed the U.S. share in 2008 and has steadied in the range of 25% to 26% since 2014. U.S. experienced the highest number of employees in manufacturing in 1979 with 19.5 million to see a gradual fall to 17.1 million in 2001. Over the last 17 years, the decline has been manifest with 12.7 million employees in manufacturing in July 2018.<sup>2</sup>

In 2017, the deficit on the U.S. trade balance reached \$375bn—equal to around 2 percent of U.S. Gross Domestic Product (GDP). This kind of statistics need, however, to be interpreted with a pinch of salt. According to Deutsche Bank research<sup>3</sup> looking at exports of American companies irrespective of whether they are operating in the U.S. or China and doing a similar

calculation for Chinese companies reduces the deficit to 10 percent of the official figure. The difference is that 97 percent of what Chinese companies export to the U.S. is manufactured in China and 3 percent by Chinese companies operating in the U.S. For American companies 33 percent is manufactured in the U.S. and 67 percent by their subsidiaries in China. A study by Peterson Institute for International Economy<sup>4</sup> discloses that 86 percent of electronics products, 68 percent of other manufacturing, 63 percent of electrical equipment and 59 percent of machinery except electrical to be levied by US tariffs came from multinationals and joint ventures rather than Chinese firms.

The U.S.'s most important trading partners are China, Canada, Mexico, Japan, Germany,<sup>5</sup> Korea, Britain, France, Italy, India, Taiwan, Brazil, The Netherlands, Switzerland, Ireland, Vietnam, Malaysia, and Singapore. China's most important trading partners<sup>6</sup> are the U.S., Japan, Korea, Taiwan, Germany, Australia, Malaysia, Vietnam, Singapore, Britain, Thailand, India, Brazil, The Netherlands, Russia, Canada, Indonesia, Saudi-Arabia, France. The gravity theory of trade – countries trade mostly with neighbours – seems only partly true for the U.S. and China.

The top five U.S. export items to China are<sup>7</sup> Soybeans, Civilian aircraft, Cotton, Copper materials, Passenger vehicles (small engines). The top five China export items to the U.S. are<sup>8</sup> cellphones and other household goods, computers, telecommunication equipment, computer accessories, toys-games/sporting equipment.

In the first round of imposing tariffs (imports of \$30bn), the U.S. selected industries such as aerospace, information and communications technology, robotics, industrial machinery, new materials, and automobiles.<sup>9</sup> In its retaliation, China focused on agricultural goods selecting certain types of meat, fish, other seafood, dairy products, vegetables, fruits and grains. Both sides opted for a tariff size of 25 percent. The next round of tariffs will hit imports of \$200bn bringing about half of Chinas exports into play, but with a lower tariff – 10 percent – keeping the options of increasing it to 25 percent at a later stage open. As was the case for stage one, China has retaliated. Currently for both countries more than half of exports are included in the lists already in operation or announced.

Trade wars hit economic globalization because manufacturers in many countries contribute to the final good through intermediate goods. Recently, suppliers of intermediate goods (components) have increased their influence over manufacturers doing the final assembling.

## **THE GLOBAL SUPPLY CHAIN**

Products sold to consumers are marked 'made in XX', but this is misleading. The final product bought by the consumer may have been assembled in country XX, but would normally have components from a large number of countries. After President Trump raised the issue of American jobs lost due to free trade, an analysis disclosed that a Ford Focus assembled in the U.S. – thus in everyday vocabulary an 'American' car – only got 40 percent of its components from the U.S. and Canada.<sup>10</sup>

For economic growth and employment, it may matter more to deliver a large share of components used by other countries than doing the final assembling itself. This is borne out by

the automotive industry as analysed by Wilson Kia Onn Wong.<sup>11</sup> He points out that ‘over the past 30 years, automotive component suppliers have steadily assumed ownership over the actual vehicle-making process, reducing automakers to mere assemblers, and being more focused on what they perceive to be higher value-added activities such as branding, marketing and international business expansion ... these suppliers and not their automaker clients are now the primary forces driving the revolution in automotive technology ... the world’s leading automotive components supplier, Bosch, posted 2015 revenues of Euro70.6bn overshadowing key automaker clients such as Renault with revenues of Euro 45.3bn’.

