

RESEARCH ARTICLE



The US–China trade war, the American public opinions and its effects on China

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ABSTRACT

Donald Trump's trade war with China does not make economic sense, but he does not face much domestic opposition to this trade war. Moreover, it is a part of a broader strategy of the nationalistic Americans' attempt to suppress the rise of China. Would China give in to the requests of the US under the threat of the escalation of the trade war? In what way? My conjecture is that China is willing to compromise up to a point. What China is likely to do is to promise to buy more goods and services from the US, allow greater market access for American firms, reduce Chinese subsidies to its industries, reduce forced technology transfers by American firms, strengthen enforcement of intellectual property rights protection and make verification all these commitments more transparent. Although the US might stop escalating the trade war, it is likely that the tariffs already imposed on Chinese goods would not be removed soon. In response to that, China also would not remove most of those tariffs already imposed on imports from the US, in keeping with the spirit of the tit-for-tat policy. It is possible that a temporary cease-fire is agreed, but the trade war can last for a long time. The final assembly stage of many industries might leave China, but not necessarily the whole production process. Hong Kong can be a victim of the trade war if it escalates.

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Introduction

So far, as of the date of writing (10 February 2019), there have been three rounds of tariff wars between the US and China. All of them were initiated by the US.

When the first wave of America's 25% tariffs on US\$34 billion worth of Chinese goods took effect on 6 July 2018, China in return imposed 25% tariffs on the same amount of American goods. A second round of 25% tariffs on an additional US\$16 billion of Chinese exports went into effect on 23 August 2018. In retaliation, China immediately imposed 25% tariffs on US\$16 billion of US exports. The third round started on 24 September 2018, when President Donald Trump started levying 10% tariffs on

another US\$200 billion in Chinese goods. In retaliation, China imposed tariffs, with rates ranging from 5% to 10%, on an additional US\$60 billion worth of American goods, effective on the same day. The US threatened that the tariff rate on these goods would increase to 25% by 1 January 2019, unless the two countries reached a deal. Mr. Trump had warned that even more could be on the way. He said that if China retaliated then Washington would impose fresh tariffs on US\$267 billion worth of Chinese products. In fact, China did retaliate. If Trump went ahead with that round of import tariffs, it would mean virtually all of China's exports to the US would be subject to duties. Then, in the G20 Meeting at Buenos Aires, Argentina on 30 November and 1 December 2018, Xi Jinping and Donald Trump agreed to stop the escalation of the tariff war, and give themselves three months to talk so as to reach a deal to stop the escalation permanently.

In fact, the Trump administration's challenge to China goes beyond initiating a trade war. It has sought to limit Chinese direct investment into the US based on national security reasons through the action of the Committee on Foreign Investment in the United States (CFIUS). CFIUS is an inter-agency committee of the US government that reviews the national security implications of foreign investments in US companies or operations. The US President has personally accused the Chinese telecommunications equipment and mobile phone maker, Huawei, of posing national security threats to Western countries without providing any evidence to support his claim. Huawei is widely recognised as the company that could become the world leader in providing 5G technology to mobile devices in the future. The US is also challenging China's territorial claims in South China Sea by having its warships sailing within the territorial waters of islands for which China claims sovereignty. Vice President Mike Pence of the US was extremely critical of China's 'Belt and Road Initiative' (BRI) characterising it as 'dangerous debt diplomacy China has been engaging in in the region' in the APEC Meeting in Papua New Guinea. Again, the evidence was scant but the rhetoric was powerful. The fact that the president and vice-president of the US badmouth a rival without providing solid evidence was very unusual. It has gone beyond self-defence. All these actions of the US taken together reveal how an incumbent economic, political and military power tries to suppress the rise of an emerging rival.

The reasons for the fear of China by the US are manifold. Roughly speaking, they include the hidden subsidies that China provides to state-owned enterprises through cheap and easy credits from the state-owned banks, the large trade deficit that China has with the US, the forced technology transfers by American firms to China, the lack of enforcement of intellectual property rights protection by China, China's military buildup and economic expansion through the BRI, the fear of American firms' dependency on Chinese suppliers, and so on. Some of these fears are justified and some of them are not.

However, for the time being, let us focus only on the trade war. First, I look at some trade statistics to get an idea of the size of the trade imbalance between the US and China compared with total trade value in each country, global trade value, and the GDP of each country. The trade figures that are listed in the following tables are for trade in goods and services, not just trade in goods. Such statistics are available relatively late. For this reason, we only have data for 2016. It should be noted that

sometimes when some government officials cited the trade imbalance between the US and China, they did not specify clearly whether they were referring to trade in goods and services or just trade in goods. In fact, the American side often just cite imbalance in trade in goods only. As a result, they almost certainly over-state the trade imbalance, as the US exports more services to China than it imports services from China (see Tables 1–4).

