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Is the End of the Chinese Miracle the Start of More Trouble?

(*Or is it all now moot?*)

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UC San Diego Economics Roundtable

1750 Massachusetts Avenue, NW | Washington, DC 20036 | www.piie.com

The Trump International Economic Program

Global Reaction to Trump Administration 2.0

1. **Market themes with broad spread**
    1. Trump actions/proposals, urgency of response by foreign governments vs waiting
    2. More on AI, less on Green, nothing on financial regulation or global cooperation
    3. Heavy industry shifts to US, particularly from EU
2. **Attention to the deal market and capital flow impact of geopolitical divergences**
    1. SE Asia vs EU; BRICS ex China and Russia vs rest of LDCs; Latam without US
3. **Trump Administration order of priorities**
    1. Tariffs
    2. Deregulation
    3. Migration
    4. Taxes/budget
    5. Sanctions – China and Russia; Tech restrictions
4. **Everything pointing to a strong dollar cycle and a boom bust**
    1. Unless the Trump Administration overdoes it on migration, taxes or trade

Four fundamental tradeoffs on tariffs:

1. **Do you make tariffs across the board and lasting to get reliable tax revenue, or do you make country/sector by country/sector to allow use as a negotiating tool?**
   a. The tax revenues can be substantial (1-2% of GDP annually) IF AND ONLY IF the tariffs are across the board in terms of countries and sectors included, and they are permanent
      i. If the tariffs are limited to just China, Mexico and certain 'strategic' favored sectors, the tax revenues collected will be a fraction of that (~10-15%, or ~0.2% of GDP annually)
      ii. Can Trump Replace income taxes with tariffs? (Kimberly Clausing and Maurice Obstfeld, PIIE)

2. **Do you make it tariffs enough to meaningfully reshape trade flows and likely get significant inflation, or do you make the gestural and have little risk of inflation?**
   a. Tariffs cannot change the fundamental macroeconomic realities unless they are extremely high and broad, in which case they are likely to cause a recession. See Mistaken identities make for bad trade policy (Maurice Obstfeld, PIIE).

