Opinion **Markets Insight**

How much will higher tariffs hurt China?

The bigger challenge the country faces is a policy-driven debt-deflation loop

CHETAN AHYA

During the 2018-19 round of US tariffs on China, Beijing took several steps to ensure it did not lose market share in global exports © AP

Chetan Ahya 9 HOURS AGO

The writer is chief Asia economist at Morgan Stanley

Investors hoping that volatility eases for the rest of the year may not like what they see on the calendar. As attention turns towards the US elections in November, investors in Asia are trying to understand how US-China trade relations could evolve.

The experience of the 2018-19 round of US tariffs on China may be instructive. What we learned was that the indirect effect of tariffs on corporate confidence, global capital expenditure and hence trade put more pressure on China's growth than the direct effects on flows of exports and imports.

Although only China faced tariffs, these indirect effects weighed equally on the rest of the world and the drag on China was not disproportionate. China's GDP growth did slow by 1 percentage point over 2018-19, but its contribution to global growth over that interval generally remained stable.

This time around, the extent of damage to growth from corporate confidence will depend on whether, if re-elected as president, Donald Trump follows through on ideas he has floated to impose tariffs of 50 per cent on imports from China alone and also levies of 10 per cent on the rest of the world. It will be better for cyclical growth prospects in China if the US doesn't raise tariffs on the rest of the world.

I would argue that companies around the world have been alert to possible tariff increases, and supply diversification efforts are well under way. But tariffs on the rest of the world would pose a bigger challenge, as they could compromise supply chain diversification efforts over the past few years.

What about the direct effects of tariffs and their implications for China's exports? Last time, China took several steps to ensure that it did not lose market share in global exports, and these measures may provide offsets.

First, currency movements played a key role in softening the effect of tariffs. In 2018-19, renminbi depreciation offset as much as 65 per cent of the weighted average increase in tariffs. On the flipside, the appreciation of the trade weighted US dollar index more than offset tariffs' impact on total imports and mitigated potential inflationary pressures in the US.

Second, what began as a rerouting evolved into a much deeper integration into global supply chains. Mexico and Vietnam have seen their trade surpluses with the US grow significantly since trade tensions emerged in early 2018, but we estimate that only 30 per cent of that increase can be explained by a rise in net imports from China. This implies that the domestic value added in their exports has grown. China has made further inroads into global supply chains by providing components and investing in these economies.

Third, China has carved out new products to export and new geographies to export to, shifting away from the US to emerging markets. While China's share of US imports has slipped to 13.5 per cent today from 21.6 per cent in December 2017, its overall market share in global goods exports has risen from 12.8 to 14.4 per cent over the same period.

To be sure, China will find it a challenge to sustain the 15-20 per cent export growth needed to use its excess capacity. External conditions are shifting, as the US is not alone in imposing tariffs. The EU and several emerging markets are planning if not already placing tariffs selectively on imports from China. Tariffs, when imposed, will weigh on trade and corporate confidence and exert pressure on growth globally and China.

Moreover, China's supply-centric growth model has only made exports more critical in managing deflation. To maintain its export market share, it must compress profit margins.

This means China's deflation challenge will persist. Domestic demand remains weak, and China will not be able to export its way out of the debt-deflation loop. We forecast that nominal GDP growth will remain subdued at 4.3 per cent and 4.8 per cent in 2024 and 2025 respectively and that debt-to-GDP ratios will keep rising.

As it is, we project China's debt-to-GDP ratio to reach 312 per cent by end 2024, a level that is higher than the US and some 30 percentage points higher from where it was in end 2021.

We think its current policy stance of targeting real GDP growth with high investment will create more excess capacities and is unlikely to resolve China's economic woes anytime soon. The solution lies in boosting domestic consumption via raising social security related spending such as healthcare, education and housing and in the process reducing household precautionary saving. The small steps taken in that direction are unlikely to be enough.