The Economic Impact Analysis of US-China Trade War

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Working Paper Series Vol. 2020-11

May 2020

Asian Growth Research Institute

Abstract:

The paper aims at analyzing the policy economic impact on Taiwan and providing policy recommendation.

There are three purposes of this paper. First, we aim to analyze the advantages and disadvantages of the US-China trade war on Taiwan's economy. Second, we will explore whether the intensification of the trade war will trigger a global financial crisis. Third, we will discuss government’s strategy to arrange and create a conducive environment to welcome the return of Taiwanese entrepreneurs.

Key words: US-China trade war, Overseas Taiwanese firms returning home.

JEL Codes: F5

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I. Introduction

As President Trump suddenly turned hostile, the US-China trade war is once again in full swing in early May, 2019. U.S. increased the tariffs from 10% to 25% on China's $200 billion product exports to the United States. China in turn avengingly imposes tariffs on agricultural products and alcoholic products made in the United States. Taiwan's OEM production is difficult to avoid the impact of the trade war, and will have a significant negative impact on trade volume and supply chain restructuring. But on the other hand, in the midst of the US-China trade war, many Taiwanese entrepreneurs in China have shifted their production bases and supply chains to Southeast Asia, or returned to Taiwan to hedge. According to the statistics of the Ministry of Economic Affairs, there are currently more than 100 Taiwanese entrepreneurs that have returned. The expected investment amount is over NT$400 billion, and it is more likely to increase to NT$500 billion in the future.

What are the pros and cons of intensified US-China trade war to Taiwan's economy? The question deserves further research. Moreover, as US-China trade war continues, the impact on Taiwanese entrepreneurs in China and Taiwanese companies has also increased. Especially the United States boycott of Chinese company-Huawei, has greatly affected the Taiwanese company-Hon Hai, the OEM of its mobile phone. In addition, once the United States has a tariff of 10% to 25% on China's $325 billion products, in which almost all product items such as laptops, mobile phones, televisions, and shoes are included. The impact to China cannot be underestimated and will also attack Taiwan's exports and the supply chain of Taiwanese entrepreneurs in China. Therefore, Terry Guo, the founder of Hon Hai Company, indicated “the US-China trade war may bring a bigger global recession than the 2008 financial crisis.” For a time, it caused quite a panic. How likely is Mr. Guo’s prediction to be realized? This article will provide further discussion.

Finally, the sudden and huge return of Taiwanese entrepreneurs from China is a decent surprise for Taiwan. However, how to resolve the five shortages (The shortages in water, electricity, working labors, skilled workers and land), and how to combine the return of Taiwanese entrepreneurs with industrial upgrading, are big tasks for government. As a consequence, there are three purposes of this paper. First, we aim to analyze the advantages and disadvantages of the US-China trade war on Taiwan's economy. Second, we will explore whether the intensification of the trade war will trigger a global financial crisis. Third, we will discuss government’s strategy to arrange and create a conducive environment to welcome the return of Taiwanese entrepreneurs.

II. The Analysis of the Advantages and Disadvantages of the US-China Trade War on Taiwan's Economy

According to the report of Business Today Magazine (2019.5.15), citing Deutsche Bank’s analysis, “In 18 months if trade war fully broke out, the US and Chinese GDP growth rate will fall by 2% each, and the overall GDP of Asia may decrease by 2% in 12 months. At the same time, it also pointed out that Hong Kong and Taiwan have the largest losses in economic growth, with a reduction of 3.9% and 3% respectively, and even forced into recession.”

Secondly, Professor Chu-chia Lin, the former Minister of the Mainland Affairs Council of Taiwan, also pointed out that the US-China trade war will have negative impacts on economic growth of the United States and China. The four Asian little dragons, including Taiwan, will have GDP growth rate below 2%. While South Korea, which is a trading competitor with Taiwan, has experienced negative GDP growth in the first quarter, 2019. Obviously, the negative impacts of the US-China trade war have already appeared.

However, Director Ming-Te Sun of Economic Forecasting Center of Taiwan Institute of Economic Research (TIER) pointed out that Taiwanese entrepreneurs in China have transferred high-end products to Taiwan for production, increased investment and job opportunities. Moreover, the United States has seen a significant increase in Taiwan's imports. Therefore, "the trade war has injured Taiwanese firms' investment in China, but Taiwan's economy is benefiting."

Furthermore, Professor Peter Chow of the National Bureau of Economic Research (NBER) used econometric model analysis and also pointed out that the similarity of Taiwan and China's export goods is as high as 50% or more. The difference of intermediate goods and components is not as much as consumer products. Once the United States imposes high tariffs on China, transfer to "Made in Taiwan" will be an important consideration. Therefore, if US imposes 10% tariff rate on China, "US GDP will fall by 1.06%, China's GDP will fall by 1.05%, and Taiwan's GDP will grow by 0.47%."