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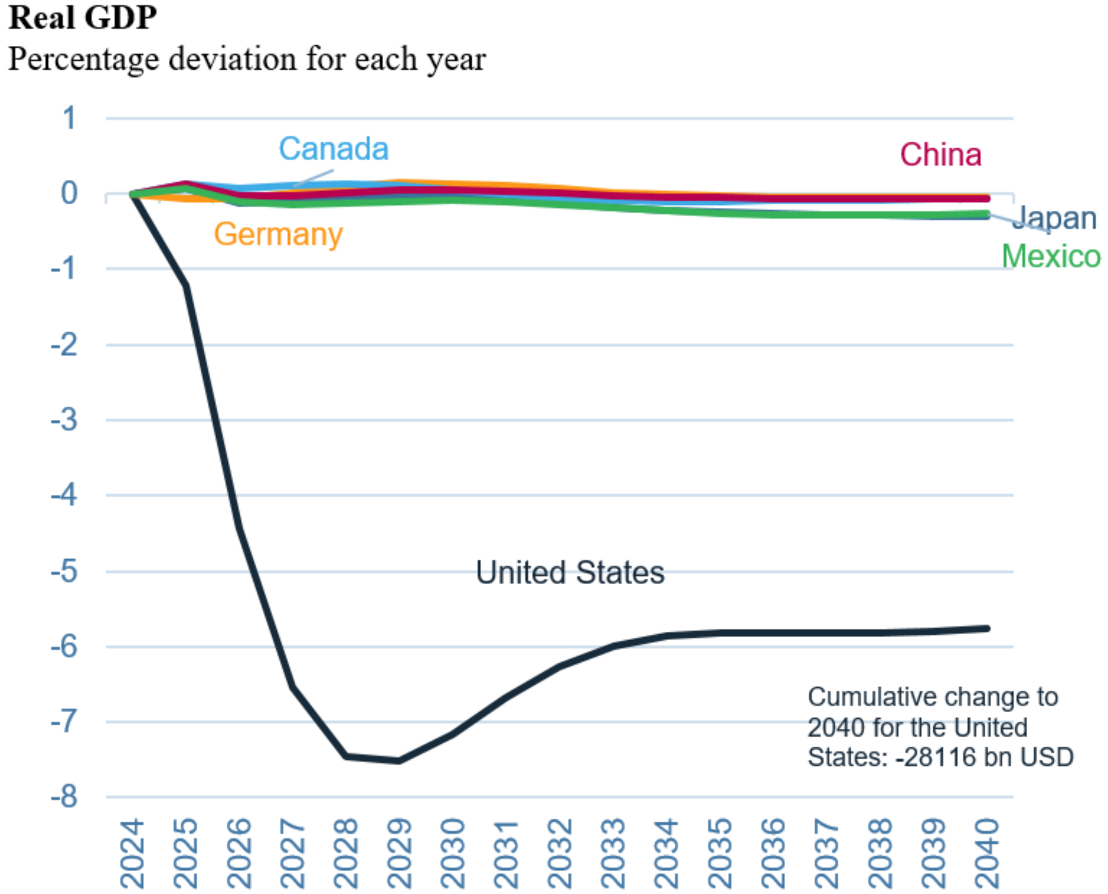
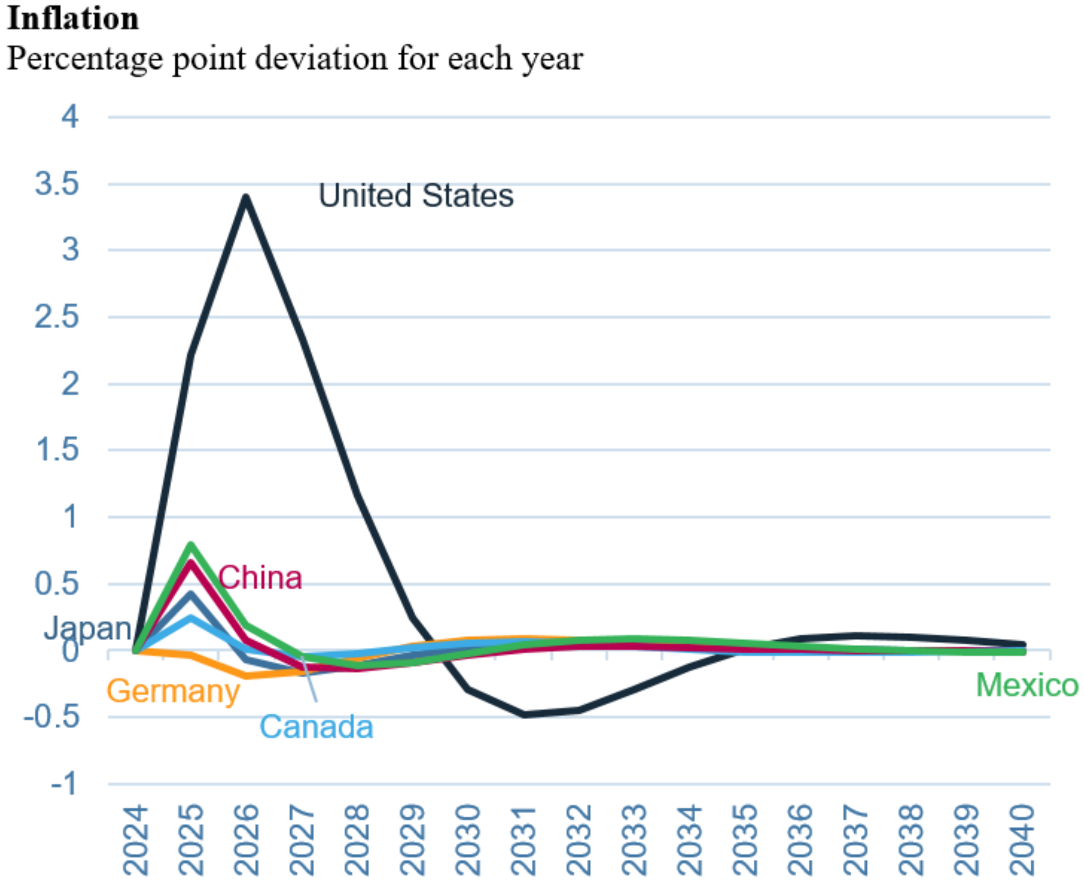
Four fundamental tradeoffs on tariffs, cont.:

3. **Do you allow for the dollar to appreciate to offset the tariffs, but simultaneously increase the trade deficit, or do you try to counteract dollar strength (and increase inflation risk)?**
    a. Talk of escalating tariffs over time in some pre-committed way is just meaningless in terms of reducing their negative impact or changing other countries' behavior. See The True Dangers of Trump's Economic Plans (Posen 2024 *Foreign Affairs*).

4. **Do you subsidize domestic producers (Agriculture, Manufacturing) to compensate for their lost sales and more expensive inputs, and nullify the effect on the trade balance, or vice versa?**
    a. Trying to goose manufacturing – whether by Biden or Trump – is wasteful favoritism to certain parts of the economy – and it won't work. See Industrial policy and the risks of national champions (Posen 2023 *Foreign Policy*) and Behind the Curve (Lawrence 2024 PIIE)

Economic Impact of Deporting 8.3 million unauthorized immigrant workers





Source: The International Economic Implications of a Second Trump Presidency. Warwick J. McKibbin, Megan Hogan and Marcus Noland PIIE Working Papers 24-20. September 2024

Likely scenarios and their implications:

Most likely scenario - Trump/Commerce/USTR and others will want to keep the bilateral discretionary negotiating tool approach to tariffs, and Treasury/NEC will want to forestall inflation effects – which means the impact is primarily micro not macro (60% likelihood, which is down from my estimate of 80% a month ago)

a. In that case, worry about China and Mexico, auto sector, pharma (production and inputs), and a few IT hardware sectors. Any claims about substantial tax revenue from tariffs should be discounted.
b. Extent of foreign retaliation or reciprocal tariffs would be limited at a national level, but industrial sector protections and FDI barriers would go up around the world.

