Opinion **Free Lunch**

China can outfox Trump's tariffs

Beijing is agile enough to swerve US protectionism

TEJ PARIKH

The US president-elect has pledged up to 60 per cent tariffs on China, but the levies may be less harmful for the country than analysts expect © Getty Images

Tej Parikh YESTERDAY

This article is an on-site version of Free Lunch newsletter. Premium subscribers can sign up here to get the newsletter delivered every Thursday and Sunday. Standard subscribers can upgrade to Premium here, or explore all FT newsletters

Welcome back. Donald Trump will be inaugurated as US president on Monday. What better time to stir the pot with a contrarian take on his team's plans to squeeze China in trade, manufacturing and technology?

Understandably, many reckon that additional tariffs and restrictions on China will be bad for its economy. But Trump's protectionist efforts could cause less harm than expected. In fact, Chinese industry could prosper in spite (or even because) of them. Here are the counterarguments.

Let's begin with the immediate, direct economic impact of tariffs. China has diversified away from the US market since Trump's first term. Total American demand for Chinese goods now accounts for about 2.8 per cent of China's GDP, according to Capital Economics.

Its calculations suggest that an increase in the effective tariff from around 15 per cent to 60 per cent (in extremis) — as Trump has threatened — could shrink the Chinese economy by a mere 1 per cent. (Other economists end up in the same ballpark.)

That’s perhaps smaller than many thought, and it is also *before* considering other offsetting factors.

China can divert exports to other destinations where there is rising demand. After tariffs hit the country in Trump’s first term, Beijing’s exports to fast-growing emerging markets soared. Demand for Chinese goods in the developed world excluding the US also picked up. Other nations — particularly those in the Belt and Road Initiative whom China has spent decades strengthening economic ties with — will want to maintain low-cost trade with Beijing.

Next, Chinese goods could still find their way to the US via trans-shipment — export through a third country — which would allow producers to avoid the levies. Trump through a third country — which would allow producers to avoid the levies. Trump has cottoned on, and is looking to clamp down on countries such as Mexico and Vietnam. That won't be easy or fast. Chinese companies are already hedging this risk by setting up factories across the world.

The renminbi is also likely to weaken when tariffs are announced. That will keep Chinese exports competitive. (Depreciation in the renminbi offset the impact of levies in Trump's first term.)

All things considered, the direct economic hit could be well below 1 per cent.

Cost of living pressures and the urgency of climate change mean the economic rationale to import cheaply from China (at least beyond the US) remains strong.

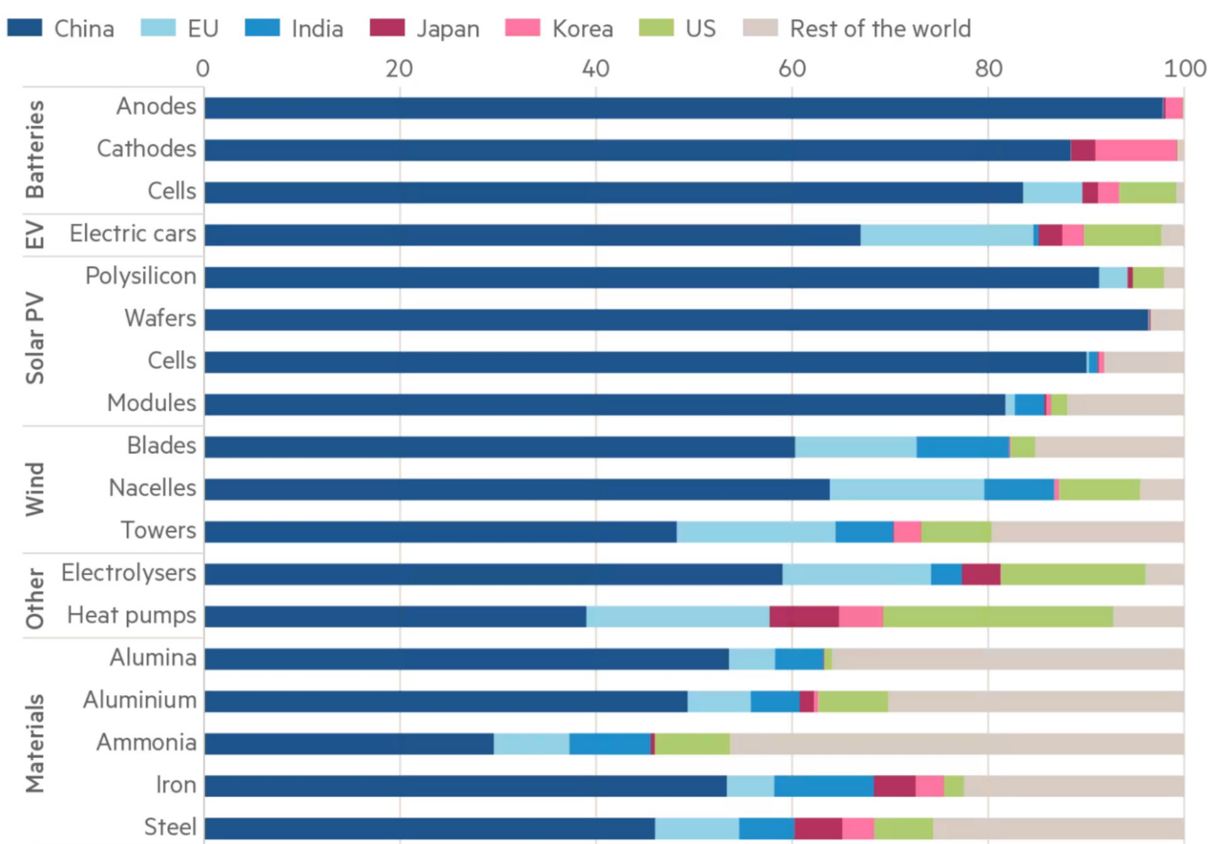
China's price competitiveness comes from its specialism in sourcing, refining and producing goods that align with global growth sectors. A decades-long, state-led industrial strategy has given China vertical dominance of the supply chains for electric vehicles, batteries and renewables, from rare earth commodities to finished products.

