China Economy

China's policy options in Trade War 2.0

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As China and the US start to play the chicken game before negotiations, things could get worse before getting better. The Sino-US conflict could first escalate as China shows its willingness to retaliate with counter-tariffs, export controls on critical materials, cut in investments to the US, technology transfer restrictions and RMB depreciation in a controlled manner, while the US might launch targeted financial sanctions and delist Chinese companies from the US stock market. In terms of economic impact, a trade war is more akin to a pandemic instead of a financial crisis as they are both supply shocks. The impact of trade war on economic growth should be smaller than the lockdown during the pandemic, as the former mainly affects cross-border trades, investment and supply chain activities while the latter affects both cross-border and domestic activities. However, the impact of the trade war might last longer than the pandemic as a war destroys mutual trust and sows the seeds of hatred between countries. To offset the trade war shock, China may lower RRR & LPRs and launch additional fiscal stimulus to boost the stock market, housing market and consumer demand. China will continue to promote self-reliance in key technologies to reduce vulnerability to external pressure. China will diversify its trading partners by strengthening trade and investment ties with non-US economies. Despite the hard-line stance, China will keep the door open for talks. A comprehensive deal - perhaps involving domestic demand stimulus, overcapacity reduction, increased purchases of US goods and fentanyl cooperation - remains an option, although mutual distrust and unclear US objectives complicate this path.

- **Retaliatory tariffs.** China has shown its willingness to hit back by announcing an 84% tariff on all US products following Trump's recent escalation of tariffs on Chinese goods to 104%. The Ministry of Commerce stated that if the US insisted on going its own way, China would fight to the end. China's response was harsher than expected and increased fire sales in the global market last Friday (4 Apr) as investors' optimism about possible Sino-US negotiations faded while investors' concern about an escalation of Sino-US conflict increased. If Sino-US tensions escalate, China could further raise tariffs on US politically sensitive sectors like agriculture, energy, automotive, aerospace and consumer goods to maximize pressure on Trump. Hardship in farm states, oil-rich states and the Rust Belt could undermine support for Trump's tariffs. The tariffs would expose the US to the stagflation risk in the near term and recession risk in the future by disrupting supply chains, raising costs, undermining confidence, curbing business investment and reducing consumer demand. The tariffs would hurt China's economic growth and add deflationary pressure by reducing overseas demand, dampening manufacturing investments, increasing unemployment risks, undermining confidence and curbing household consumption.
- **Export controls on critical materials.** China could leverage its dominance in critical supply chains to control exports of strategic materials or products in retaliation in Trump's Trade War 2.0. China placed export restrictions on rare earth elements last Friday as part of its broad response to Trump's tariffs. If the US-China trade conflict escalates, China could expand its restriction list to include rare earths, semiconductor inputs and pharmaceuticals, where the US substitutes are years away. Export controls could disrupt the supply of key products and undermine market confidence in the US. But they would also hurt the profits of Chinese companies and accelerate the decoupling of the US and China by forcing US companies to look elsewhere.
- **Controlled RMB depreciation.** The US-China conflict will put downward pressure on China's exports and renminbi. Renminbi depreciation may partially offset the impact of tariffs on export volumes as Chinese exporters may lower export prices in US dollars to maintain market share. For the most

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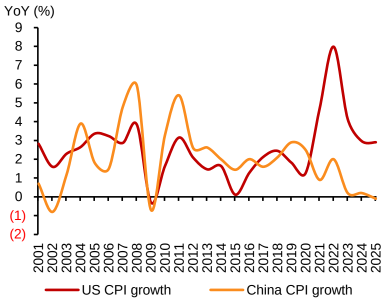

