Interview with South Korean Edaily on US-China trade issues

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Can U.S.-China trade negotiations, which are currently stalled, be concluded in the near future?

That is very unlikely. The current trade dispute between the US and China is not amenable to a quick or easy solution. As well as the large bilateral trade deficit the US runs with China and dissatisfaction that the Chinese market is nowhere near as open to US firms as the US market is to Chinese firms, the Trump administration has taken particular aim at what it sees as China's egregious intellectual property (IP) practices, as detailed in the March 2018 USTR Section 301 215 page report.

These are systemic issues for whose resolution to satisfy the Trump administration would require China to change fundamental aspects of its Party-dominated State-led capitalism model.

Even if a headline-grabbing agreement were to be reached, it is likely to be largely cosmetic and is unlikely to diffuse the ongoing tensions between these two economic and geopolitical rivals.

Some predict that President Donald Trump and Chinese President Xi Jinping will meet at the G20 summit later this month to set the stage for a negotiated settlement. What do you think about that?

It is likely that the two presidents will meet at the G20 summit and generate some good photo ops, replete with smiles and handshakes, but the chances of this leading to a fundamental breakthrough are slim.

As per the Section 301 actions and Vice President Pence's October 2018 speech at the Hudson Institute, and reflecting the president's oft-stated position that China has exploited the US when it comes to trade and that tariffs are an effective policy tool that plays to the US's benefit, the Trump administration is taking a conceptually different and much tougher approach to China than previous administrations.

For its part, China would no doubt like to diffuse the trade tensions with the US, but the nature of the issues - its IP practices (the USTR identified four bones of contention in its March 2018 report), the ubiquitous role of SOEs (State-Owned Enterprises) in the economy, and the Made in China 2025 plan to achieve leadership in a range of high-tech sectors - are not amenable to quick or easy solutions, particularly when the Trump administration appears to be seeking fundamental change not superficial commitments.

If both Trump and Xi are seen to make concessions, it is said that will make it difficult to conclude the negotiations for fear of political damage in their countries. How do you think domestic political mechanisms affect U.S.-China negotiations?

Domestic political considerations and interests drive all international negotiations, and these negotiations are no different. President Trump and President Xi operate in very different domestic political systems, however.

President Trump's short-term calculus in dealing with China (as with other countries) is conditioned by his having a firm eye on the 2020 presidential election. He does not want to do anything to upset the (strong) economic and market applecart; on the other hand, he seems to believe, or is doing a very good job of convincing the world that he believes, that imposing tariffs on China would help to bring back manufacturing investment, production and jobs to the US, particularly to the midwest industrial heartland.

President Xi does not face the same kind of electoral pressure but ultimately he is accountable to his supporters and has to balance competing interests among the ruling elites, particularly more internationally-minded reformers versus more nationalist hard-liners. He too has to balance economic growth considerations against not appearing to allow the US to infringe on China's sovereignty. It's a big ask.

Could the U.S. presidential election of 2020 be a variable in trade negotiations?

Most certainly. If less than 40,000 voters in Pennsylvania, Michigan and Wisconsin had voted for Hillary Clinton rather for Donald Trump, he would not have won. President Trump needs to hold these states in 2020 and he appears to see "being tough on trade", and tough on China (and Mexico) in particular, as the best way to do that, and he may sincerely believe that this is the best thing for the country too.

The Trump administration insists it can withstand trade disputes because the U.S. economy is strong. Also, China seems ready for a long-term war. Which country do you think will suffer more if the trade dispute is prolonged?

The US economy is better positioned economically to withstand a prolonged trade dispute than China, but not because "the US economy is strong" cyclically, that is, in terms of the current conjuncture.

There are two reasons.

The US is already a highly developed economy, whereas China is still a developing economy. US per capita nominal GDP is 6.5 times that of China, and in PPP (purchasing power parity) terms it is 3.5 times bigger. China does not want to do anything that could cause its nearly four-decade-long process of economic development to be interrupted let alone thrown off course.

A second reason is that China runs a large trade surplus with the US. This trade surplus adds to China's GDP and detracts from the US's. Intuitively speaking, China cares more about losing its exports than the US cares about losing its imports. Viewed from another angle, falling Chinese exports hits Chinese producers and workers, while the corresponding falling US imports hits US consumers. In China, the impact is more concentrated; in the US it is more diffuse.

But there are two qualifications. One, permanent tariff increases (and it matters a lot whether any tariff increases are viewed as being temporary or permanent) may result in a corresponding rise in the value of the dollar, if the real exchange rate remains unchanged (this would be the case, for instance, if net national savings did not change as a result of the tariffs, since net national savings equals the current account balance, and the nominal exchange rate would have to appreciate in the face of increased tariffs in order to keep the real exchange rate, and hence the current account balance, unchanged).

Two, the economy-to-market-to-politics feedback mechanism is much more direct and potent in the US than in China. If a prolonged trade war were to trigger a sharp drop in the US stock market, itself leading to a weaker economic outlook, the Trump administration might be less inclined to stay the course.

Hardliners in the Trump administration say the administration should press Beijing until it fundamentally changes its economic structure. However, it is unlikely that China will comply with such hardliners' demands. For this reason, there is a high concern that the era of peaceful coexistence between China and the U.S. will end and conflict will continue. How do you predict future U.S.-China relations?