The country commands close to a [third of global manufacturing output](https://www.ft.com/content/38997f3b-d1f1-46dd-a173-c19b63304f12) (exceeding the output share of the next nine largest producers combined). It has a revealed comparative advantage across a broad range of goods: not just the old-school "Made in China" toys and clothing, but high-end, sophisticated products too.

Indeed, efforts to restrain China's industrial prowess often underestimate just how dominant it is and Beijing's ability to use state apparatus to support its producers. Goldman Sachs' China economist Lisheng Wang has suggested "continued policy support for high-tech manufacturing" and "fiscal easing" would help mitigate the impact of tariffs.

Installed manufacturing capacity

By region/country, 2023 (%)



'Electric cars' values are calculated based on 2023 production numbers, adjusted according to the utilisation rates of car assembly plants in the region
Source: IEA analysis based on IEA (2024a) and IEA (2023b)

Beijing could use rising US protectionism around the world as an opportunity to improve trade ties with America's frustrated allies. It could also retaliate by blocking access to vital raw materials. China has 36 per cent of the world's rare earth reserves, but controls 70 per cent of the global supply (hence Trump's obsession with Greenland).

Finally, though the west has advantages in artificial intelligence, semiconductors and quantum computing, protectionism in these areas may not hinder China's development of advanced technologies as much as some might expect.

BNP Paribas Asset Management's Chi Lo argued in a note last year that "restrictions can only bolster China's resolve to become tech self-sufficient". Lo's view brings the proverb "necessity is the mother of invention" — popularised by 20th-century Danish economist Ester Boserup — to mind.

With national control over its private sector, Beijing is using subsidies, directives and incentives to meet President Xi Jinping's objective to be world-leading in scientific and technological innovation. State-driven industrial strategy has its flaws, but China is better than any other at doing it well.

That means US export controls can incentivise Chinese companies — supported by Beijing — to redouble efforts on import substitution and tech independence through innovative workarounds, domestic collaboration and even black markets. Manufacturers face "fierce competition" with one another for state support.

"On net, American restrictions have accelerated China's innovation drive," said Dan Wang, a fellow at the Yale Law School's Paul Tsai China Center. "Before, Huawei and BYD would buy the best components on the market, but now their incentives are aligned to the Chinese government's. Huawei's money now goes to local semiconductor firms."

According to the Australian Strategic Policy Institute, China led in just three of 64 critical technologies between 2003 and 2007, but had become the lead country in 57 of those technologies between 2019 and 2023.

Despite being cut from western semiconductor supply chains, Huawei and SMIC developed a smartphone with cutting-edge chips in 2023. Last year, Huawei unveiled plans to mass produce an AI chip.

Beijing has developed a domestic engine to power scientific innovation. It has the world's largest number of STEM graduates, and provides long-term capital for research and development (which, as a share of GDP, is closing in on the US). This has undermined the restrictions put in place in Trump's first term and under Joe Biden's administration.

Still, things may not go China's way. For instance, Trump's protectionist agenda could drive wider global uncertainty, depressing demand and amplifying the hit from tariffs on Beijing's economy. The rest of the world may get tougher on Chinese imports too. Plus, the country's state-led innovation model is no panacea. It relies on the government making the right calls when allocating (and pulling) funds. That can be wasteful.

China also has significant structural economic issues. Its growth trajectory has weakened, and it is struggling to revive animal spirits and boost consumption levels following the property market crash. That leaves it too reliant on export- and investment-led growth.

But the point remains. Trump's tariffs may not be as harmful to China's manufacturing and technological supremacy as anticipated. Beijing has bigger challenges to worry about.

Thoughts? Rebuttals? Message me at freelunch@ft.com or on X @tejparikh90.

Food for thought

Though economists are still grappling with matters here on Earth, this piece argues that the profession should point its attention to the stars. SpaceX and Blue Origin's recent exploits, rising space debris and satellite competition all underscore the need to think about how to manage resources in outer space.

globalisation. Sign up here

Unhedged — Robert Armstrong dissects the most important market trends and discusses how Wall Street's best minds respond to them. Sign up here