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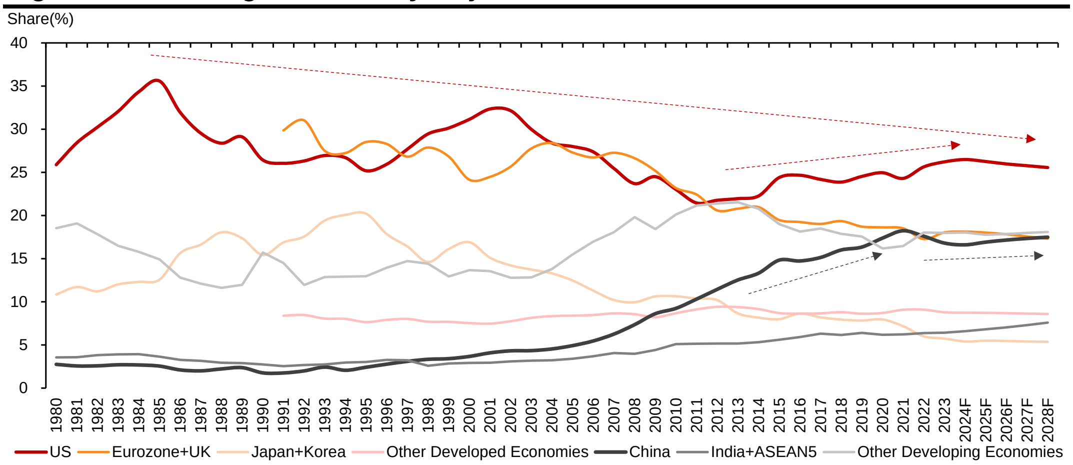
part, Chinese policymakers are reluctant to let the renminbi depreciate as they see its stability as part of financial system stability and a symbol of economic strength. By seeking a balance between boosting exports and market stability, China may prefer a controlled RMB depreciation in Trump's trade war 2.0. Only in extreme cases could China use renminbi depreciation as leverage to pressure the US, as the latter politicalises exchange rates. Looking ahead, US$/RMB could rise moderately if the Sino-US conflict escalates and fall again if their conflict eases or China launches aggressive fiscal stimulus. We expect US$/RMB to reach 7.45 at end-2025. Renminbi depreciation is negative for offshore Chinese equities, emerging market currencies and commodities.

- **Boosting domestic demand especially consumer demand.** Regardless of the outcome of the US-China trade war, China needs to consume more and produce less, strategically boosting consumption. As the trade war causes the stock market to plunge, hurts business and consumer confidence, and adds deflationary pressure, China may further cut RRR and LPRs in 2Q25 to boost market sentiment. Meanwhile, China might launch additional fiscal stimulus especially targeting consumption, but the timing is uncertain as the policymakers might view the fiscal and consumption stimulus plan as a bargaining chip in negotiations with the US, which means the policy plan will not be implemented unless the two sides reach a primary consensus. China's policy easing will provide some support to the stock market, housing market and consumer confidence, but cannot fully offset the negative impact of the trade war in the short term. **Diversifying trade partners by strengthening ties with non-US economies.** Trump's trade war 1.0 in 2018-2019 mainly focused on China, while his trade war 2.0 targets almost all trade partners. Trump's fire against the world creates a good opportunity for China to strengthen trade and investment ties with non-US economies. Although Trump may try to negotiate with other countries to include poison pill provisions against China, it is not easy for him to succeed. Firstly, Trump has no credibility as he could renege on previous promises at a moment's notice. Secondly, China has become the largest trading partner of more than 100 countries through its continuous opening up and supply chain upgrading. China has forged close trade, investment and supply-chain links with East Asia, Southeast Asia, the Middle East and Europe, making it difficult for these regions to completely cut off ties with China. Finally, Trump's call for no trade surplus with the US is difficult for other economies because the US has excess demand with low savings rates and high fiscal deficit while other economies have excess supply with high savings rates. The US share in China's total merchandise exports and China's share of US total goods imports respectively declined from 19.2% and 21.2% in 2018 to 14.6% and 13.1% in 2024. At the same time, China's trade relations with Southeast Asia, Mexico, Latin America and the Middle East increased.
- **Investment and technology decoupling.** As the two countries start to play the chicken game, the conflict could escalate from trade to cross-border investments. The US could add Chinese companies on the sanction list or delisting list while China could instruct its SOEs to reduce investments in the US. China could also block technology transfers, as suggested by its reluctance to approve a TikTok algorithm sale, leveraging its market access as a bargaining chip. The investment decoupling will hurt business and investor confidence, slow technology spill-over and reduce long-term returns on investments.
- **Diplomatic negotiations.** Despite the hard line, China has left the door open to talks, urging the US to lift tariffs and expressing a willingness to negotiate. A comprehensive deal - perhaps involving domestic demand stimulus, overcapacity reduction, increased purchases of US goods and cooperation on fentanyl - remains an option, although mutual distrust and unclear US objectives complicate this path.
- **Long-term self-reliance on key technologies.** China could double down on technological innovation and industrial self-sufficiency. This would include

heavy investments in semiconductors, robotics, smart appliances and other high-tech sectors targeted by US restrictions, aiming to reduce vulnerability to external pressure over time.