According to the above analysis, it is hard to judge the positive and negative economic impacts of US-China Trade War on Taiwan. Hence, we seek to make clear of the hidden truth. Firstly, Professor Peter Chow's model was based on the premise that US imposes 10% tariff on 200 Billion products from China to US. However, the tariff is now raised to 25%, thus the impact should be greater. Secondly, Professor Chow's analysis did not take into consideration of the trade war's impacts on Taiwanese businesses in China. Among the top twenty foreign firms exporting from China to US, ten are from Taiwan. The impacts on Taiwanese businesses in China will affect their demand from their subsidiary companies in Taiwan. Furthermore, Professor Chow did not take into account the fact that China's economy worsens due to the trade war, which in turn affects its import capacity. He also did not analyze the possibility of global economics exacerbating because of the downturn of Chinese economy which may have an impact on global trade volume and Taiwan's export.

As for Director Sun's analysis on the increase of Taiwan's economic momentum due to Taiwanese enterprises returning to Taiwan, it is true but some of the estimated numbers may be realized in years. Moreover, some of the returning Taiwanese enterprises invest in land and equipment transfer, which are not included in the GDP calculation; thus his estimation may be too optimistic. Secondly, it is questionable whether the transfer-order effect will continue once the international firms' supply chain is stable. In addition, neighboring country Korea has a similar trade structure to Taiwan, and its export has already been decreasing. There are many doubts on whether Taiwan can rise against the obstacles or not.

Furthermore, US's Entity List requires enterprises located in the US, including the US firms and foreign firms which use more than 25% of American technology, not to export to Huawei and other Chinese firms. China in turn releases the Unreliable Entity List as a countermeasure. The technology war started from boycotting Huawei to banning export to numerous Chinese tech companies. The expansion of war will impact TSMC, Largan, Advanced Semiconductor Engineering, Foxconn and other Taiwanese companies as well as their export.

To be fair, in terms of the impacts, once the US-China trade war breaks out and lasts for more than a year, both US and China will have a downgrade of 2% in economic growth (3% according to Deutsche Bank and 1.6-2% according to UBS). According to Directorate General of Budget, Accounting and Statistics, when China's GDP decreases by 1%, Taiwan's GDP will be affected by 0.29%. If China's GDP drops by 2% then it is likely that Taiwan's GDP drops by 0.58%. This does not include the reformation cost in supply chain for Taiwanese enterprises. This cost may be balanced out with transfer order.

In terms of benefits, if Taiwanese enterprises bring about 500 billion dollars within 5 years, then it is approximately 100 billion each year. Let's say the additional value is 40%, it's about 0.23% of GDP. The negative impact is -0.58%, and the effect of Taiwanese enterprises heading back is 0.23%, so the total impact is Taiwan's GDP drops by 0.35%. This does not include impacts on financial markets, currency fluctuation and their effects on Taiwanese firms and economy.

Overall, according to institutions' estimation on economic growth in 2019 which is 2.2%, if we deduct 0.35% from that number, then it will be harder for Taiwan to maintain a 2% growth. As a result, to maintain the economic momentum and to reduce the impact of decreased export, it is vital and inevitable to expand the domestic demand and consumption.

III. Will the Total Break out of US-China Trade War Stir up a Tsunami Bigger than the Global Financial Crisis?

Although so far, US-China trade war is on the edge. For the US, aside from boycotting Huawei and coming up with the Entity List, The FED also implied the possibility to cut interest rate, seemingly preparing the US for the trade war. China came up with Unreliable Entity List to fight back, targeting President Trump's stronghold, the Agricultural Producing States, raising the tariffs on wine and meat products from 10% to 25%. Meanwhile, it uses rare earth, an important source for high-tech industries, as another countermeasure. The restriction on rare earth export provides space for further imagination of the trade war in a time full of tension on both sides. Most experts estimated that it would be unlikely for President Trump and President Xi to come up with a trade agreement during their meeting at the G20 Summit in late June. However, is it really impossible afterwards? We believe that there is still chance for trade agreement in the future, because there are downsides on both sides and it is risky for them to fight a war of attrition. Given a graceful way to back out of the tension, the possibility of a trade agreement is not low.

To The US, its downside is that President Trump is facing Presidential Election next November. Once the stock market and housing market collapse, the impact on agricultural producing states' products becomes too big, or the tariffs induce an inflation, US citizens will suffer. As for China, its weakness is the internal supply side reform, alongside with the trade war with US, it becomes besieged by enemies. The crucial thing for market observation will then be whether China can withstand its economic condition. Thus, even though a trade agreement may still come about, it just needs to take some time.