Table 1. Bilateral trade imbalance between the US and China in 2016.

Total value of exports of goods and services from China to US in 2016 (including exports through China's Hong Kong to the US)	US\$500 billion
The above value as a percentage of total value of Chinese exports	20.1%
The above value as a percentage of total value of US imports	18.2%
Total value of imports of goods and services by China from US in 2016 (including imports through China's Hong Kong from the US)	US\$182 billion
The above value as a percentage of total value of Chinese imports	8.4%
The above value as a percentage of total value of US exports	8.1%
The bilateral trade imbalance between the US and China in 2016	US\$318 billion

Notes for Tables 1–4: (1) Total trade value is calculated by summing up trade in goods and services. (2) The value of global exports and imports is calculated by summing up the values of all the reported countries. (3) The ranking of top exporting countries is not directly available from the database, and is calculated based on the methodology stated in (1) and (2) above. (4) Exports and imports include those of goods and services.

Data sources for Tables 1–4: (1): World Bank Database: "GDP Growth Rate of China" (<https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?locations=CN>); (2) Trade data: (a) Data for exports and imports of goods are from *TrendEconomy*: "Annual Merchandise Trade Statistics by Country" (<http://data.trendeconomy.com/dataviewer/trade/statistics/h2>); (b) Data for trade in services are from UN Comtrade Database (<https://comtrade.un.org/data>).

Table 2. Trade dependency of China and the US in 2016.

Total value of exports from China to the rest of the world (including US) (including exports through China's Hong Kong)	US\$2,494 billion
The above value as a percentage of GDP of China (GDP of Chinese Hong Kong is excluded)	22.3%
Total value of imports by China from the rest of the world (including US) (including imports through China's Hong Kong)	US\$2,263 billion
The above value as a percentage of GDP of China (GDP of China's Hong Kong is excluded)	20.2%
Total value of exports from US to the rest of the world (including China)	US\$2,177 billion
The above value as a percentage of GDP of the US	11.7%
Total value of imports by US from the rest of the world (including China)	US\$2,744 billion
The above value as a percentage of GDP of the US	14.7%

Table 3. GDP of the US and China compared with total global exports in 2016.

GDP of China (excluding GDP of China's Hong Kong)	US\$11,191 billion
GDP of the US	US\$18,624 billion
Global exports	US\$20,755 billion

Table 4. The top five exporting countries in 2016.

	Exports (billion USD)	% of global exports
China (mainland)	2,282	11.00%
US	2,177	10.49%
Germany	1,600	7.71%
Japan	817	3.94%
UK	744	3.59%

Thus, the bilateral current account imbalance (i.e. imbalance in trade of goods and services) between China and the US was about US\$318 billion in 2016. This is 8.4% less than the imbalance in trade in goods only, which was US\$347 billion in 2016. The US government kept citing the imbalance in trade in goods only as the most relevant figure. This is against common practice in economics, where trade deficit refers to current account deficit. If the US government was, as Donald Trump said, concerned about ‘China is making more money from the US than the US is making money from China’, why is selling services not considered making money?

In fact, if one considers only value-added trade, the bilateral trade imbalance is even smaller. According to Koopman, Wang, and Wei (2014), ‘... because China is the final assembler in a large number of global supply chains, and it uses components from many other countries, especially East Asian countries, its trade surplus with the US measured in value-added terms is 49% less than that measured in gross terms in 2004’. If this percentage is applied to 2016, the bilateral current account imbalance between China and the US would be about US\$162 billion. This would be the true value of goods and services made in China sold to the US minus the true value of goods and services made in the US sold to China. The imbalance is much reduced. However, even this number should not be important from the point view of the economic welfare of the US. What is important to the US, if trade imbalance is to be a concern at all? Should be its overall trade imbalance, not any bilateral imbalance with another single country? This, together with other evidence, leads one to conclude that the US is concerned with suppressing China rather than the significance of its overall trade imbalance to the economic health of the US.

What is the motivation for Donald Trump to initiate the trade war with China?