The likeliest alternative - trying to shift the US corporate tax code with a Destination-based cash flow tax (DBCFT), and having a 10% ‘universal’ tariff partially fund it (25% chance and rising)

a. Some conservative public finance efforts make a case for this on tax principles, it would be like a VAT sales tax with discriminatory preference for exports over imports. Not ideal.
b. Any broad tariff rises would be a MAJOR shift in tax incidence and major upward pressure on the dollar – so unlikely to get through Congress.
c. See Clausing and Lovely, Trump’s bigger tariff proposals would cost the typical American household

The US Federal Reserve will be slow to respond - to either tariffs or tax changes

This is mistaken in my view and will likely lead to late rate hikes (starting between July and September 2025).

- The Fed should have recognized that their monetary policy tightening was not having much traction on financial conditions or more broadly
- The market situation this sets up is continued creeping upward of market expectations for FFR and 10-year rate (via slower/fewer rate cutes expected), but still not enough pricing in the likelihood of hikes coming

My working assumption - we get moderate-to-low end of Trump administration proposals in tariff, migration, tax, pressure on fed policies – enough to be harmful and inflationary, but not enough to be recessionary.

- **IF** the Trump Administration overdoes it, then we could get a recession – the risk of them overshooting is most likely on immigration/deportation because of political asymmetries and denial of impact.
- **IF** the Trump Administration combines high/broad tariffs with other sharp restrictions (on investment, migration, tech inputs), then there is a recession risk and likely Fed cuts.

The major risks to the US economic outlook for 2025-26 are not from tariffs

Downside:

- Too aggressive anti-migration or deportation policy leads to labor shortages, wage spikes and stagflation (housing-led)
- The Republican majority Congress passes some version of the DBCFT (including broad tariffs) which produces a consumer-led recession while increasing deficits, spiking long-rates
- The market does not adjust sufficiently to Fed rate hikes coming after the Federal budget in May-September, and there is a sharp sell-off in equities and other risk assets

Upside:

- The last 9 quarters of significantly improved US productivity growth turn out to be driven (now) by AI and the trend persists or even increases, leading to more rapid growth without inflation

The end of China’s economic miracle

A macroeconomic turning point for China

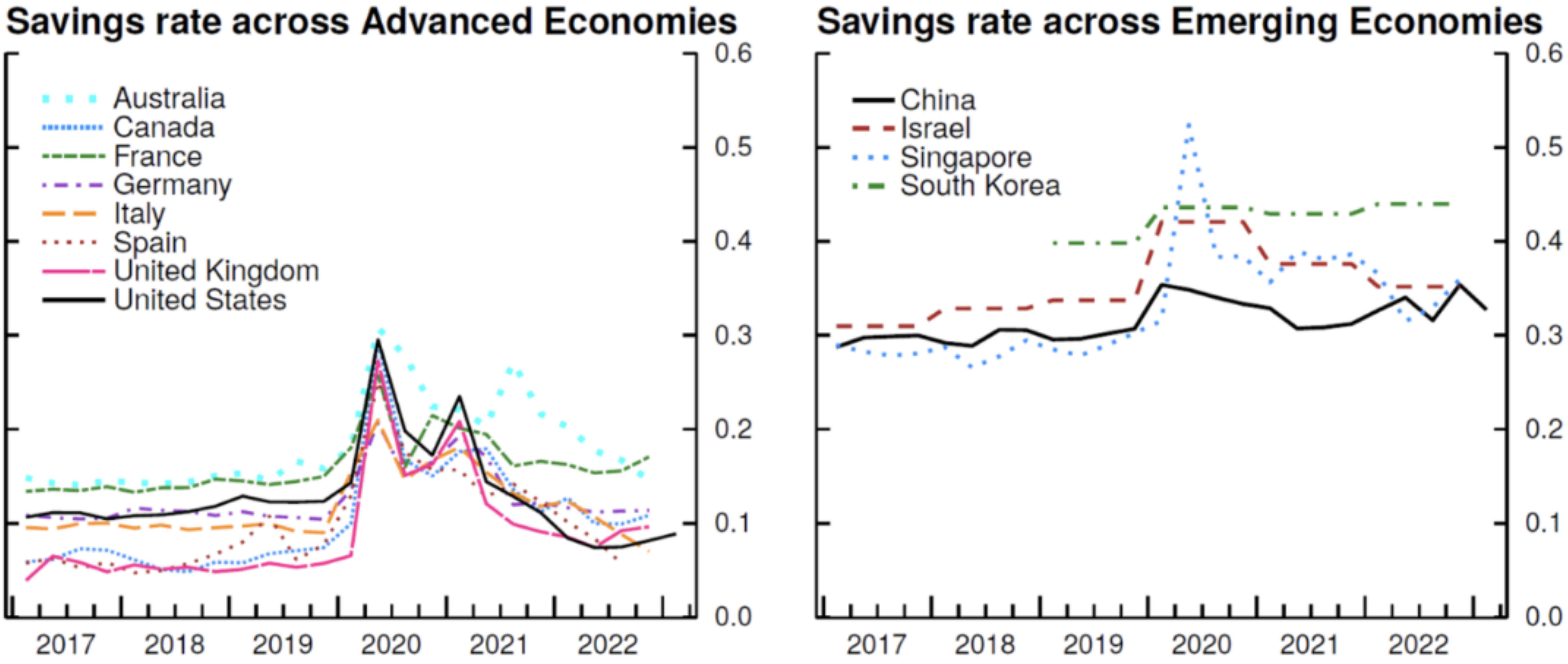
- A lasting shift in household and SME behavior towards self-insurance and liquidity
- Caused by a jump in CCP arbitrary interference in everyday commercial life
  - Ending "no politics, no problem" since Deng
- Resulting in lower investment and durable goods consumption, more low-risk savings, lower response to stimulus policies
- Could encourage Xi to further emphasize SOEs and increase barriers, in turn further encouraging exit
- Opportunity for US to shift from sanctions to suction of capital (financial, tech, and human) from PRC