US-China relations have entered a new phase, reflecting cumulative shifts in the relative economic and geopolitical balance of power.

As a result of China's sustained, rapid economic growth and development (and helped by its huge population), it now rivals the US in overall economic size: 16% of global nominal GDP in 2018 versus the US's 24%, but 19% versus 15% when measured in PPP terms. China's per capita GDP lags by a lot that of the US, but this fact merely serves to underscore the inevitability of China, should it continue on its current long-term economic development trajectory, eventually becoming a much larger economy than the US.

Meanwhile, under President Trump's America First/Make America Great Again doctrine, the US is signaling that it is no longer willing and able to play the role of "benevolent hegemon" in underwriting the liberal international order.

The hope and expectation in the West, perhaps naively, had been that, as China progressed up the economic development ladder, getting closer to the technological frontier and developing a burgeoning middle class, it would start to converge towards the West in terms of political and social norms and freedoms too, implying a weakening of the Communist Party of China's (CPC) political monopoly and a loosening of the State's grip on the economy and on society. Such an evolution would have set up the prospect of the US and China increasingly cooperating not just on mutual trade and investment but also in international burden-sharing and jointly taking the lead in the supply of global public goods.

This may still happen and is a good aspiration to have, but, as it becomes clearer that China's system of CPC political control and State-led capitalism is here to stay, it increasingly appears likely that the US and China will, like two giant economic/geopolitical tectonic plates, push up against one another, causing friction if not the occasional tremor or worse. Peaceful coexistence will need to be striven for, and underwritten by mutual restraint, rather than taken for granted.

Some experts point out that President Trump's insistence on "America First" will undermine its alliances, weakening U.S. leadership in the long run and negatively impacting competition with China. What do you think about that?

I see President Trump's "America First" mantra as serving notice on the world, and its allies in particular, that the US is no longer prepared to play the dominant role it did in the postwar period as the underwriter of global security and the liberal international order.

It is a basic tenet of international relations that every country puts its own interests first. If any country other than the US were to say that it puts its interests first, it would not be an issue, but when the country that systemically has been bearing a disproportionate share of the burden of underwriting the global public goods of security and free trade says it, it signals the need for a regime shift, one towards a more distributed pattern of burden sharing when it comes to military expenditures within security alliances such as NATO or the Japan-US Security Alliance or South Korea-US Security Alliance and a system of free trade that is more reciprocal and symmetric in terms of market access.

Given the rebalancing of relative economic weight in the world that has occurred in recent decades, I see the Trump phenomenon as more of a symptom of the need to revisit and evolve the rules of the game and burden-sharing associated with Western alliances and broader global security and the liberal international order than as a cause of their breakdown.

The market expects the Fed to take a rate cut due to the U.S.-China trade war. When will a rate cut be possible? How many rate cuts are expected this year?

There has been a major shift in thinking at the Fed since it raised the target range for the federal funds rate by 25 basis points (bp) to 2.25-2.5% last December. At that time, the median participant on FOMC (Federal Open Market Committee) was forecasting two more 25bp hikes this year, but by March the median FOMC participant did not envisage any more rate hikes this year.

With inflation below target, the Fed is likely to cut rates this year if economic growth dips and the Fed attributes this to headwinds from trade tensions with China, something Chairman Jay Powell, in a nod to the markets, said in a June 4 speech the Fed is “closely monitoring” and, if necessary, will “act [on] as appropriate to sustain the expansion”.

The Fed is unlikely to make a rate cut before September, however. This is because the Fed has already announced that by September it will no longer be reducing the size of its balance sheet. The Fed would not want to be cutting rates while still shrinking its balance sheet as this would represent a combination of interest rate “easing” and balance sheet “tightening”.

If the Fed does make a rate cut (of 25bp), it is unlikely to stop at one or it may even cut by 50bp to give the economy and markets a shot in the arm.

How do you look at the U.S. stock market this year?

Not being an equity strategist or a professional investor, I would rather not comment on the outlook for the stock market, other than to say that the stock market tends to rise over the medium- to long-term in line with economic growth and the associated growth in corporate earnings (eg, the S&P500 is now

84% above its pre-financial crisis peak) but in the short- to medium-term it can experience sharp and unpredictable swings.

The United States and China are the biggest trading partners for South Korea. How do you think the trade war affects Korea? If you have any advice about Korea, please let me know.

To the extent that there was sustained and serious trade disruption between China and the US, South Korea could be affected through two channels, one potentially beneficial, the other damaging.

South Korea could benefit, on its import side, from some trade diversion as both China and the US sought to divert some of their lost exports elsewhere and on the export side from export opportunities created by China and the US losing share in each other's market. To the extent that the US-China trade frictions lowered growth in both countries, however, as economic theory would tend to predict, South Korea's exports to both countries would suffer collateral damage.

It would be gratuitous of me to offer advice to South Korea, other than to reiterate the standard advice of economists that the best way to guard against possible negative external shocks is to have in place sound domestic structural and macroeconomic policies, including having good contingency plans, and to maintain good channels of communication with both countries and being prepared to act as an "honest broker" if required.