First, there is a political motive. Trump was elected partly with the support of people living in the relatively rural area of the US. Many of these people are manufacturing workers who were hurt by imports from China, especially after China’s accession to the WTO in 2001. In a paper titled ‘The China Syndrome: Local Labour Market Effects of Import Competition in the United States’ published in the *American Economic Review*, Autor, Dorn, and Hanson (2013) provide evidence that Chinese exports to the US led to unemployment and hardship of manufacturing workers in pockets of locations, many of whom were rural. According to their finding, ‘... Rising [Chinese] imports cause higher unemployment, lower labour force participation, and reduced wages in local labour markets that house import competing manufacturing industries’. During his presidential campaign, Trump promised to be tough on China. Thus, it is useful political posturing for Trump to at least appear to be tough on China, and to appear to attempt to reduce bilateral trade deficit with China.

Second, there are some somewhat justifiable economic rationales for initiating the trade war with China. The US accuses China of using policies to force American companies to transfer technology to their Chinese partners. In many sectors, American companies are required to engage in joint venture with Chinese companies in order to invest directly in China by setting up production facilities there. The US also accuses

China of failing to enforce intellectual property rights protection for American firms. Thus, the US tries to use the trade war as a lever to force China to change its behaviour in these areas.

Third, there are some misguided economic rationales. If reducing the overall current account deficit of the US is the goal, then trying to reduce bilateral trade deficit with China does not lead to that result. It would only lead to increases in trade deficits with other countries that sell similar goods to the US, e.g. Vietnam, Indonesia, Thailand, and Malaysia. This is because the overall current account balance of the US is equal to domestic investment minus domestic savings, and as long as these two variables do not change much, the overall current account balance of the US would not change. Another misguided economic rationale is that Trump wants to use tariffs to protect certain manufacturing sectors of the US so as to bring manufacturing jobs back to the US. However, this is going against economic forces, as the US does not have comparative advantage in many manufacturing sectors anymore. It can only lead to lower economic growth and lower living standard for the American people.

How does the American public feel about the US–China trade dispute?

The short answer is: a majority of people do not support the trade war, but they do not feel strongly enough about the issue to change their mind about whether or not to vote for Trump or the Republicans as long as the trade war does not affect the broader economy, which is booming now. These people include even those who are supposedly adversely affected by the trade war directly, such as soybean farmers. The fact is that most Republican voters, either supporting Trump or not, do not care enough about the issue to strongly oppose him.

On the other hand, Democrats are traditionally more protectionist than Republicans. A majority of blue collar workers are Democrats. They would probably support the attempt to bring manufacturing jobs back to the US by restricting imports from China, even though they do not know for sure whether the policy would indeed work. Some Democrats who are not blue-collar workers feel that restricting cheap imports from low-income countries can help low-income American workers.

By and large, those who are against having a trade war with China are: first, American firms that export to China or make use of imports from China to produce goods and services; second, more educated people; and third, traditional conservative Republicans. Let us look at some poll results. Americans overwhelmingly think that trade is more of an opportunity to boost the economy than it is a threat to it, according to a WSJ/NBC News polling conducted on 10–14 March 2018 that showed support by a 66–20% margin. And that feeling transcends party lines. In a poll of registered voters taken by the *Wall Street Journal* on 15–18 July 2018,

- 49% said that raising tariffs and barriers to imports from other countries would raise the costs of consumer goods and hurt the US economy. Only 25% said that it would protect American jobs and help the US economy.

- 53% said that they opposed the recently imposed tariffs on foreign goods and that they would hurt the average American. Only 26% supported the tariffs and thought they would help the average American.
- 38% approved and 45% disapproved of the way Trump handled trade between the US and foreign countries.

The following are the details of the questions asked and the breakdown of the responses:

Q16: Do you think raising tariffs and barriers to imports from other countries will do more to ... (rotate top two)

- Protect American jobs and help the US economy
- Raise the costs of consumer goods and hurt the US economy
... OR ...
- Will it not have much impact one way or the other on the US economy?

The breakdown of the responses (results shown reflect responses among registered voters):

- Protect American jobs/help economy 25%
- Raise the costs of goods/hurt economy 49%
- Not have much impact one way or the other 16%
- Mixed, some of both 2%
- Not sure 8%

President Trump recently imposed tariffs which will make some products made in other countries and sold in the US more expensive. In return, some of these countries have imposed their own tariffs on some US products.

Q17: Do you support Trump’s actions and think they will help the average American, or do you oppose Trump’s actions and think they will hurt the average American, or do you think Trump’s actions on this issue will not have much impact one way or the other?

The breakdown of the responses (results shown reflect responses among registered voters):

- Support Trump’s actions/will help 26%
- Oppose Trump’s actions/will hurt 53%
- Actions on this issue will not have much impact one way or the other 17%
- Not sure 4%

Q10: Please tell me if you approve or disapprove of President Trump’s handling of trade between the US and foreign countries in July 2018. If you do not have an opinion either way, please just say so.