Economic Long COVID
Not a collapse of either economy or regime

- The financial and real-estate sector problems could be surmounted as before, if the political economy allows
- The problem is that it is no longer credible for the regime to constrain itself from future intrusions
- Sluggishness and immune response to policy, leading to a less dynamic economy
- Other factors could offset the downshift in trend growth temporarily, but not reverse the basis
- The initial response to increased authoritarianism is greater obedience due to lack of options

Figure 1 Evolution of savings rates during the COVID-19 pandemic

Accumulated savings during the pandemic: An international comparison with historical perspective
Francois de Soyres Dylan Moore Julio Ortiz / 5 Jul 2023, VoxEU



Note: Data are annual for Israel and South Korea, and quarterly for all other countries.
Source: Haver Analytics.

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China's 'zero Covid' policy was a mass imprisonment campaign

Murong Xuecun

Tue 18 Apr 2023 03.00 EDT

The Chinese government used the pandemic to accumulate ever more power. The result was a totalitarian, anti-scientific humanitarian catastrophe

China

China's parliament approves changes to speed up 'emergency' laws

By **Laurie Chen**

March 13, 2023 12:18 AM EDT · Updated 6 months ago

Aa

Chinese economy + Add to myFT

Chinese economists told not to be negative as rebound falters

Authorities struggling to restore confidence in post-Covid recovery want analysts to avoid mention of deflation risk

China's economy is suffering from weak consumer demand, declining exports and an ailing property sector © Andrea Verdelli/Bloomberg

