Tariffs, Trade and Beyond

The US-China Challenge

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Executive summary

Many observers of US-China relations have focused on trade disputes and their potential impacts on interlinked global supply chains and on global economic growth. However, the tensions between the two nations run far deeper than trade balances. This "great game" of the 21st century is no less than a struggle between an incumbent superpower and a rising challenger. And, now the proverbial cat is out of the bag.

This article considers the current US-China trade conflicts in a broader context, highlighting the depth and complexity of the US-China relationship as each country competes to enhance its global influence. We also suggest that US-China trade issues are occurring as global supply chain models evolve and, here, we examine some of the drivers of change in global trade that investors should focus on.

- Why and how global trade matters
- US and China: differences in trade dynamics
- Drivers reshaping global supply chains
  - Technology
  - Intellectual property
  - 5G communications and cybersecurity
  - AI and quantum computing
  - Military presence
- Influence and leadership in a digital world
- Conclusions and investment implications

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Introduction

Much of the attention surrounding US-China relations has centered on the trade wars. However, we see the tensions between the two nations running far deeper than the mercantilism of bilateral trade balances. The dénouement of this "great game" of the 21st century—that is, the struggle between an incumbent superpower and a rising challenger—has long been debated. However, what had not been clear was how and when this struggle would come to a head. At the onset of the US-China trade disputes (which now seems so long ago), the consensus assumed a speedy resolution. Given the co-dependence of these economies and the interconnected nature of global value chains,[1] it seemed inconceivable that the status quo could be disrupted for an extended period. However, in the last few months, this perception has shifted to deep concern. While it is still likely that the US and China can reach an agreement on the rules of engagement when it comes to trade—whether that is in one month or in six or more—the proverbial cat is out of the bag.

The present predicament may be reminiscent of past occasions where American economic supremacy was believed to be under threat. For example, in the 1970s and 1980s, when Japan emerged as an Asian powerhouse, the US and Japan entered into multiple tit-for-tat trade skirmishes. It could be argued, however, that these past confrontations were not of the same strategic importance, real or perceived, as we see between the US and China today. The US-China opposition ranges across economic, geopolitical and technological lines—those at play today and those shaping the future. Indeed, the opposition represents a struggle for dominance in the digital 21st century as it is still evolving.

1. *See note on global value chains on page 3.*

Global value chains for calculating global trade statistics

A note on global value chains (GVCs)

Over the past few decades, exports from one country to another have increasingly involved complex interactions among a variety of domestic and foreign suppliers. These international trade, production and investment linkages are known as global value chains (GVCs). International trade partnerships are the result of a firm's strategic decisions to optimize where to outsource, where to invest and where to carry out its various activities—favoring access to the skills, materials and infrastructure it needs that can be had at a competitive cost and quality.

To calculate the value-added in GVCs, we sum two kinds of exporting activities:

1) a country's imports of foreign inputs that are used to produce the goods and services that it exports. (This is known as the "backward" participation rate, which is a ratio of foreign value-added content of exports to total exports.)
2) a country's domestically-produced exports that are inputs to a "downstream" foreign partner in the production process. (This is known as the "forward" participation, which is the ratio of domestic value-added content sent to foreign countries relative to total exports.)

From a policy perspective, the focus should be on the total value that firms are generating and not the share value-added that is being performed domestically. In Vietnam, for example, the share of domestic value-added in exports fell from 64% to 53% from 2005-2016, but at the same time, the total domestic value-added exported was multiplied by 4. So Vietnam gained more and exported more over the period.

Note: The joint OECD – WTO Trade in Value-Added (TiVA) initiative established in 2013 considers the value added by each country in the production of goods and services that are consumed worldwide. The TiVA methodology eliminated some of the double counting problems that had existed in traditional trade statistics. TiVA indicators are designed to inform policy makers better by providing new insights into the commercial relations between nations.