The breakdown of the responses (results shown reflect responses among registered voters):

- Approve 38%
- Disapprove 45%
- No opinion 16%
- Not sure 1%

However, the trade issue aside, in the same poll, 50% of registered voters approve of Mr. Trump's handling of the economy, with only 34% disapproving.

Next, let us look at some newspaper reports. The *Financial Times* reported on 14 July 2018 that 'In Iowa, the state's two Republican senators have both condemned the tariff gambit. However, pollsters say they have yet to see Republican voters share their representatives' alarm'. Moreover, the newspaper reports, 'A Washington Post-Schar School poll, conducted between June 2 and July 27, 2018 found that 57% of Americans disapprove of Mr. Trump's actions on trade. However, in the 15 states most likely to be affected by the tariffs tit-for-tat, Mr Trump currently has a 57% approval rating, according to the same poll'.

What are the costs of the trade war to the US?

I conjecture that, in the short term, the US probably loses considerably less than China. Some research results (e.g. Lai and Qi 2018) indicate that, in 2011, the US gains from trade with the rest of the world was about 3% of GDP, but China's gains from trade with the rest of the world was much larger, being about 18%. This means that China is more dependent on trade than the US.

Furthermore, the US economy is booming, while China's economic condition consists of many uncertainties. Its growth rate is slowing down. This strengthens the hand of the US in the trade war for two reasons. First, the costs of the higher tariffs (higher prices of consumption goods for consumers and higher costs of imported inputs for firms) become more bearable when the economy is strong. Second, China relies on the US market to sustain its growth rate. Thus, in order to sustain its growth rate, China would be more willing to cooperate with the US in exchange for the US not raising its tariffs on Chinese goods. The cooperation from China probably includes greater access to Chinese market for American firms, reducing the extent of forced technology transfer for American firms, or even political and military concessions from China (e.g. help on North Korea issue and South China Sea issue).

In the long term, however, I conjecture that the US would lose its credibility in the rest of the world. It loses its moral high ground as it does not play by the rule (e.g. it ignores WTO rules by unilaterally imposing tariffs on other countries), badmouths trading partners and rivals without evidence to support the claims, and uses bullying tactics. By openly demonstrating its contempt of multilateralism, the US loses its status as the champion and leader of free trade, and as the leader of multilateralism. Other countries would view the US as enjoying many privileges but shying away from

shouldering the obligations of being the leader in establishing and enforcing fair multi-lateral rules.

What are the costs of the trade war to China?

I conjecture that in the short term, if there is going to be a full-fledged trade war, China would suffer for two main reasons: decrease in GDP growth due to lower gains from trade, and lower standard of living as goods become more expensive.

However, in the long term, I believe China can adjust. First, the open hostility of the US to China's aspiration for technological supremacy would stimulate China to be more self-reliant and would induce it to speed up the development of independent science and technology capability. Second, China would likely speed up its economic reforms in areas such as the financial system, state-owned enterprises, and re-balancing the economy towards making aggregate demand more reliant on consumption and less on net exports and investment.

Note that if one looks at the annual data on current account surplus of China and those on the growth of China's GDP, one cannot find a strong correlation, either contemporaneous or lagged. Figures 1 and 2 demonstrate that current account surplus is not an important contributing factor to the growth of China. In fact, the proper way to think about the gains from trade for China is not that it gains more from a larger current account surplus, but rather that the sources of gains from trade include (1) imports of intermediate inputs lower the costs of producing final goods, (2) imports of final goods lower the price index of final goods and (3) specialisation and trade induce-ment of more efficient allocation of resources such as labour, capital and land. All these effects increase the real GDP. All these gains can be achieved under zero current account balance. The reason why reduction of exports hurts a country is that imports have to be reduced in tandem so as to maintain a constant current account balance. Thus, the damage of the trade war arises from the reduction of the total value of