Figure 1: Share of global GDP by major economies



Source: Wind, CMBIGM

Figure 2: Share of global manufacturing value added by major economies

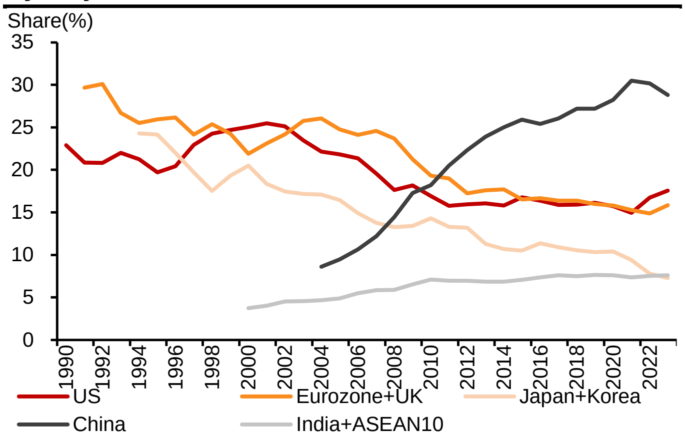


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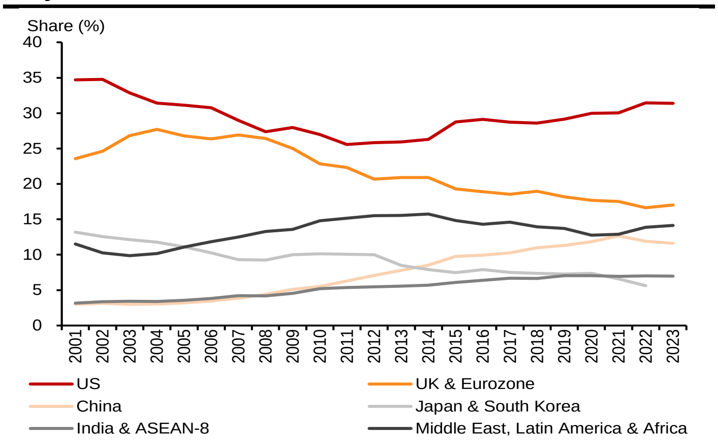
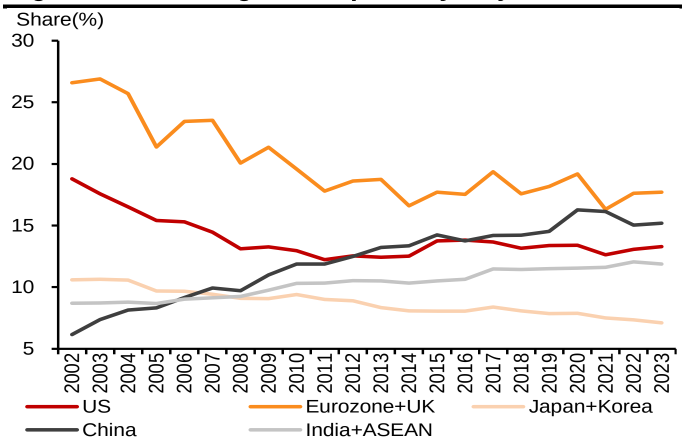
Figure 3: Share of global household consumption by major economies