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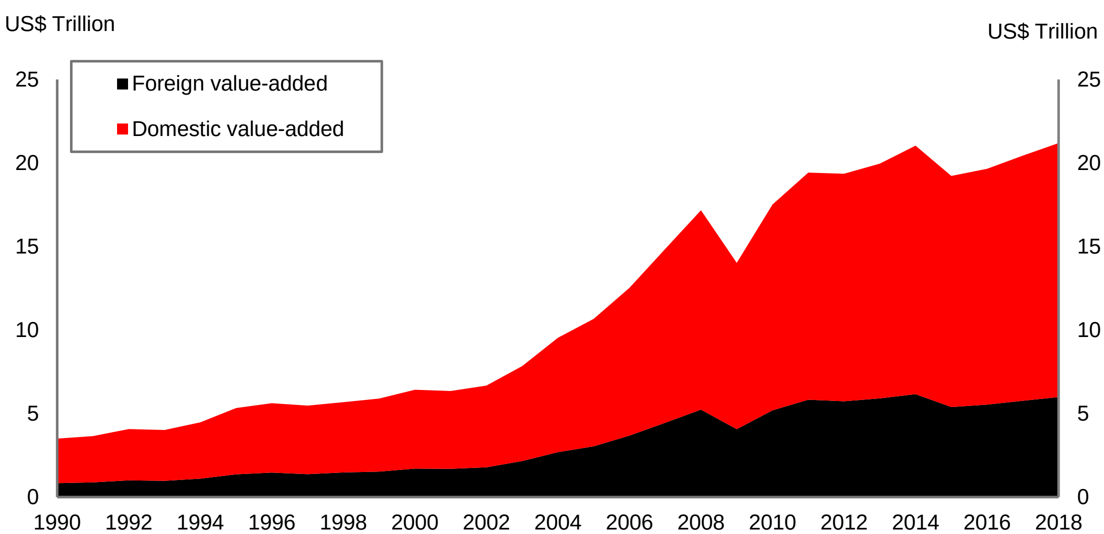
Why and how global trade matters

Partially as a consequence of trade tensions, the International Monetary Fund (IMF) has already revised its global growth expectations for 2019 down to 3.3%, or 0.02% below its January 2019 estimate.[2] Beyond the headlines of bilateral trade disputes, it is apparent that in today's world, global supply chains are complex and many can be difficult to disentangle. In fact about 70% of global trade involves GVCs in which services, raw materials, parts, and components cross borders—often numerous times. (Figure 1) Nevertheless, as the trade disputes continue into a second year, some US firms are shifting production out of China to Vietnam, India, Taiwan and Malaysia, among other countries. In fact, Vietnam's exports to the US increased nearly 29% from January – May 2019, while Vietnam's imports from China increased nearly 20% over the same period.

Deutsche Bank Global Research estimates that global trade volumes are now at almost USD 25 trillion, as opposed to just about USD 6 trillion in the early 2000s.[3] Furthermore, one-third of global trade in value-added terms is now composed of foreign value-added (Figure 2), showing that trade is not only about manufacturing and exporting products, but also involves substantial cross-border activity in intermediate goods and services.

Figure 1. Global trade: long-term trends in value-added terms



Global trade volume is close to USD 25 trillion today; over two-thirds occurs through GVCs.[4] This suggests how interconnected economies are today.

Source: UNCTAD, Deutsche Bank Global Research, as of 31 May 2019.

2. *World Economic Outlook, April 2019, Growth Slowdown, Precarious Recovery.*
3. *OECD, Deutsche Bank Global Research.*
4. *Global value chains (GVCs) represent complex international network structures involved in the flow of goods, services, capital and technology across borders. Global Value Chain Development Report 2019, World Trade Organization, the Institute of Developing Economies (IDE-JETRO), the Organisation for Economic Co-operation and Development, the Research Center of Global Value Chains headquartered at the University of International Business and Economics (RCGVC-UIBE), the World Bank Group and the China Development Research Foundation.*

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US and China: differences in trade dynamics

If we examine foreign value-added as a percentage of exports for some key countries in global trade, we note that just about 8% of US exports have a foreign component, while this is true for about 16% of Chinese exports. (Figure 2)

Figure 2. Global trade integration: by the numbers

Exports including a foreign component		Contribution of exports to GDP	
US	8%	US	10%
China	17.5%	China	20%
Mexico	37%*	Mexico	40%
South Korea	30%	South Korea	45%