In Asia, a strong supply chain has been built with China importing intermediate goods to be assembled into final products for export to the U.S. According to Fitch Ratings,<sup>12</sup> countries most likely to be hit via the supply chain by a trade war are Korea, Japan and Taiwan which supply China with semiconductors, and Vietnam and Malaysia which supply China with machine parts and components for communications equipment.

## **IMPLICATIONS OF TRADE WAR ON THE ASIAN SUPPLY CHAIN**

The trade war will suppress economic growth. IMF’s Chief Economist stated in July 2018 that if threatened trade barriers become reality, global output could drop by about 0.5 percent with the U.S. economy being “especially vulnerable.”<sup>13</sup> In September 2018 a Chinese official stated that with the U.S. imposing tariffs on all Chinese imports the negative impact on China’s economy is about 0.7 percent of GDP.<sup>14</sup> This does not reflect the full picture as domestic economic policy measures can be introduced to compensate for the trade war’s negative growth effect. So far, news is out that China contemplates to stimulate the economy while the U.S. will compensate farmers to soften the fall in growth.

A fair bet is a *short-term, direct* insignificant (negative) impact on American and Chinese growth. Repercussions on economic growth in other countries including Southeast Asia will be minimal and will be nothing compared to what was seen during the Asian financial crisis in 1997 and the global financial crisis in 2008. More significant and more interesting for Southeast Asia is the *indirect* impact over a *longer term*.

The negative effect on Southeast Asia stems from higher consumer prices in the U.S. due to tariffs, which dampens consumption. The spill over happens because the final product marketed in the U.S. is ‘made in China’ through components imported from other Asian countries. Asia’s intra-regional trade accounts for 57.3 percent of total trade and is going up.<sup>15</sup> A considerable part of this are components going to China. Intraregional foreign direct investment (FDI) has risen as a share of total FDI from 48 percent in 2015 to 55 percent in 2016.<sup>16</sup> One of the drivers is expectation among Southeast Asian companies that access to the U.S. market would continue to be open to Chinese goods, guaranteeing Chinese demand for components. They have invested accordingly. The overall impact may not be significant, but some companies whose future is within the Asian supply chain that produces for consumption in the U.S. with China doing the final assembling may suffer.

The positive effects fall into three categories: Opportunities to replace Chinese goods on the American market; American goods on the Chinese market; and the prospect of East Asia

moving towards a self-sustaining economic entity with its own business cycle and producing more and more for domestic consumption.

On the American market, tariffs lead to trade diversion. Southeast Asian products will be less expensive as they are not hit by the trade war. The size of this effect depends on congruity between Southeast Asian and China production determining how many products from the two 'regions' compete with each other; or seen from the American consumer's point of view whether Chinese goods were preferred to Southeast Asian goods because they were cheaper or because there were no alternatives. Only in the first case may U.S. imports switch from coming from China to having Southeast Asia as the source. Trade diversion will take place and may over time be visible, but history tells us that it will not happen overnight and will in fact require a strong effort by Southeast Asian producers to market their products. As an example of possible trade diversion in Southeast Asia's favour is Malaysia's export to the U.S. of electronic equipment (\$9.4bn) and machinery (\$2.4bn)<sup>17</sup> which may see increased market shares. A similar picture is expected for the Philippines.<sup>18</sup>

On the Chinese market, a similar trade diversion will be seen as China retaliates by raising barriers for U.S. products. The Chinese list of retaliations include agriculture and resources, where Southeast Asia may offer alternatives to American products, making it likely that benefits will flow faster and be stronger. 120 food products have been mentioned as being on the Chinese list. China buying Liquefied Natural Gas (LNG) from the U.S to close the trade gap, explicitly mentioned by Secretary of Commerce Wilbur Ross on 23 March 2018<sup>19</sup> may be the victim of a trade war – at least in the short-term – and open up for more energy exports from Southeast Asia to China. Another Southeast Asian product to gain may be palm oil which will replace soybeans imported by China from the U.S.