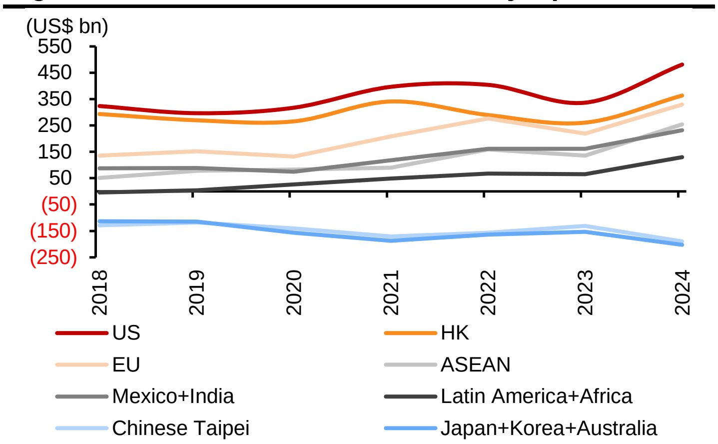
Source: Wind, CMBIGM

Figure 4: Share of global exports by major economies



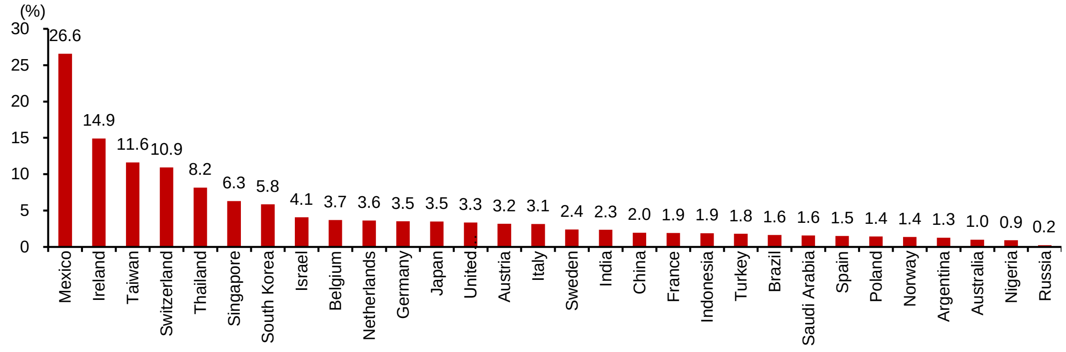
Source: Wind, CMBIGM

Figure 5: China's trade balance with major partners



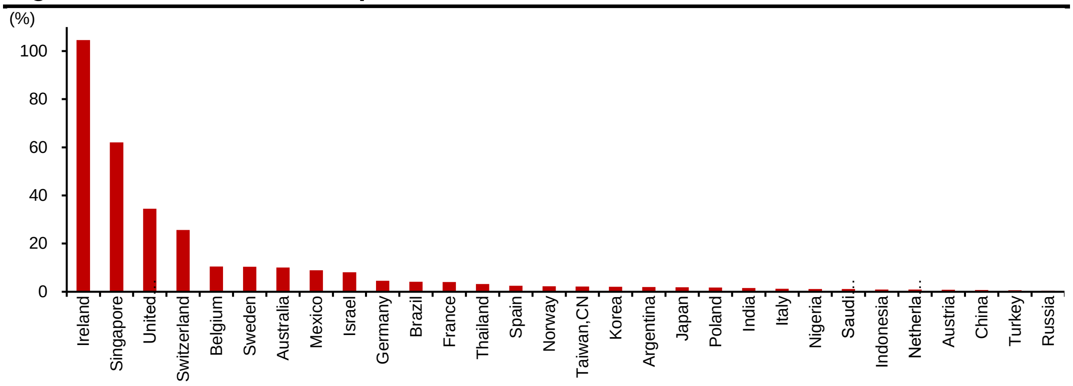
Source: Wind, CMBIGM

Figure 6: Exports of goods to the US as % of GDP in 2023



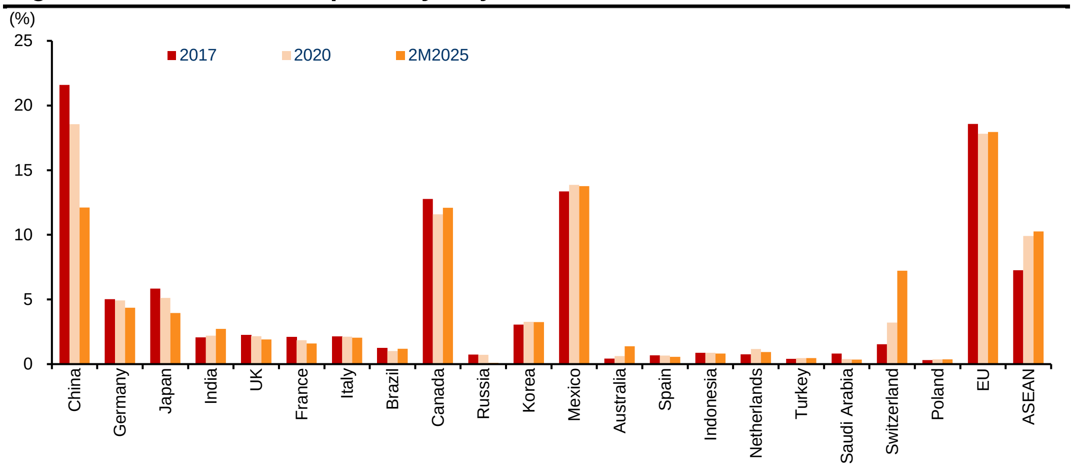
Source: Wind, CMBIGM

Figure 7: Direct investment position from the US as % of GDP in 2022



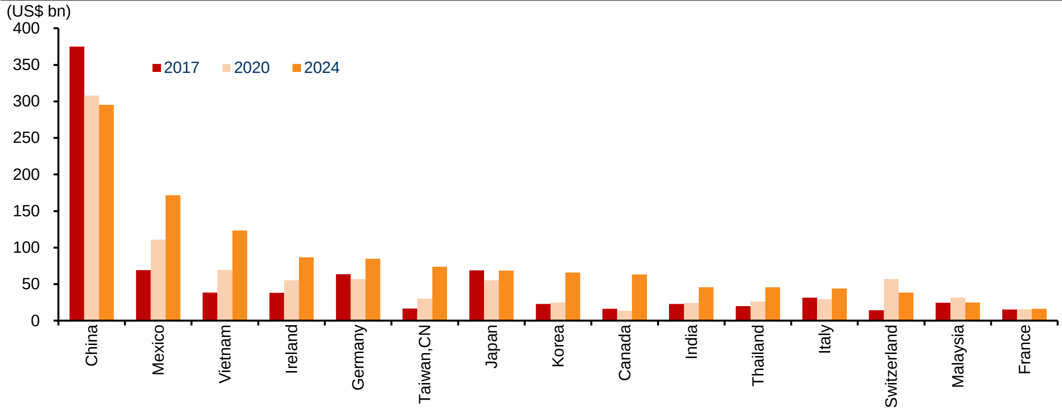
Source: Wind, CMBIGM

Figure 8: Shares in US Imports by major economies



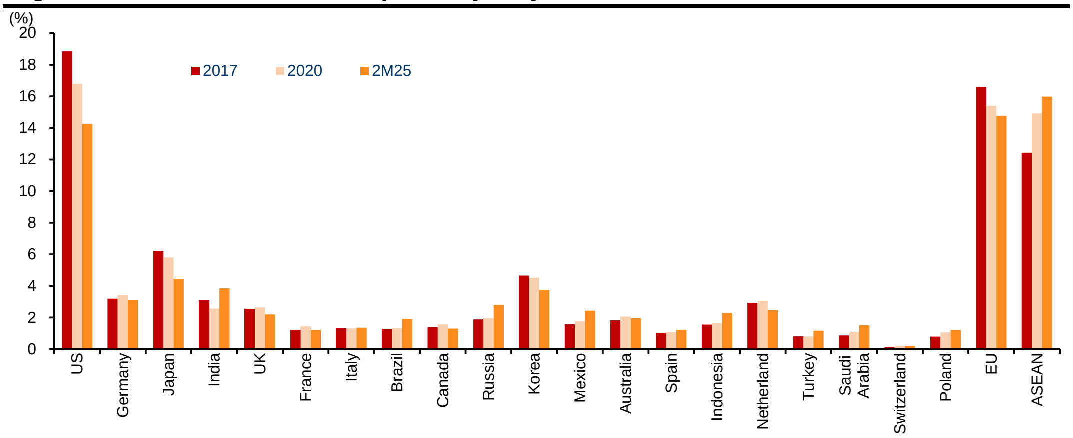
Source: Wind, CMBIGM