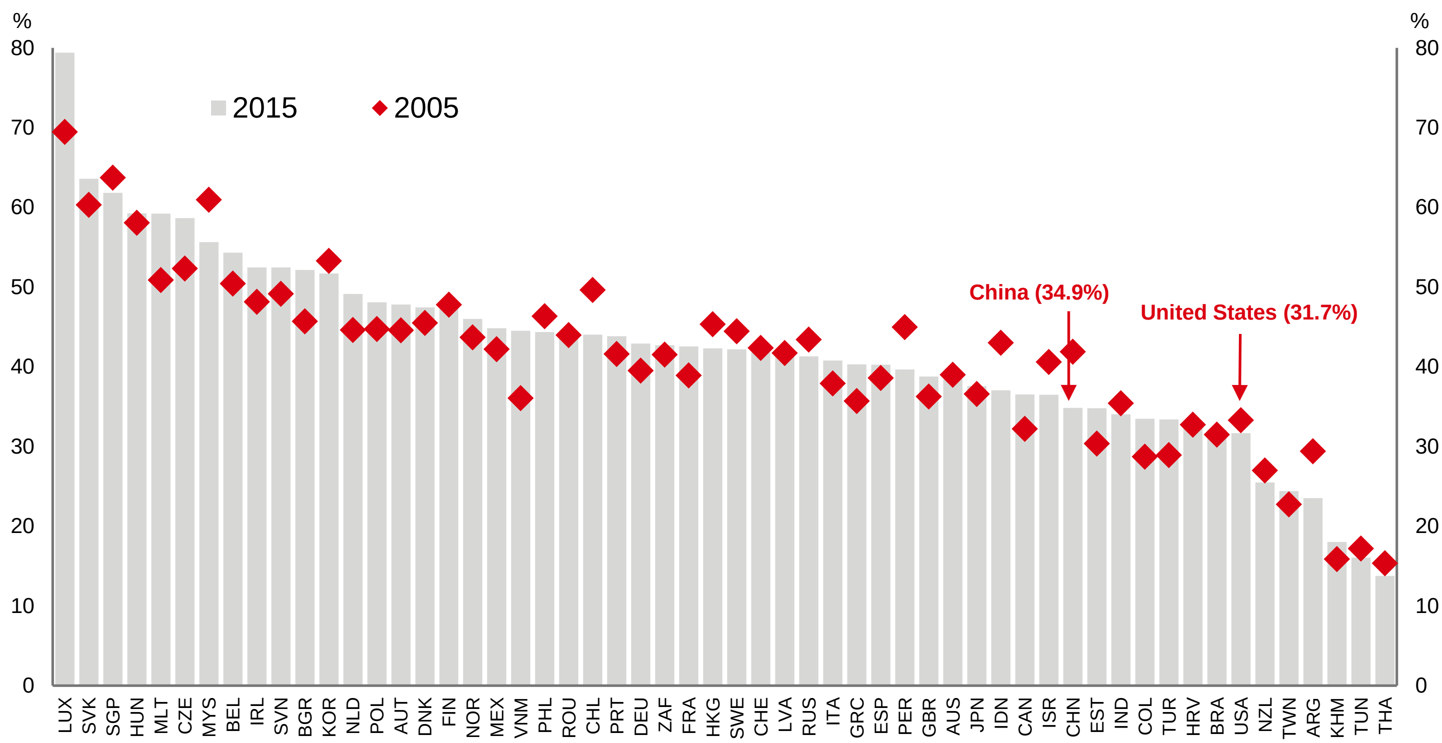
** In Mexico, we see the highest percentage of cross-border production, where about 37% of its exports include foreign components, due to the integration of the automobile industry across the US and Mexico. This is why President Trump's threat to impose tariffs on imports from Mexico was seen as such a blow to Mexico and the US automobile industry. South Korea also stands out as a country susceptible to trade frictions.*

Source: OECD, Deutsche Bank Global Research, May 31, 2019.

Overall, GVCs today are of greater importance to China as a hub than they are to the US. In the US, for example, a good 30% of trade is part of the GVC, while for China, it is 35% of trade (Figure 3). About 17% percent of Chinese exports add value using foreign inputs while this is true for only 9% of US exports. On the other hand, about 22% of US exports are used as value-added inputs for the exports of other countries, while the equivalent for China is about 17%.

China has advanced its economy through its growing importance in GVCs.

