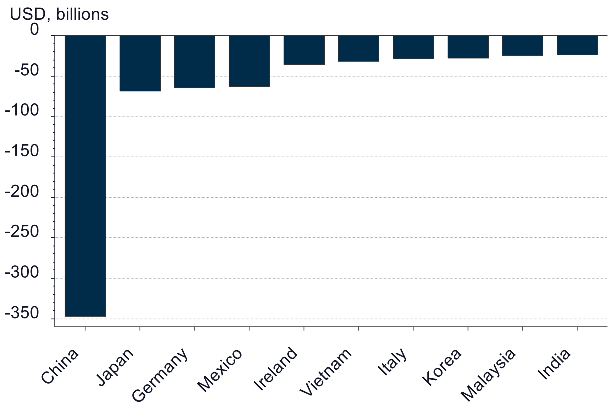
6 APRIL 2017

US – China summit: let the games begin!

- **Trade is likely to top the agenda of Donald Trump's meeting with his Chinese counterpart Xi Jinping today.**
- **We expect few tangible results from today's meeting, but it does mark the start of a high-stakes economic 'game' between the two sides, which the US is likely to win.**
- **Ultimately, this should lead to better access to China's markets for US firms – US service sector firms, especially technology firms, would be the biggest beneficiaries.**

Donald Trump meets with his Chinese counterpart, Xi Jinping, today with trade at the top of the agenda. Mr Trump may have softened his aggressive tone towards China recently, but he did take to Twitter earlier this week to say that today's meeting would be "very difficult".

US visibles trade balance, 2016



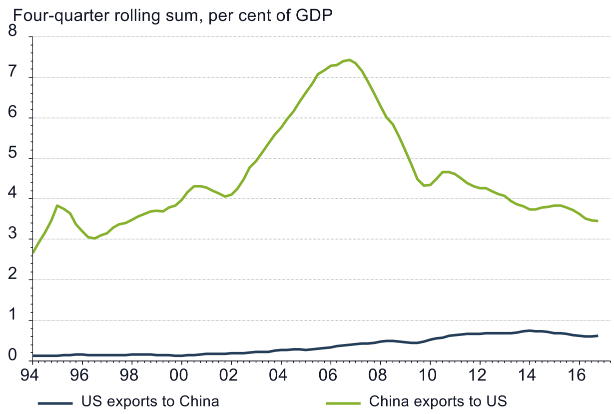
Source: Thomson Reuters Datastream / Fathom Consulting

Mr Trump is concerned by the large US trade deficit with China, which stands at more than US$300 billion per year, and is more than the US trade deficit with all its other trading partners combined. To reduce it, starting today, we expect Mr Trump to engage in, and win, a high-stakes economic game of chicken with China. The US holds all of the cards, not China. Why?

First, China's unelected politicians crave, and need, social cohesion to maintain their grip on power. Key to maintaining this grip is avoiding the sort of economic turmoil that starting a trade war with its biggest export market would cause. After all, maintaining economic stability is one of the reasons that China's policymakers have 'doubled down' on their bad habits of credit-fuelled, state-backed investment instead of pursuing economic rebalancing.

Second, nearly 4% of China's GDP is derived directly from exports to the US. An equivalent figure for the US would be less than 1%. Moreover, the US could find alternative sources for many of the things that it buys from China. China, on the other hand, could not replace the US as an export market. In other words, China's economy needs the US more than the US economy needs China.

US trade relationship with China



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Third, the US position in these trade negotiations is strengthened by international trade law, and China's systematic violation of obligations under World Trade Organisation (WTO) rules. The US has scope to open, and win, lawsuits against China at the WTO, a point not lost on both leaders.

Indeed, a report published in January 2017 by Barack Obama's trade representative lists a catalogue of Chinese misdemeanours. These include: restricting access to its markets; favouring local firms; stealing intellectual property; and illegally subsidising local industries.

Of course, US presidents before Donald Trump have tried, and failed, to force China to change its ways. But by raising the stakes more than others have done in the past, Donald Trump might just succeed. After all, if China is convinced that the US will take a more aggressive stance, it will be in its own self-interest to cooperate, as highlighted by the payoffs in the chart below.

A high-stakes economic game

		China plays…	
		Cooperative	Aggressive
US plays…	Cooperative	US 2, China 2 Will we end up here?	US 1, China 3 We are here
	Aggressive	US 3, China 1	US 0, China 0

Admittedly, today's meeting may yield little of substance, and the tone between the two leaders is likely to be cordial. But the meeting does mark the start of what is likely to be a prolonged, and potentially acrimonious set of negotiations between the two sides.

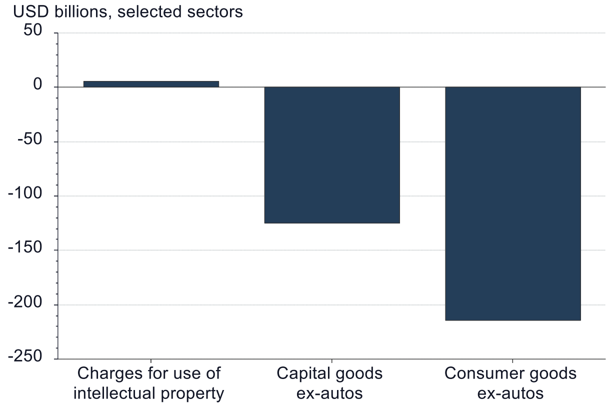
We do not expect Mr Trump to slap a 45% tariff on all imports from China, as he threatened during the election campaign. And Mr Xi could try and curry favour with Mr Trump by pledging funds to finance his infrastructure spending plans.

Nevertheless, once the US trade representative of the new administration is in place, we expect Donald Trump to use the the well-documented misdemeanours of China as a pretext to slap tariffs on some Chinese imports, such as steel.

While this would raise some revenues for the US government, it would only lower the US trade deficit at the margin. A far better prize, and a more effective way for the US trade deficit with China to fall, would be for China to grant much greater access to its market for US firms than it currently does. This would be particularly advantageous for US service sector firms, especially technology firms, which hold a comparative advantage in their field, yet export very little to China.

US trade balance with China in 2016

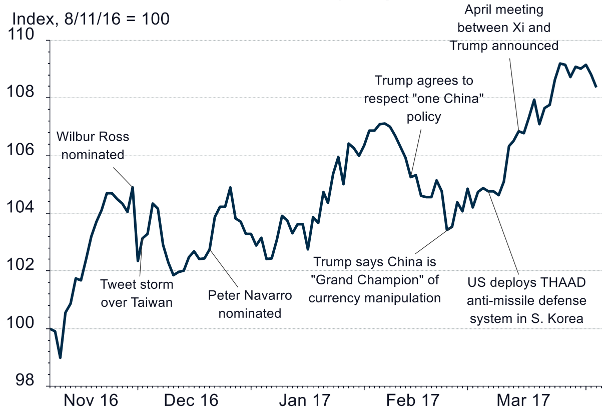
USD billions, selected sectors



Source: Thomson Reuters Datastream / Fathom Consulting

Indeed, those US-listed firms that already enjoy access to the Chinese markets have outperformed their peers since the election of Donald Trump, according to our China Exposure Index (CEI). In other words, investors in US firms that derive a significant share of their revenues from China, expect these firms to outperform their US counterparts. It seems, we are not the only ones expecting the US to win the game of chicken.

US China Exposure Index (CEI)



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