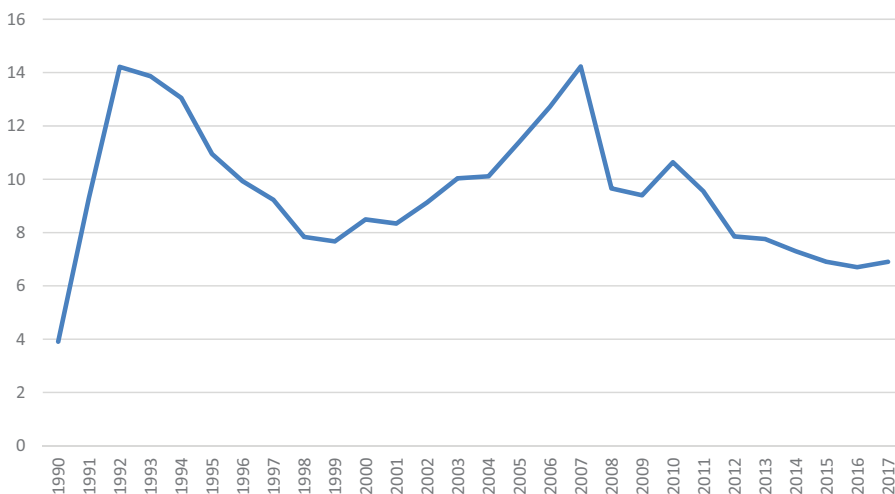


Figure 1. Real GDP growth rate of China. Data source: World Bank Database: "GDP Growth Rate of China" (<https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?locations=CN>).

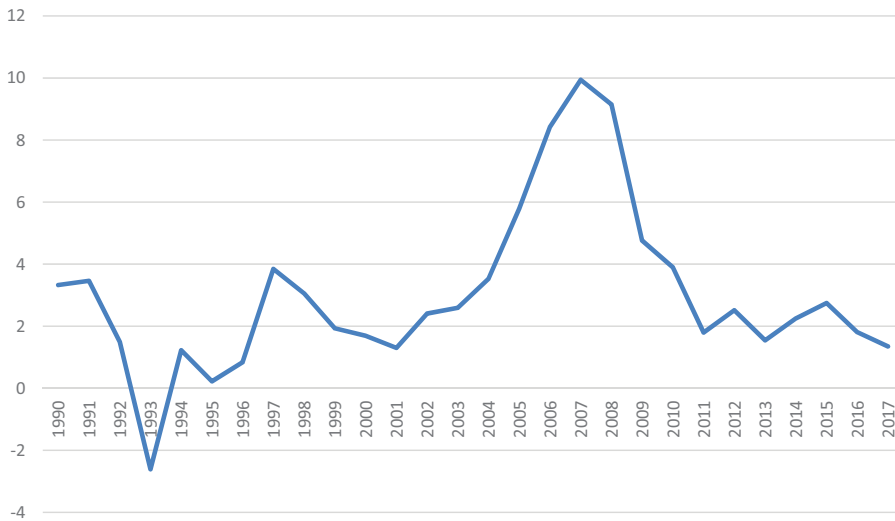


Figure 2. China's current account balance as a percentage of GDP. Data source: World Bank Database: "Current Account Balance as a Percentage of GDP for China" (<https://data.worldbank.org/indicator/BN.CAB.XOKA.GD.ZS?locations=CN>).

Table 5. Effects of 45% tariffs on imports of each other and no change in overall current account balances in all countries (%).

	China	US
Output	-1.36	-0.11
Total exports	-10.61	-6.68
Total imports	-10.60	-6.70

imports and exports. Based on this approach, a recent study throws light on how the trade war affects the real GDP of China, as explained below.

According to the prediction by Guo et al. (2018), under the scenario that both the US and China impose 45% tariffs on all imports from each other, and that the overall (not bilateral) current account balances of all countries do not change, the bilateral imports between the US and China slump in all sectors, with half of the 18 sectors considered by the authors dropping by more than 90% (see Table 5 for details). According to them, 'The collapse of bilateral trade is particularly pronounced in the sectors in which each country has a comparative advantage: US exports of agricultural goods, wood, paper, and computers, and China's exports of textiles and computer and electrical products'. Thus, it leads to a reduction of total exports of China to the rest of the world by 10.6% and a reduction of total exports of the US to the rest of the world by 6.7%.

Under the above scenario, China loses the US market due to higher tariffs, and thus it exports less to the US. Its output (i.e. real GDP) drops by 1.36%, a non-trivial reduction. The US exports less to China due to the tariffs from both countries, but its output is reduced by only 0.11%. This result is consistent with the finding of Lai and

Qi (2018) that China gains a lot more from trade with the rest of the world (about 18%) than the US does (about 3%). The assumption that the overall current account balances of all countries do not change as a result of the increased tariffs is plausible since the overall current account balance of a country is equal to national savings minus national investment, and they might not be much affected by trade policies. In other words, the overall current account balances of China and the US should not be correlated with the increases in tariffs imposed by the two countries on each other's goods.

How would the trade war unfold and what is the end game?

I conjecture that, though China might compromise by halting temporarily the tit-for-tat policy, it is likely that China would resume its tit-for-tat policy should the situation warrants, such as further escalation of the US tariffs. China needs to carry out its tit-for-tat retaliatory policy for both economic and political reasons. Economically, China wants to use the retaliation to force the US to back down from or at least halt the escalation of its protectionist measures. Politically, the Chinese government cannot appear to be weak in the face of unreasonable unilateral provocation from the US.