Figure 9: Top 15 countries with the largest US trade deficit



Source: Wind, CMBIGM

Figure 10: Shares in China exports by major economies



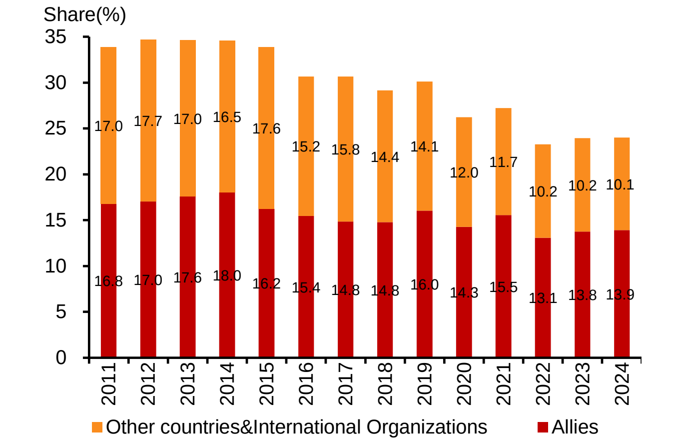
Source: Wind, CMBIGM

Figure 11: China's dominance in global supply of some materials

	Rare earth (e.g., neodymium, dysprosium, lanthanum)	Semiconductor Inputs (Gallium, Germanium, Antimony)	Natual graphite	Refined spherical graphite	Lithium and combalt	Magnesium and aluminum components	Pharmaceutical Ingredients (APIs and Precursors)
China's market share	60% of global production and over 80% of refining capacity	98% of global gallium, 60% of germanium and over 70% of antimony	60%-70% of global