Sun Yu in Beijing AUGUST 5 2023

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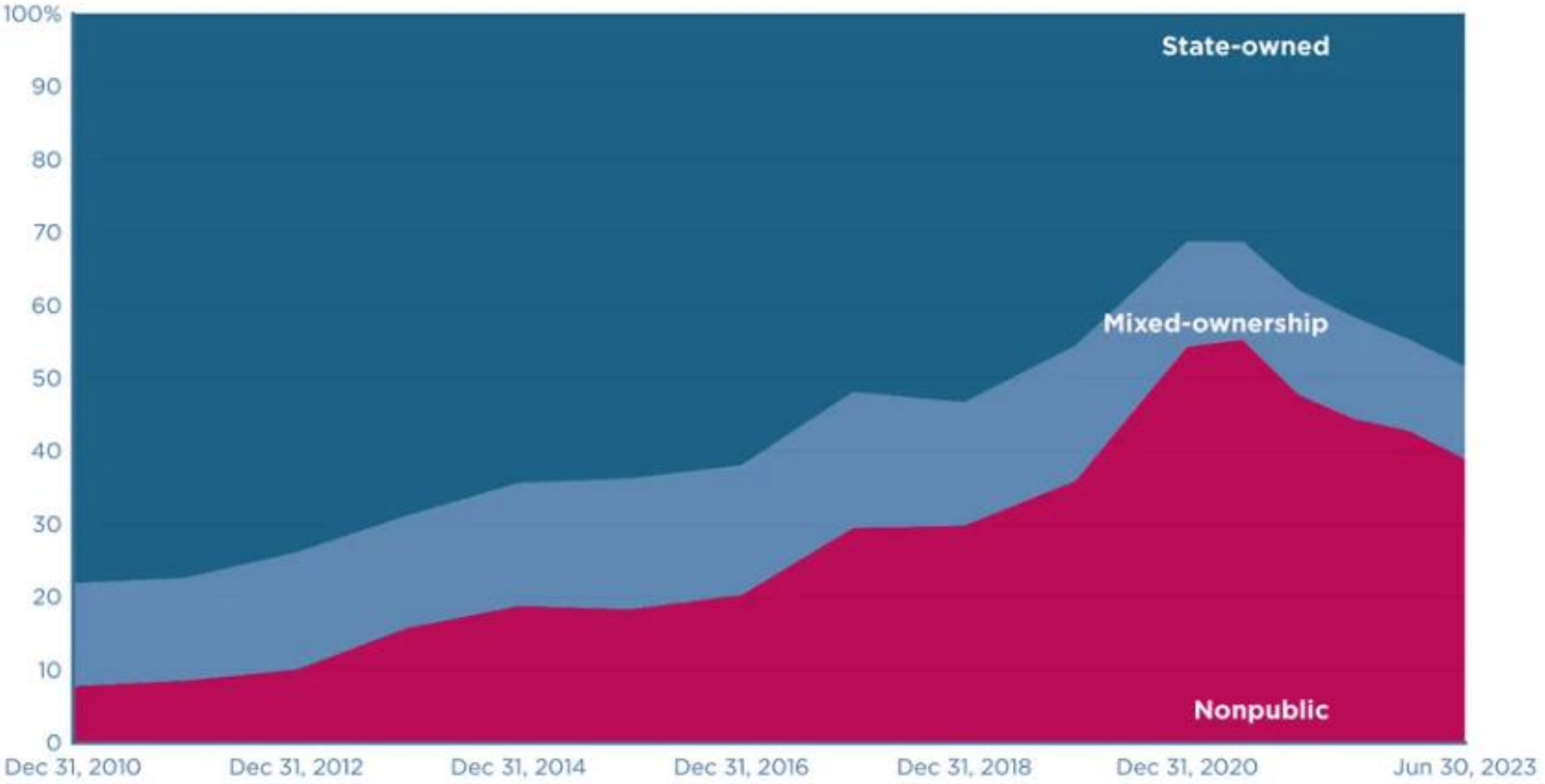
China's state vs. private company tracker: Which sector dominates?

Share of aggregate market capitalization of China's top 100 listed firms, by ownership, end-2010 to mid-2023



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Notes: End-year data from 2010 to 2020; half-yearly from 2021. China's top 100 listed firms are defined as the 100 mainland Chinese firms with the largest market capitalizations, whether listed in the mainland or abroad, including so-called variable-interest entities. "Nonpublic" are firms in which state entities hold an equity stake of less than 10 percent. "State-owned" are firms in which the state owns a majority stake. "Mixed-ownership" are firms in which the state owns an equity stake between 10 and 50 percent.

Source: Wind, authors' calculations.