Figure 3. GVC participation rates in different countries



Source: OECD, Deutsche Bank Global Research, May 31, 2019.

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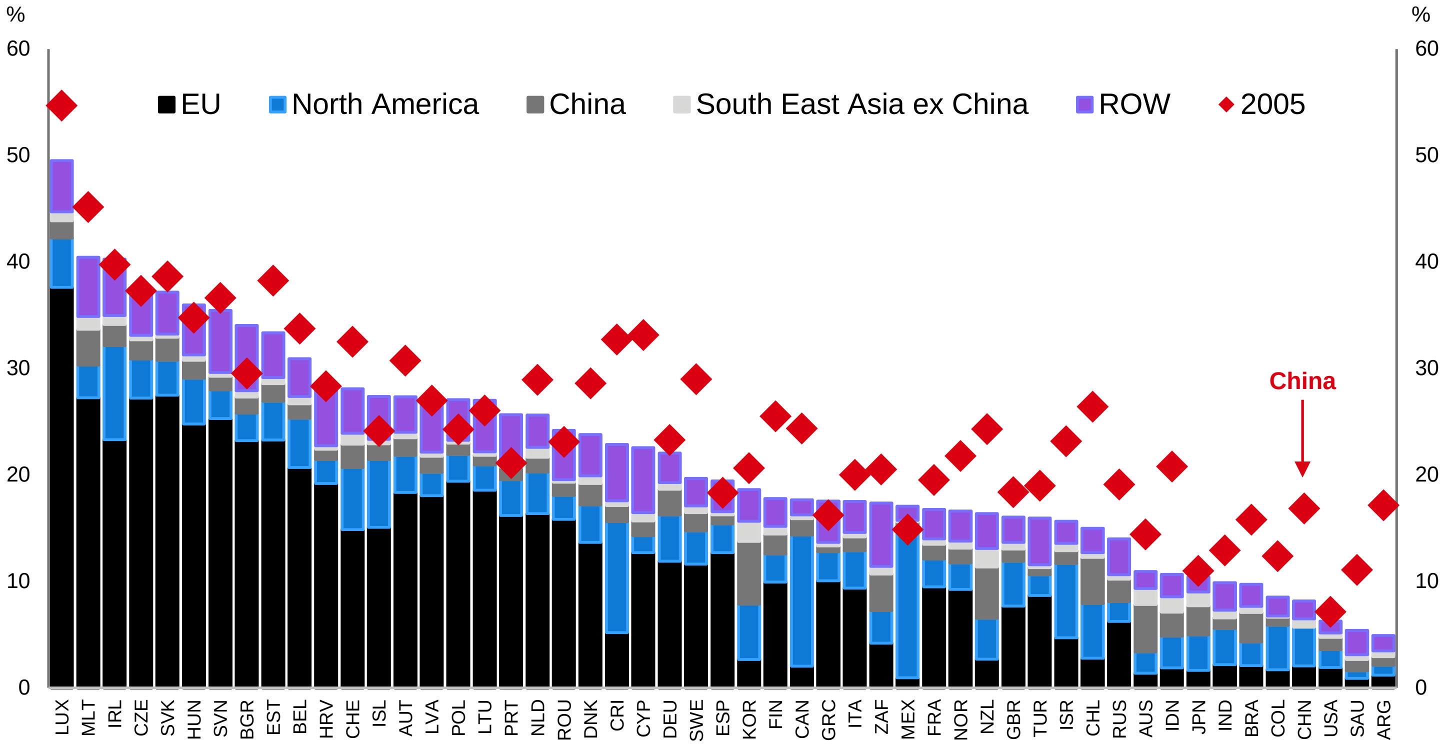
US and China: differences in trade dynamics

As China has grown more integrated with global supply chains, its economy has become more diversified and less dependent on exports to the US market. In 2005, nearly 18% of Chinese employment was dedicated to serving foreign demand. Today, it is just 8% and only about half of this demand comes from the US. (Figure 4.)

Figure 4. 2015 domestic employment sustained by foreign demand



Source: OECD, Deutsche Bank Global Research, May 31, 2019.