supply	over 90% of global supply	60% of global lithium and 70% of cobalt	50%-55% of global magnesium, over 60% in aluminum alloyes	over 70% of US APIs
Sectors in wide use	EV, wind turbine, missile, consumer electronics	Chips, solar panels and batteries	EV & grid-storage batteries	EV & grid-storage batteries	EV batteries	Auto parts, aerospace	Antibiotics, generics and vitamins

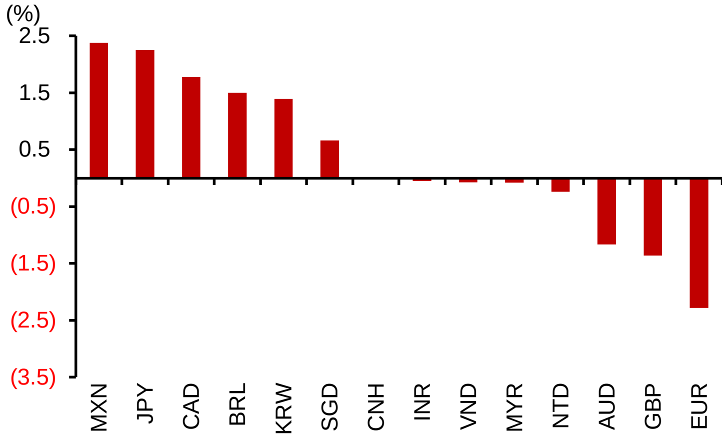
Source: Wind, CMBIGM

Figure 12: Share of US Treasury holdings by allies and other countries



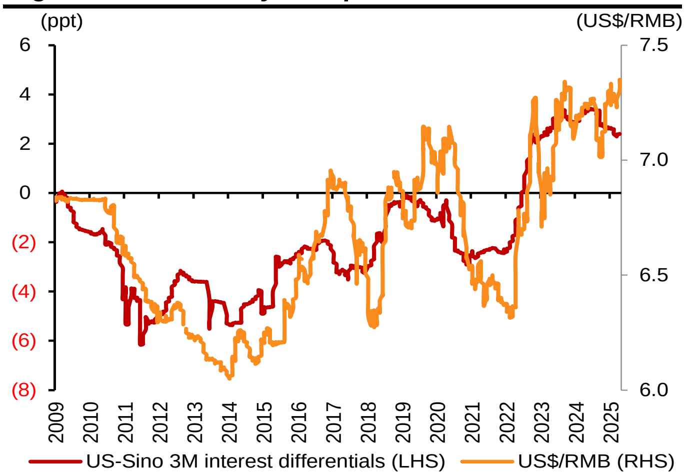
Source: Wind, CMBIGM

Figure 13: % changes in USD against major currencies after Trump announced the reciprocal tariffs