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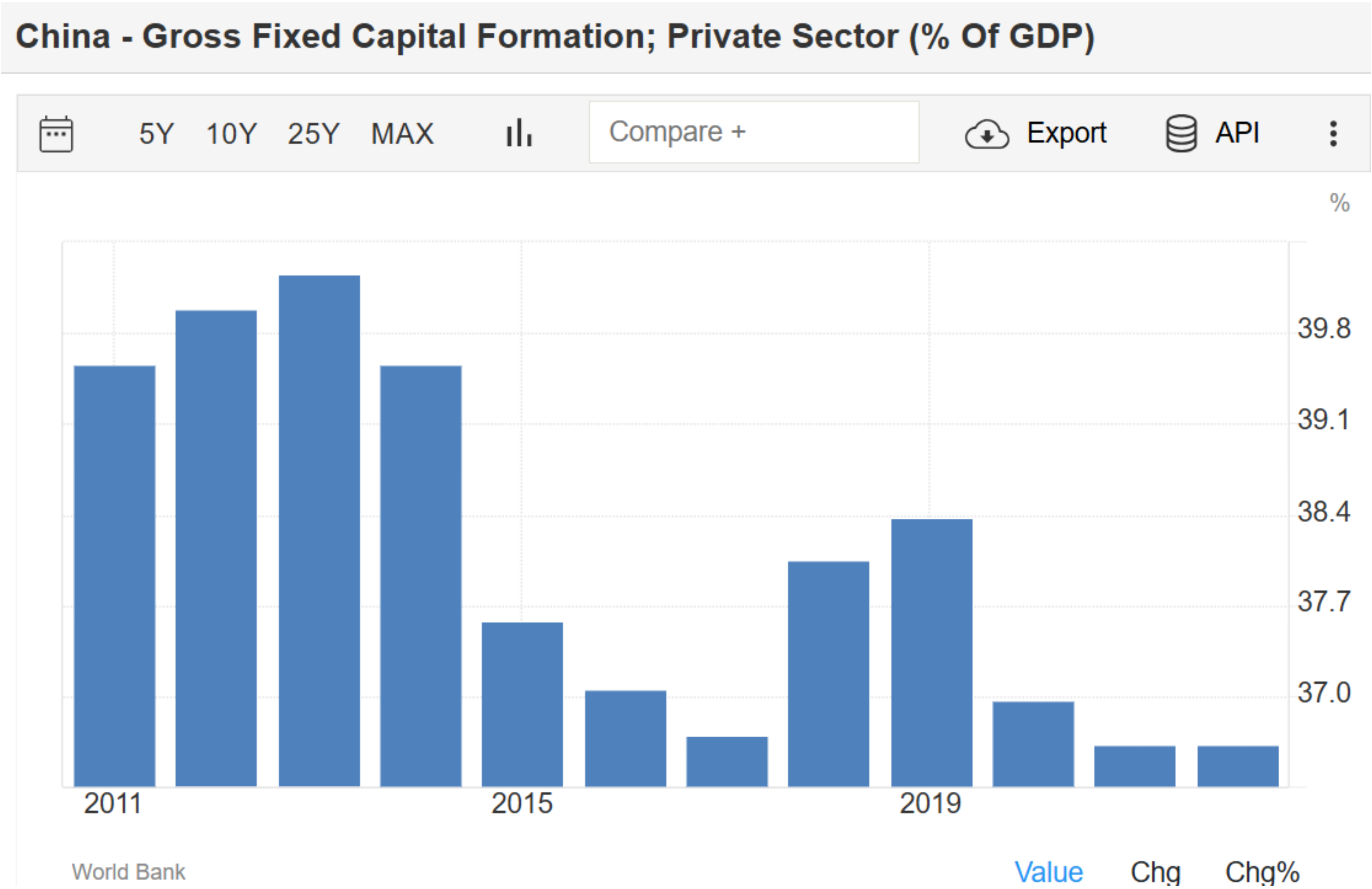
Private Business Fixed Investment



China-US trouble gets worse?

Does the US want a weak or strong Chinese Economy?

- Biden in April 2023: We are threatened by China's economic competitiveness and its potential dominance
- Biden in August 2023: We are concerned that China's economic difficulties may lead to greater aggression and risk taking abroad (wag the dog).
- These are not in contradiction – one is about capabilities, other is about intents
- But they are in tension in terms of US policy goals and sorting out the signal

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What does the Trump Administration want from China?

- Some officials are like Goldfinger to Bond, “Do you want me to talk?” “No, Mr. Bond, I want you to die.” – but that is absurd
- Is the goal to limit foreign influence? To limit territorial expansion? To limit dependence on Chinese production? To forestall Chinese technological progress? To reduce bilateral trade deficits? To deter specific hostile or ‘unfair’ behaviors?
- No one in USG seems to offer China an economic off-ramp – if you do this, then we will stop doing that to you.
- Except perhaps Trump himself