Since the trade agreement has yet to come about, how long will this trade war last? The longer it lasts, the worse off for both countries' economy. It will cause difficulties for operations in enterprises, make it difficult to pay back their debts. It will result in drop on housing price, and the ability to pay mortgages will also decrease, which have negative impacts on the financial sector. Only then will the economic impact expand from trade and real economy to finance and thus incite a global financial crisis. The possible epicenter for this crisis is China, and US comes in second. If US stock market drops 30-40%, then it may lead to a tsunami that takes down Lehman Brothers. However, US still possess policy tools such as cutting the interest rate and QE to face problems.

As for China, it is not possible for a storm affecting China or the whole world to form unless the trade war lasts for more than one year, which leads to the significant debt rise of China's state-owned enterprises and banking sector's reserve ratio dropping sharply, as well as the house price decliming by 20-30%. As for now, Chinese state-owned enterprises' debt is around 50-60% of GDP, but if the central government does not support these state-owned enterprises, the unemployment rate will rise considerably and will bring about negative impacts politically speaking. Hence, the government will choose to support them. In terms of liquidity, China's Required Deposit Reserve Ratio is 14-15% and can afford to downgrade to 5-6%. Also, it has various tools such as tax reduction, subsidy and issuing public debt to tackle problems in the short run.

Although the western civilization surrounding Bank for International Settlements has continuously make warnings, stating that a huge financial storm may occur to the Chinese economics; all things considered, in the short run, China has solid economic foundation (massive foreign reserve, 3 trillion USD so far), close attention on economy (centralization and relatively flexible governing approaches) and abundance in tools (downgrading required deposit reserve ratio, subsidy, tax reduction and issuing public debt). It can still withstand the current situation. It is unlikely for a Chinese financial crisis to spark off in the short run, let alone one that affects the whole world.

However, US-China Trade War is not only on a trade level, it is a Thucydides Trap, a confrontation between the major ruling power and the major rising power. Even if US and China can come to a trade agreement, there will still be conflicts in technology, money and even global economic leadership in the future.

In addition, right now in the US, not only Republican Party, Democratic Party and American business sector, but also ordinary citizens mostly consider China a strategic competitor. As a result, US-China conflict between these two major powers is predicted to last for ten or twenty years.

To sum up, although the US-China trade agreement is postponed, both US and China have weaknesses, and there is still possibility to come to a deal. If it is reached within half a year or one year, then the chance of export and real economy pulling down the financial sector and causing financial crisis will be rather low.

If the agreement is not reached and the trade war lasts for over a year, then it may expand from real economy to financial sector, and thus a financial crisis may form. Hence, we must keep close attention to the development of the agreement, the price drop in US stock market, the change in Chinese state-owned enterprises debt, whether liquidity is enough, and the speed in decrease of housing price. Observing these indicators to further analyze the possibility of the financial storm. Obviously we have to learn from the historical lessons to stay out of troubles. For corporations and individuals, we should focus on our core competitiveness, do not use excessive financial leverage. Meanwhile, banks should enhance their capital adequacy ratio and raise non-performing loans coverage ratio to avoid being affected by non-performing loans and lack of liquidity due to the trade war. Only by doing so can Taiwan withstand adversity and stay out of the possible financial crisis.

IV. The Government Actively Preparing for the Return of Taiwanese Enterprises

As US-China Trade War is ascendant, Taiwanese enterprises in China are actively restructuring their global supply chain, moving to Southeast Asia, Taiwan or Mexico and USA. Along with the fact that US-China conflicts are shifting from trade to technology and even global economic leadership, the confrontation may prolong to ten or twenty years. Businesses must arrange their global layout, diversify their risk, which is the most important issue on hand. Thus, the amount of investment that Taiwanese enterprises bring back to Taiwan has exceeded expectations, more than 100 projects so far, around 500 billion. The government also positively provides land of Taiwan Sugar Corporation as well as tax discounts and incentives to welcome Taiwanese enterprises.

The government has recently proposed two important measures to react, including “the Welcoming Taiwanese Enterprises Return and Invest in Taiwan Action Plan” and “the Draft Act on the Use and Taxation on the Inward Remittance of Overseas Fund” (Under Examination in the Legislative Yuan). Welcoming Taiwanese Enterprises Return and Invest in Taiwan Action Plan is led by the National Development Council, with a tenure of 3 years from 2019 to 2021, oriented to match enterprise demands. According to data, enterprises meet the requirement and are categorized as businesses that are affected by US-China Trade War, the investment back in Taiwan contains smart technology and functions, or belong to the 5+2 industry innovation fields and high value-added products or components; government will provide customized single-window service, integrate the resources of Ministry of Economic Affairs, Ministry of the Interior, Ministry of Science and Technology and provide relevant land (higher flat area ratio for example), water, electricity, human resources (foreign worker quota), priority and resource on tax and fund (favorable interest rate on margin loan) to enterprises.