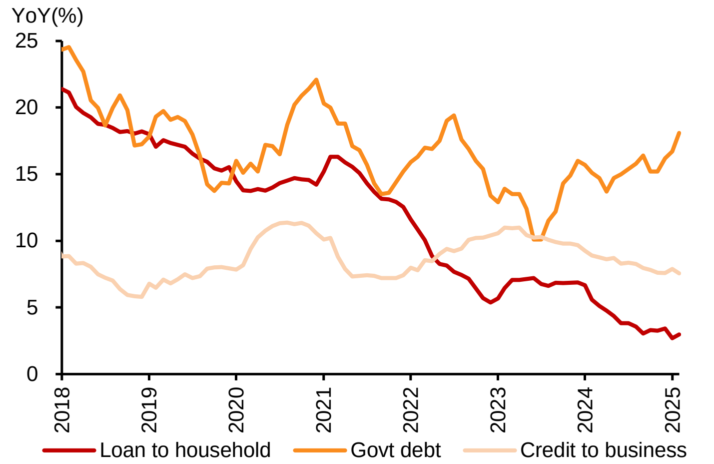
Source: Wind, CMBIGM

Figure 14: US & CN yield spreads & USD/RMBrate



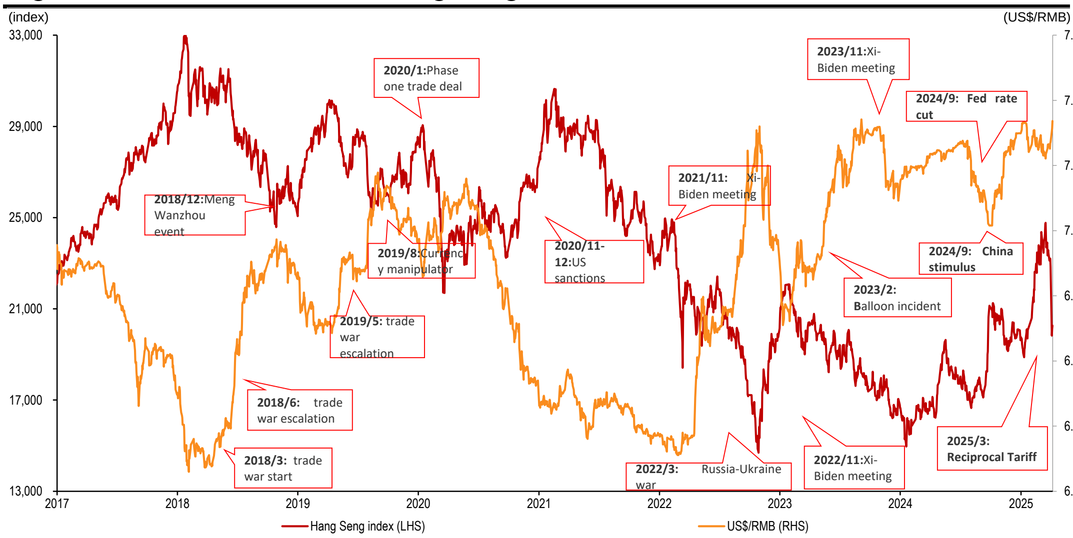
Source: Wind, CMBIGM

Figure 15: China's credit growth by sector



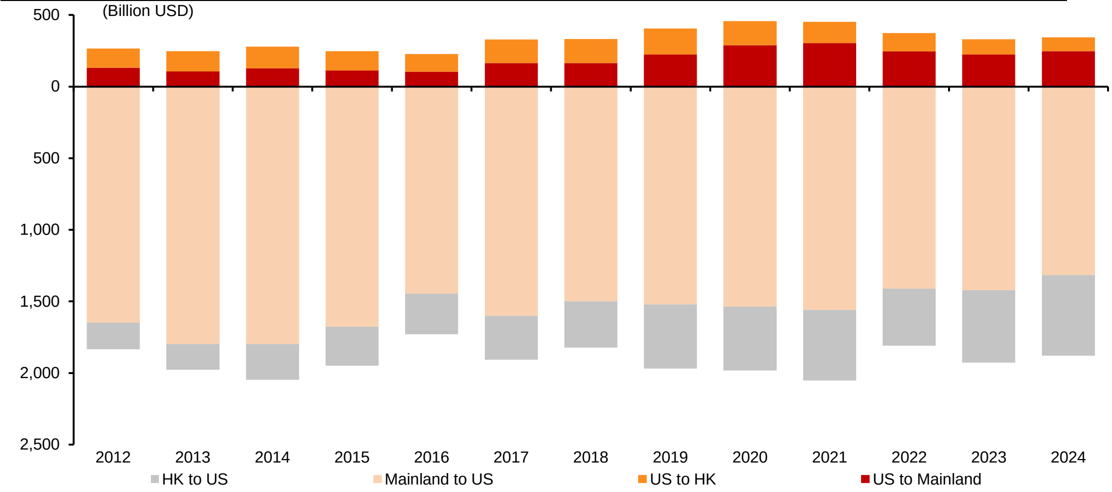
Source: Wind, CMBIGM

Figure 16: USD/CNY rate and Hang Seng Index



Source: Wind, CMBIGM

Figure 17: Portfolio investment positions between the US, Mainland China & Hong Kong



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