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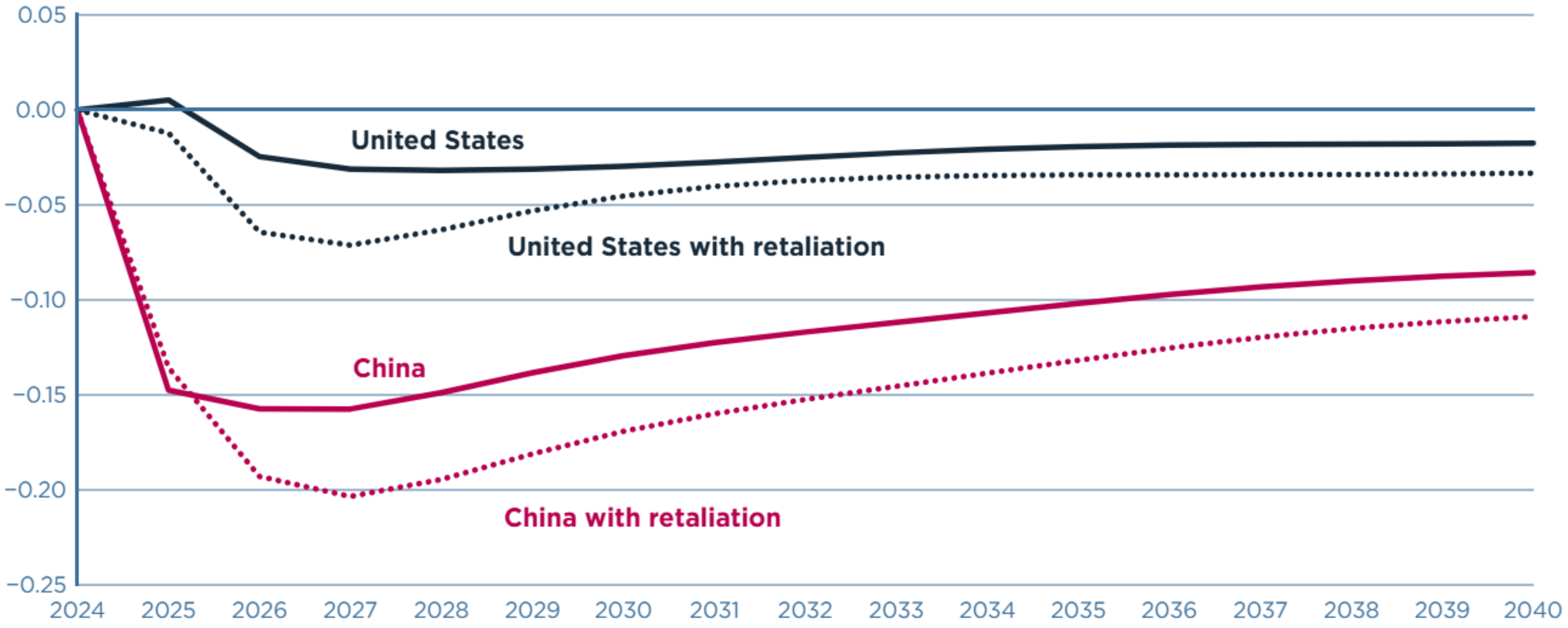
Figure 2

An additional 10 percent tariff on China would damage both the US and Chinese economies

Projected percent change from baseline forecast with and without retaliation by China, 2024–40