It is also clear that China would stop whenever the US stops, because the only reason China retaliates is to force the US to back down.

Would China give in to the requests of the US under the threat of the escalation of the trade war? In what way? My conjecture is that China is willing to compromise up to a point. However, it probably would not promise to outright ban any Chinese firm from demanding technology transfers from its US partner as part of a larger business deal. China sees these technology transfer deals as voluntary contracts between two parties, and that they do not violate any WTO rules. Nor do I think China would outright abolish the requirement that foreign firms need to enter into joint venture with Chinese firms as a condition for setting up production facilities in China. What China is more likely to do is to promise to buy more goods and services from the US, allow greater market access for American firms (and all foreign firms, in the areas where China is already planning to liberalise), reduce Chinese subsidies to its industries, reduce forced technology transfer, strengthen intellectual property rights protection, and make verification of all these commitments more transparent.

Would the US stop escalating the trade war and claim victory after some concessions from China in the coming trade talks? My answer is that it would be possible that a temporary ceasefire will be agreed, but the trade war could last for a long time. China would promise to strengthen intellectual property rights protection, buy more US goods and services, and allow greater market access for American firms. Some US tariffs on Chinese good would stay so that Trump can claim that he is not soft on China. Although the US might stop escalating the trade war, it is likely that the tariffs already imposed on Chinese goods would not be removed soon. In response to that, China also would not remove most of those tariffs already imposed on imports from the US, in keeping with the spirit of the tit-for-tat policy. Thus, the trade war can drag on for a long time.

However, I do not believe the trade war would affect the long-term policies of China, such as trade policy, industrial policy, re-balancing the economy towards more consumption-based and the BRI. China would continue to liberalise trade and support the WTO and multilateralism, and at the same time sign free trade agreements with many countries. The 'Made in China 2025' initiative would continue, though it might be carried out in a lower profile so as to avoid being suspected of subsidising its industries. Perhaps instead of providing subsidised credits to the state-owned enterprises, it can give them subsidies in research and development (R&D). R&D subsidies are legal under WTO rules. China might in fact speed up the protection of Intellectual Property Rights (IPR) using the pressure from the US to force the strengthening of domestic enforcement of IPR. It is possible that China would use the pressure from the US to allow the entry of more American and foreign financial firms so as to stimulate the financial market to become more efficient. Because of the open hostility of the US, China would likely search for more avenues to maintain economic growth. Thus, it is likely to speed up the development of its financial sector, reform and reduce subsidies to the state-owned enterprises to make them more efficient, and re-balance the economy towards more consumption-based. It is unlikely that the BRI would be much affected.

What will be the effects on the Hong Kong SAR of China?

Technically, the Hong Kong SAR of China is to be shielded by a US deal, called the 'United States-Hong Kong Policy Act', which means that the country has treated the city separately from China in terms of trade and economic affairs since the return of its sovereignty from Britain to China in 1997. So the tariffs the US slapped on China do not apply to the Hong Kong SAR.

However, companies of the Hong Kong SAR that own manufacturing facilities across the border and those that are in the re-export and transshipment business stand to be hardest hit if the trade war escalates. The logistics business would lose as there is less trade between China and the US going through China's Hong Kong.

If the trade war escalates, companies involved in the final assembly part of the global value chain would be most adversely affected (e.g. firms involved in processing trade in China) as the final assembly part of the production process is likely to move out of China. So far, most consumer goods (for which China is the final assembler) are not much affected yet. But as the trade war escalates and it covers more and more types of goods, it would eventually affect the Hong Kong SAR through the increased tariffs on consumer goods that are manufactured by factories in the Chinese mainland owned by Hong Kong residents.

According to the Trade and Industry Department of the Government of the Hong Kong SAR (2018), in 2017, the value of Hong Kong's imports amounted to US\$559 billion. The value of exports was US\$497.3 billion. The Chinese mainland was Hong Kong's largest supplier in goods in 2017. The value of Hong Kong's total imports from the Chinese mainland accounted for 46.6% of Hong Kong's total imports in 2017. Major imports were electrical machinery, apparatus and appliances, telecommunications and sound recording and reproducing apparatus and equipment, office machines

and automatic data processing machines, articles of apparel and clothing accessories, and professional, scientific and controlling instruments and apparatus.