Global trade: the growing role of services

In most countries, services are becoming an ever-larger part of global GDP; and, over the past 10-years cross-border services trade has grown over 60% faster than trade in goods.
Today, services account for about 70% of global GDP and 46% of global exports measured in value-added terms. Quantifying services trade, however, is not an easy task. This is because traditional trade statistics do not capture some of the services components that feed into the value of a traded good—such as R&D and design, engineering, legal, accounting, and logistics services, along with intangibles such as intellectual property.

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US and China: differences in trade dynamics

The US economy today is less impacted by global trade dynamics than China, less dependent on global resources and a larger supplier to other countries. Although this might suggest that the US has an upper hand in its trade disputes with China, China has moved away from being disproportionately dependent on trade and particularly on trade with the US. There are many incentives to have the two come to a compromise given their own perceived strengths and interconnections, but the potential for positions to harden is real, especially if provoked by domestic political pressures.

Certainly, the globalization of trade has had its fair share of detractors in the US—and many blame it for rising inequality and for manufacturing job losses. But the data shows a different, far more complex and evolving picture in which automation, digital technologies and artificial intelligence (AI) are starting to shape global trade and supply chains. One can only hope that if and when the political backdrop becomes less polarized, the positive impacts of global trade for economic productivity and growth will re-emerge.

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Drivers that are reshaping global supply chains

Technology

Technology is a key battleground in the competition for supremacy among nations, not only for China and the US. As the world moves inexorably towards digital and "Globalization 4.0,[5]" barriers to entry across most industry sectors may be diminished.

For some time, the US has enjoyed a clear lead in technology development, but a deliberate Chinese strategy has narrowed this gap over the last few years. It is not hard to understand why this is such a contested area. The application of new technologies to diverse industries, such as agriculture, manufacturing, military, aerospace, medicine and, increasingly, a large part of the services sector, makes economies more knowledge-intensive and this has meaningful consequences for a country's long-term growth and even its social structures. Technology is also reshaping the essentials of GVCs by reducing transaction costs, changing production processes and creating digitally "smarter" goods.

President Xi has stressed the importance of leadership in technology for developing a modern economy. Of course, the US is not keen on relinquishing its leadership here. Therefore, it seems a *fait accompli* that for the foreseeable future, the two countries—each at the forefront of developments in technology and cyberspace but with distinctly different economic and political structures—are more likely to be competitors than collaborators.

Global trade will undergo profound change as digital technologies, automation and AI begin to reconfigure global value chains.

Intellectual property

A large bone of contention between the US and China is China's longstanding perceived role in forced technology transfers and in the theft of intellectual property (IP) rights. The prevailing view in the US is that the Chinese government promotes the theft of US intellectual property as a matter of state policy to advance its own development.

Today, China's framework of IP law and regulation is much closer to international standards. Nevertheless, China's political system—with state-controlled firms and the state-orientation of its economy—can make it difficult for foreign firms to navigate China's IP laws and rights effectively. The results of the 2019 China Business Climate Survey from the American Chamber of Commerce in China noted that firms investing in China seek increases in regulatory transparency, market access, IP protection and security against forced technology transfer. In tech and R&D-intensive industries, nearly 50% of respondents said these factors were inhibiting further investment in China.

5. *The theme of the 2019 World Economic Forum's annual meeting in Davos, Switzerland: Globalization 4.0: shaping a global architecture in the age of the fourth industrial revolution.*

5G communications and cybersecurity

China has a first mover advantage in 5G—another cause for US distrust

China's promotion of "civil-military fusion" aiming to align its civil and defense technologies and reduce its reliance on foreign technologies has caused western firms and governments to be wary of collaborating with China for fear that they may be inadvertently promoting Chinese military objectives and escalating national security concerns.

The Defense Innovation Board recently published a report[6] warning that China has established a first-mover advantage in 5G communications and networking equipment. China has invested about USD 180 billion in 5G and has about 350,000 5G base stations deployed, or nearly 10 times that of the US. This is significant as the technology is expected to shape innovation and the Internet of Things (IoT) for years to come; a first mover in 5G potentially dictates the design of a global architecture, reaping not only financial benefits, but also long-term strategic benefits.

The US administration's initial ban on US technology sales to Huawei, now the largest telecommunications company in the world, is one recent display of the how the two countries are vying for dominance in 5G technology.