Click to filter by: Real GDP Inflation



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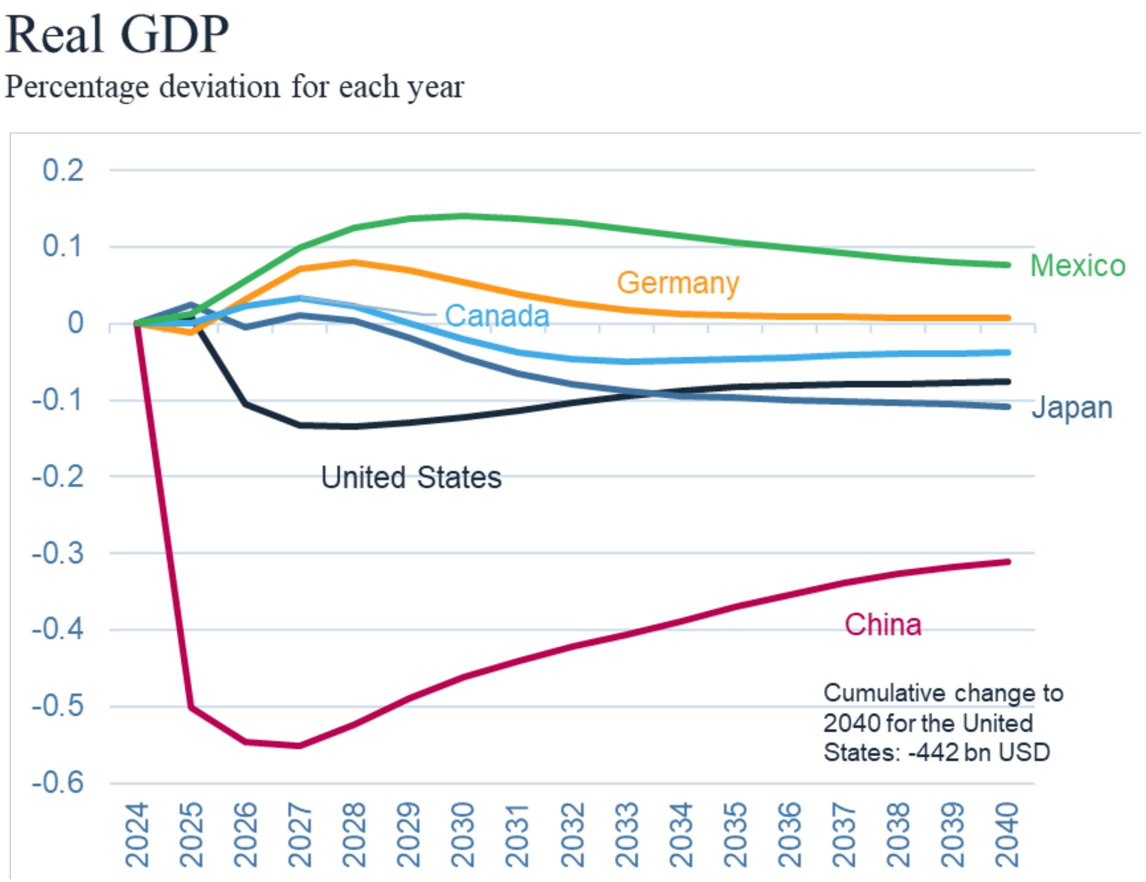
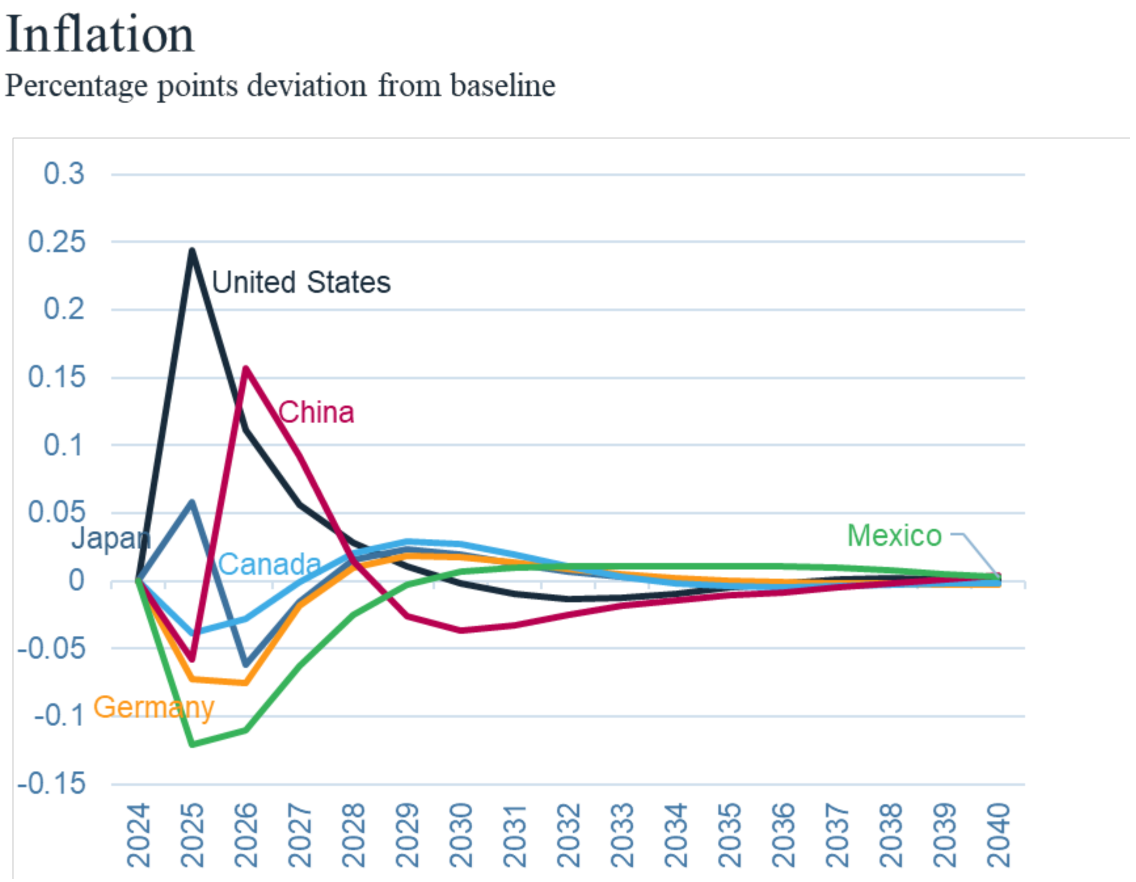
Source: Warwick McKibbin, Megan Hogan, and Marcus Noland, ***The international economic implications of a second Trump presidency,*** PIIE Working Paper 24-20.

Economic Impact of Revoking China's PNTR status





Source: "Economic Implications of Revoking China's Permanent Normal Trade Relations (PNTR) Status." Megan Hogan, Warwick J. McKibbin, and Marcus Noland. PIIE Policy Brief 24-9. September 2024

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There is an alternative path: Suction not Sanction

- DeepSeek shows that export controls/tech barriers are not terribly effective in general equilibrium – sow the seeds of their own demise and are too costly to sustain
- Take a page from the late 1930s and the 1970s-1980s: open up US economy to flight of talent, tech, investment, finance from rival
- Underscores that the target is CCP not the people of PRC
- Undermines (slowly/partially) CCP own strength and drives a further wedge between the Chinese economy and future credibility
- Presents gains for the US rather than economic costs

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