The Draft Act on the Use and Taxation on the Inward Remittance of Overseas Funds is led by Ministry of Finance and is still under planning, but is already put to the priority review bill list. It provides tax benefits to Taiwanese enterprises that intend to transfer their fund back to Taiwan, if they engage in relevant policy-prioritized industries or financial products, projects and venture capital in the start-up field that are recognized by the government. Once the investment is made, it provides tax refund. Within a year after the bill is passed, investment in real economy may enjoy 8% favorable tax rate; and 10% favorable tax rate within the second year. (Not yet decided.)

As this text stated, since the Welcoming Taiwanese Enterprises Return and Invest in Taiwan Action Plan was implemented this year, it has been three months and there are already 100 enterprises returning. The estimated investment amount is more than NT$ 500 billion and is predicted to create more than 40,000 domestic jobs.

In terms of Welcoming Taiwanese Enterprises Return and Invest in Taiwan Action Plan, major reflections from the society include:

(1)Unfair to local businesses: The Action Plan is giving special aid to foreign Taiwanese enterprises returning to Taiwan, and this is in turn unfair to local enterprises.

(2)Exacerbating the urban-rural gap: Industrial land price in Northern Taiwan is ten times the amount of the price in Southern Taiwan, and is still unavailable for seekers. Entrepreneurship and tax generating effect are still highly focused on the northern part of Taiwan. The urban-rural gap continues to expand.

(3)Even harder to upgrade the industry: Most Taiwanese enterprises returning to Taiwan seek to gain the foreign worker quota, indicating that they are still production oriented, and are dependent on land, water, electricity, labor package. In addition, they are not compatible with high added value operation model.

(4)Business risk does not necessarily decrease: Since Taiwanese enterprises move part of their production line back to Taiwan, they increase the import from Mainland China; which make the US customs highly supervise the imported products from China to Taiwan and the manufacturing process, making Bureau of Foreign Trade stricter on licensing certificates of origin.

V. Policy Recommendation

Forward looking to the future, considering the condition of public opinion mentioned above, the government should have higher level and more positive strategic thinking other than subsidy when it welcomes Taiwanese enterprises that are coming home. Here are the suggestions:

1. Upgrading the industry as the main point, backup plans as supplement:

So far, Taiwanese enterprises in China mostly rely on massive scale production, which requires certain amount of factors of production and Taiwan's resources are not capable of handling massive transfer of production capacity. Hence, when it comes to reviewing, we should employ methods like (1) Enterprises' investment business plan should include investment in 5+2 industry creativity, AI, IoT, Big Data, Smart Mechanical application and other relevant fields; (2) Tax refund on real economy investment should be restricted to programs that are related to upgrading industry, such as 5+2, AI, IoT, Big Data, Smart Mechanical, and purchase of hardware device that are research and development oriented, labor hiring in research and development and so on.

2. Combining Taiwanese enterprises that are returning with foreign investment to develop Taiwan into Asia-Pacific's research and development center:

As the Taiwanese enterprises are coming back, if the government can allocate more fund to combine foreign enterprises' technology and talents to develop Taiwan as Asia-Pacific's research and development center; it would help Taiwan to reborn after US-China Trade War and grasp the new chance to develop.

3. Export Processing Zone and Free Trade Zone provide a space for Taiwanese enterprises to return to Taiwan to conduct deep processing and create added value, enhancing the buffer cushion for Taiwanese enterprises that are not easy to return:

Many Taiwanese enterprises want to return, but Northern Taiwan lacks land and labor, which makes it difficult for them to move back. If Export Processing Zone and Free Trade Zone are in place, the plan to conduct deep processing in Taiwan can avoid the negative impacts of US-

China Trade War. However, it must meet the requirement of 35% rule of origin. It is required that if the products are made in two countries, it can reexamine whether it meets the place of origin standards. For instance, US is concerned about components' rule of origin. If the production capacity can be diverted to countries other than China, Taiwan or US, it will change the products' place of origin.

4. Through inter-departmental integration and the design of civil servant incentives, it aims to systematically solve the problem of 5 shortages:

In terms of inter-departmental integration, so far the leading officials of the departments have been ambitious, but they lack the interaction of policy, thus their policies contradict each others and the results are diminished. Hence, the Executive Yuan should come up with common goal KPI that are recognized through inter-departmental cooperation when it comes to the policy on Taiwanese enterprises returning to Taiwan. Such communication is beneficial to inter-ministries' cooperation and can maximize the outcome and results of policies.

Secondly, in terms of restructuring civil servant incentives, the government should expand the difference in salary, strengthen the incentive mechanism, and decriminalize the act of making profit for others, in order to encourage civil servants to bravely take actions, while withholding burden of proof when they receive disproportional income.

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