The distrust between the US and China extends to their views on internet governance. Here, one might think that the application of shared principles, rules and international law to cyberspace and the legitimate scope of cyber-espionage and cybersecurity could find constructive common ground. However, again each country perceives the other as trying to promote its own sovereignty and national interests at the expense of the other's. China's technology funding and its "Made in China 2025" ambitions are clearly applicable to building its military strength. Of course, the US views this build-up as a threat even as cyber capabilities are legitimately dual-purpose and invisible in contrast to physical military infrastructure, defining the Cold War in the 20th century.

AI and quantum computing: strategic technologies in the race to the future

AI is another strategic area in which Chinese companies have made significant progress that will likely shape the future of economic and military competition globally. China has made a concerted effort here with investments in AI research and its related applications given the reliance of AI on big data, which is more readily available in the Chinese ecosystem due to the size of the Chinese population and its predilection for digital services. In 2017, China articulated its desire to make it and Chinese firms world leaders in AI and AI-applications by 2030.

However, many experts believe that with R&D spending through private firms, US firms still retain an edge in terms of advanced algorithms. Additionally, the chips that these algorithms run on are American-designed. Also, in the fast-growing and powerful field of quantum computing, the US has a distinct and sizeable lead—particularly in quantum computer hardware. China is working hard to narrow the gap given the technology's implications on vastly faster processing speeds for business and military communication and tracking technologies.

6. The 5G Ecosystem: Risks and opportunities for DoD, April 30, 2019.

A battle for influence

The era of Pax Americana, when the US was primarily responsible for setting up an international order of institutions and systemic rules, seems to have drawn to a close. For decades, this system has supported the long-term strategic objectives of the US. However, over time, the system took its toll as the world continued looking to the US to take a lead role in resolving global issues and maintaining the legitimacy of the world order. As the US is less willing to absorb the costs of this role, other players—especially China—have had an opening to gain influence and to start setting the rules.

China's Belt and Road Initiative (BRI) is a USD 1 trillion infrastructure development and investment initiative to enhance China's connectivity and role on the global stage. It aims to shape the future of the global economy by facilitating connectivity, promoting financial integration and trade (and the greater internationalization of CNY) and by opening up the Chinese market to the countries covered by the BRI.

The BRI involves more than 70 countries, impacts nearly two-thirds of the world's population and could boost world GDP by about USD 7 trillion annually over the next 20 years.

In terms of scope, the BRI has some resemblance to the 1948 US Marshall Plan where the US provided about USD 12 billion (or approximately USD 100 billion in 2018 dollars) in reconstruction aid to Western Europe from 1948-1951. The US financed the Marshall Plan mainly through grants. The BRI has already financed an estimated USD 448 billion in regional development—but this has been mostly through loans.

The BRI can be viewed as a mechanism that could potentially pressure countries to take sides on the US-China contest for influence—and of course this has caused consternation in the US and several other countries. They fear that the BRI is a pretext for China's military expansion goals. Very recently, for example, China has entered an agreement with Cambodia as part of the BRI: this agreement purports to give exclusive use of the Ream Naval Base (on Cambodia's coast on the Gulf of Thailand) to China's military.[7]

China's Belt and Road Initiative (BRI)

Announced in 2013, the BRI is composed of two initiatives—one land-based and one sea-based. The land-based Silk Road Economic Belt envisions a network of western- and southern-bound routes through the former Soviet Union and Southeast Asia to Europe. The sea-based 21st century Maritime Silk Road project aims to develop a network of ports linking Eastern China with South and Southeast Asia and Africa.

7. *"Deal for naval outpost in Cambodia further China's quest for military network," Wall Street Journal, July 22, 2019.*

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Drivers that are reshaping global supply chains

Military presence

The issues of competition between an incumbent and a rising power can penetrate many areas and disciplines—including military strength and the projection of such. The projection of military might is most evident in the South China Sea where China's claims of sovereignty over the waterway boundaries and its build-up of small islands and reefs have been keenly contested internationally, especially by the US. The US, France and the UK (among others) regularly conduct "freedom of navigation operations" in the adjacent waters that are decried by the Chinese authorities. We have already seen near-misses between American and Chinese vessels and the danger of an accidental confrontation is very real. Further, while experts still consider Chinese military technology and strength inferior to that of the US, China has advanced dramatically in these disciplines. In the recently-published article, "Space Threat Assessment," the Center for Strategic and International Studies expresses serious concern about the rapid development of Chinese counter-space technology and the Chinese testing of kinetic anti-satellite (ASAT) systems with the ability to knock-out high altitude deep space targets.