In 2017, the Chinese mainland was the largest domestic export market of the Hong Kong SAR as well, accounting for 39.7% of Hong Kong's total domestic exports. The major domestic exports were medicinal and pharmaceutical products, plastics in primary forms, pulp and waste paper, cereals and cereal preparations, and electrical machinery, apparatus and appliances. Interestingly, a lot of trades of the Hong Kong SAR with the Chinese mainland were re-exports. In 2017, the value of goods re-exported through Hong Kong from and to the Chinese mainland was US\$435.9 billion, accounting for 88.6% of the Hong Kong's total re-export trade value. In the same year, 27.3% of the total exports of Hong Kong SAR to the Chinese mainland were for outward processing, reaching US\$71.7 billion. Among Hong Kong's imports from the mainland of China, 40.5% were related to outward processing, amounting to US\$99.4 billion. Thus, in 2017, trade with the Chinese mainland related to outward processing accounted for 16.2% of the total trade of the Hong Kong SAR.

Therefore, if there is no ceasefire in the US–China trade war and the US follows through on its promise, then it is likely that the Hong Kong-mainland trade, especially trade related to outward processing, would be severely hit. In that case, the economy of China's Hong Kong can be severely hit as well.

Both in the value-added and employment terms, the trading and logistics sector accounted for about 20% of Hong Kong's economy in 2016 (the Census and Statistics Department of the Hong Kong SAR 2018). It was the largest sector in the four key industries of Hong Kong (in terms of value-added), namely trading and logistics (21.6%), financial services (17.7%), tourism (4.7%) and professional services (12.5%). These percentages are quite stable over time. Thus, Hong Kong is very trade-dependent. Moreover, through forward and backward linkages, the damage to the trading and logistics sector would spread to financial services and professional services. Thus, Hong Kong's economy can be severely hurt by the reduction in trade between the US and China.

Finally, if the economy is severely hit, the effect is probably going to spill over to the financial market, especially the stock market. The Hang Seng Index fell from 30,814 on 1 January 2018 to 27,946 on 10 February 2019 (the time of writing), a 10% drop. If this trend persists, capital inflows into the Hong Kong SAR would decrease, which would further hurt its financial services industry.

Further thoughts

In light of the trade talk taking place in late February 2019 between China and the US resulting from the three-month truce agreed between Presidents Trump and Xi, I have some further thoughts.

First, it is possible that the trade tension between the US and China can be eased as a result of the trade talks between the two countries. It is more likely at the time of writing (i.e. 10 February 2019) than in July 2018 that China would compromise, as the Chinese economy has shown more signs of weakness, in particular the slowing down of the growth rate. Thus, I believe that China is willing to compromise, such as by

taking measures to enforce IPR, buy more goods from the US, allow more market access for US firms (including financial firms), reduce forced technology transfer, reduce subsidies to its industries, and make verification of these commitments more transparent.

By and large, China is more eager than the US to get a deal to ease the tension, as China's gain from trade with all its trading partners is higher than that of the US. China's economy is already slowing down, and it is burdened with debt problems and stalled reform and slow productivity growth. On the contrary, the US economy is still booming. However, there are also incentives for the US to get a deal, due to the risk of stock market gyrations, the pressure from the business sectors, and the increased probability of a recession arriving earlier than expected. With a trade war going on, a US recession can arrive earlier than without a trade war, as the trade dispute exacerbates the slowing growth in China and other economies (which contributes to stock market volatility) resulting from the disruption of global trade. Moreover, US consumers would eventually feel the bite of higher prices of goods imported from China and American producers would eventually feel that bite of higher prices of intermediate goods imported from China.

Such a deal, if reached, would have to be comprehensive enough to satisfy the US, but brief enough to satisfy China. China is probably going to use this opportunity to push through some reform measures against the will of the domestic vested interests. In those areas, China would be more committed and is willing to be more transparent. These areas would include enforcement of IPR, reduction of subsidies to some industries, especially state-owned enterprises, and opening up its financial market. These measures would be the ones that would strengthen China's compliance with the WTO rules. China probably would not commit beyond what are required of its compliance with WTO rules or already on its reform agenda, such as opening the financial sector gradually. It would strengthen its compliance in areas where not just the US but also other major industrialised countries, such as the European Union (EU) and Japan, complain about China. These areas include forced technology transfer, enforcement of IPR and industrial subsidies. In addition, China would also try to reduce the large current account surplus with the US so as to alleviate the concerns of US politicians.

In order to alleviate concerns of other countries and to comply with the spirit of the WTO rules, perhaps China can phase out providing cheap and easy credits to state-owned firms through the banking system, but switch to subsidising R&D instead. China by and large does not give explicit subsidies to industries but it does provide helps to state-owned enterprises through easier and cheaper credits from state-owned banks. Thus, though China does not literally violate WTO rules, this kind of industrial policy can be interpreted by foreign countries as providing indirect subsidies to industries, and thus violating the spirit of the WTO rules.