For Southeast Asia, a trade war offers the opportunity of concentrating on the East Asian supply chain producing for East Asia. Knowing that growth and consumption will be higher in East Asia than for the U.S., such a prospect may not be so bad. The growing importance of components suppliers (the automotive industry mentioned as an example above) may in the longer run turn out to be beneficial. It will only be the case, however, if components suppliers realize the change in the role of components from simple inputs to playing a role in the definition of the final product. A mind-set shift may be required from delivering a component designed and ordered by the final producer to perceiving how the component can enhance the performance of the final product, turning component suppliers into partners in designing the final product. If this is done, the trade war may help Southeast Asia climb up the value-added ladder as a component supplier.

The possibility of shifting assembling of goods from China to Southeast Asian countries cannot be ruled out, but such a step will take time and runs the risk of the U.S. reacting by imposing tariffs on Southeast Asia.

## **CONCLUSION**

The trade war will primarily hit consumers in the U.S., multinational companies operating in China, and Chinese producers. Growth in the two countries will fall slightly. Some economic

sectors in Southeast Asia may suffer in the short term, but overall the repercussions on Southeast Asia may in the medium and long-term be positive.

In the long-term reinforcing the regional supply chain in East Asia to spread to all of Asia, will gain further strength with severe economic and political costs for the U.S. Asian countries will move towards a regional supply chain with rules defined by them in accordance with their own interests. Maybe the biggest loser over time will be American multinationals and the biggest winner Southeast Asia.

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<sup>1</sup> Congressional Research Service, *U.S. Manufacturing in International Perspective*, Marc Levinson, February 21, 2018.

<sup>2</sup> Federal Reserve Bank of St. Louis, Economic Research, All Employees: Manufacturing. 3. August 2018. Link: <https://fred.stlouisfed.org/series/MANEMP>

<sup>3</sup> Newsletter (email) of 26. March 2018.

<sup>4</sup> Mary E. Lovely and Yang Liang, Trumps Tariffs Primarily Hit Multinational Supply Chains, Harm U.S. Technology Competitiveness, Peterson Institute for International Economy, Policy Brief 18-12, May 2018.

<sup>5</sup> EU member states are shown individually. EU as a whole is the U.S. largest trading partner and China's second largest after the U.S.

<sup>6</sup> Due to the special role of Hong Kong it is left out. Statistically it is China's second biggest and the U.S. nineteenth trading partner.

<sup>7</sup> <https://www.chinabusinessreview.com/what-america-exports-to-china/>

<sup>8</sup> <https://www.weforum.org/agenda/2018/03/this-is-what-the-us-imports-from-china/>

<sup>9</sup> <https://www.businessinsider.sg/trump-china-tariff-full-list-of-goods-products-2018-6/?r=US&IR=T>

<sup>10</sup> David Johnson, "How American is your car," *Time Magazine*, 2. March 2017. Link: <http://time.com/4681166/car-made-american/>

<sup>11</sup> Wilson Kia Onn Wong, *Automotive Global Value Chain*, Routledge, Abingdon, 2018.

<sup>12</sup> <https://sg.news.yahoo.com/winners-losers-china-us-trade-113108709.html>

<sup>13</sup> <https://www.bloomberg.com/news/articles/2018-07-16/risks-to-global-growth-rising-as-trade-tensions-grow-imf-warns>

<sup>14</sup> Vice-chairman of the China Securities Regulatory Commission, Fang Xinghai quoted in the *Straits Times*, 19. September 2018.

<sup>15</sup> Asian Development Bank (ADB), *Asian Economic Integration Report*, 2017.

<sup>16</sup> Asian Development Bank (ADB), *Asian Economic Integration Report*, 2017.

<sup>17</sup> [http://www.worldsrichestcountries.com/top\\_malaysia\\_exports.html](http://www.worldsrichestcountries.com/top_malaysia_exports.html)

<sup>18</sup> <https://wits.worldbank.org/CountryProfile/en/Country/PHL/Year/2015/TradeFlow/Export/Partner/USA/Product/all-groups>

<sup>19</sup> Bloomberg news. Link: <https://www.bloomberg.com/news/articles/2018-03-22/wilbur-ross-to-china-boost-u-s-gas-imports-to-please-trump>

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