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Conclusions

Competition or collaboration?

Technological dominance is a strategic issue; the funding, R&D and talent required to develop advanced technologies all play a critical role in shaping a country's advantages and disadvantages. Also, unlike competition in the physical realm, the fast-paced virtual world is far harder to police, and rules and commitments are tough to enforce, despite best efforts to agree upon "rules of engagement." While productive collaboration (or creative cooperation) across countries or regions is certainly possible, it is more likely that competition among countries and/or regions continues to grow. This is especially pronounced in the context of China and the US given their economic size, global influence and completely different economic and political models. Consequently, one must expect this relationship to encounter bouts of tension and subsequent periods of market disruption over the longer-term.

Investment implications

The US-China trade disputes have immediate implications for investors in terms of positioning their portfolios, but we believe that the issues involved in the US-China competition entail substantive, long-term struggles as the world moves towards a digital future and the global economy is restructured. Name one or more these secular trends and structural changes?

As the story of the US-China rivalry progresses and impacts the world economic order, we will continue to experience periods of turmoil and uncertainty, inducing significant market volatility. As investors, we aim to scrutinize the fundamental drivers of this unfolding narrative in our risk-return trade-off assessments–especially in emerging markets (EM) which are generally well-integrated in global supply chains. While EM countries may be idiosyncratically diverse, they are largely capital-deficient and rely on the global economy for foreign direct investment and portfolio flows as engines of growth.

We have tried to capture the complex and evolving US-China relationship and its potential impacts on the global financial system:

- Since the great financial crisis, markets have been dominated by global central banks, acting to dampen economic and financial volatility while supporting financial assets. We believe that the US-China relationship (and all that this relationship entails) could even supplant central banks as a key market influencer and result in periods of heightened volatility
- While a short-term "fix" to the US-China trade issues may emerge, we think a lasting solution is hard to come by given the magnitude of the stakes involved. This would suggest that investors retain liquidity to deploy if and when rising volatility should offer a point of entry
- Extensive data analysis can help us identify the likely winners and losers implicated in the US-China competition and will provide us opportunities to actively manage risk and allocate capital in EM
- A complete unwinding of globalization and reconfiguring of GVCs is unlikely so that if investors see excessive pessimism priced into the valuations of integrated economies, they should be willing to deploy capital in those economies

Key Risks

Risk Considerations. There is no assurance that a portfolio will achieve its investment objective or will work under all market conditions. The value of investments may go down as well as up and you may not get back the amount originally invested. Portfolios may be subject to certain additional risks, which should be considered carefully along with their investment objectives and fees.

- **Exchange Rate Risk** Changes in currency exchange rates could reduce or increase investment gains or investment losses, in some cases significantly.
- **Counterparty Risk** The possibility that the counterparty to a transaction may be unwilling or unable to meet its obligations.
- **Liquidity Risk** is the risk that a Fund may encounter difficulties meeting its obligations in respect of financial liabilities that are settled by delivering cash or other financial assets, thereby compromising existing or remaining investors.
- **Operational Risk** may subject the Fund to errors affecting transactions, valuation, accounting, and financial reporting, among other things.
- **Derivatives Risk** Derivatives can behave unexpectedly. The pricing and volatility of many derivatives may diverge from strictly reflecting the pricing or volatility of their underlying reference(s), instrument or asset.
- **Emerging Markets Risk** Emerging markets are less established, and often more volatile, than developed markets and involve higher risks, particularly market, liquidity and currency risks.
- **Interest Rate Risk** When interest rates rise, bond values generally fall. This risk is generally greater the longer the maturity of a bond investment and the higher its credit quality.
- **Default Risk** The issuers of certain bonds could become unwilling or unable to make payments on their bonds.
- **Credit Risk** A bond or money market security could lose value if the issuer’s financial health deteriorates.
- **CoCo Bond Risk** Contingent convertible securities (CoCo bonds) are comparatively untested, their income payments may be cancelled or suspended, and they are more vulnerable to losses than equities and can be highly volatile.

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