So, the principles on which China would determine the areas of compromise would likely be: (1) The measures can help China's reforms by using external commitment to overcome the resistance to reforms by domestic vested interests, e.g. to increase foreign market access of certain areas of the financial market, enforce intellectual property protection, and (hidden or explicit) subsidise certain industries or state-owned enterprises.

(2) The measures can help to make China a better international citizen by addressing the concerns of a majority of the important trading partners besides the US (e.g. EU, Japan and other European countries) and other international organisations. In other words, China wants to be viewed as ‘playing by the rules’ by a majority of its trading partners, in areas such as IPR, forced technology transfer, and subsidies of certain industries. (3) Specific concerns of the US that does not hurt China very much but can benefit the US a lot, or that is mutually beneficial, e.g. buying more goods from the US, allowing more FDI from the US and from the West, and taking measures to reduce the bilateral current account deficit of the US with China by re-routing the global value chains of American companies so that indirect exports from the US to China becomes direct exports from the US to China.

On the broader question of the economic-political relationship between the US and China, it appears that Donald Trump is more effective in getting China to make concessions to the US or penalising China for behaviours that the US detests than the previous administrations. This view would seem to be vindicated if China really makes the above concessions to the US in the US–China trade talk in late February 2019. If China is willing to make such concessions, it would seem to be true that in the short run the Trump administration is able to extract more concessions from China or change China’s behaviour to the liking of the US than the previous administrations. However, this would be done at a high cost to the credibility of the US in the long run. The US has been ignoring WTO rules and become openly hostile to China and badmouthing China with no evidence to back up its claims. This would stoke reciprocal hostility from China and the Chinese people and heighten nationalism in China. The US’s ignoring of WTO rules and other norms of international relations would also hurt the credibility of the US in the world as a leader in the global economic and political order, which the US has built up since the end of the Second World War. In other words, the Trump administration is more short-sighted than the previous administrations, and so it focusses more on short-term gains and discount long-term costs.

Going beyond the US and China, it looks like many European countries are going to follow the US’s footsteps in implementing measures to limit the market access of some of China’s products in their countries. Many European countries were and are hurt by Chinese exports, and some of them also feel being hurt by forced technology transfer and intellectual property theft or industrial subsidies of China. But these countries have less incentive to be openly hostile to China and badmouthing China. First, each one of them is not as large as China economically. Second, they have less conflicts with China politically, such as in the South China Sea, Taiwan, and Tibet and Xinjiang issues. The US is an incumbent economic, political and military power being challenged by China, which is a rising economic, political and military power. Thus, the US has more incentive and more bargaining power to play hardball against China. Therefore, it is likely that the European countries would be the followers and bystanders who stand closer to the US than to China.

What is really interesting is that it is quite likely that Donald Trump would change US–China relationship for a long time to come. It is conjectured that the US’s hostile attitude towards China is not going to change quickly in the next administration even after Trump stops being the US President. Donald Trump has successfully aroused the

nationalistic sentiments of the American people against China. Currently, no one in the US dares to speak up for China. It is politically correct to be suspicious of China nowadays. For example, some Americans who are not necessarily supporters of Trump are coming out to accuse China of trying to unduly influence the US through the Confucius Institute, and sending students to the US to learn science and technology from American universities so as to beat the US in the technology rivalry. The efforts to limit Chinese investment in the US gain bipartisan supports. Both Democrats and Republicans support being tough on China and politicians in both parties view China's investments as often posing national security threats to the US. This nationalistic sentiment is hard to fade even after Trump stops being the President.

In view of this development in US-China relationship, what would be China's response to the US's hostility? Unfortunately, it is likely that Chinese people would become more nationalistic. For example, the Chinese government and the Chinese people feel that it is unfair for the US to badmouth the Chinese technology company Huawei for being national security threat without any evidence. They view this as the US and its allies trying to suppress China's economic development. China would be more determined to be independent in its technological capability, independent in the use of its own currency in international transactions and its own international payment system, more mindful of its sovereignty over its Taiwan and Hong Kong, and so on. However, I think the Chinese people should keep their nationalism in check and replace it by the determination to reform the economy to become more efficient, to be truly technologically advanced and to be truly open to the rest of the world. In the face of the suspicions of the West, China should be more transparent in its policies and actions. It should provide evidence that the accusation of the US and some other countries that China is a security threat is simply not true.

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