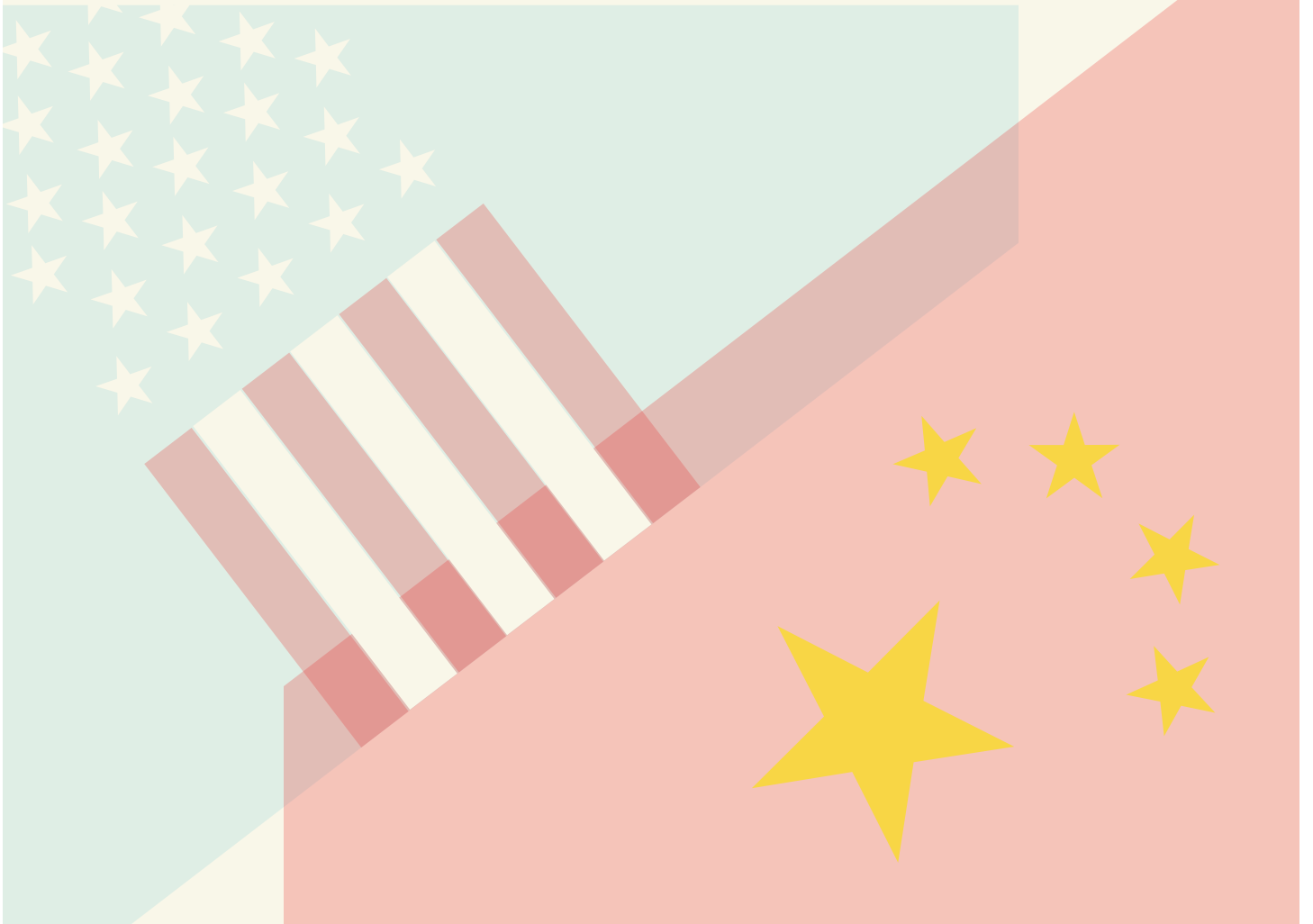


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Economic Report

2019 First Quarter Update



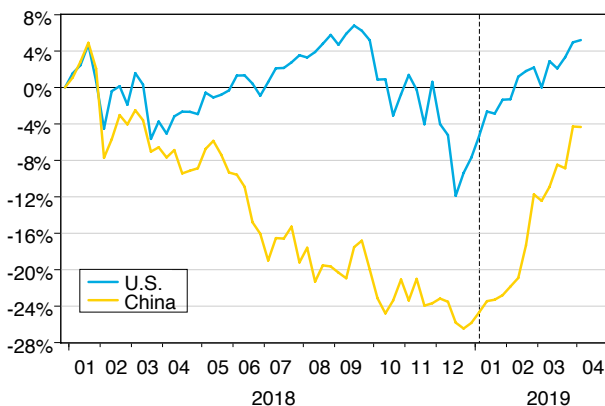
A NEW U.S.-CHINA TRADE AGREEMENT: AROUND THE CORNER?

By William Yu, Economist, UCLA Anderson Forecast
& Jerry Nickelsburg, Director, UCLA Anderson Forecast

TRADE TALK IS MAKING PROGRESS

The world breathed a sigh of relief when the U.S. announced that there would be no additional tariffs imposed on Chinese imports on the March 31, 2019 deadline. The explanation was that the trade negotiations between the U.S. and China were making progress. A full-blown trade war was avoided, for the moment. Although equity markets react to many different news items affecting company profits, it is not a coincidence that the Shanghai Composite index rebounded and almost recovered most of its loss in 2018 (Figure 1, yellow line), and the U.S. S&P 500 index (Figure 1, blue line) turned around at approximately the same time. But will an agreement take place? There are difficult issues still to be resolved. Nevertheless, there is some indication that movement towards a limited agreement is occurring.

Figure 1. Percentage Changes of the S&P 500 Stock Index and Shanghai Composite Stock Index, January 1, 2017 to Date



Source: Yahoo Finance

WHAT MIGHT BE IN A NEW TRADE DEAL?

The information being reported in the press points to concessions on the part of both China and the U.S. that might be part of a modest trade deal. However, one should view this information skeptically as the release of it might well be a negotiating tactic. In the end, some may not be included in an agreement. Both Xinhua Press and Trump Administration officials have signaled that the following chapters are being negotiated:

- Purchases by China of U.S. goods and services (the amount and time frame not yet specified)
- An opening of some (TBD) Chinese markets to U.S. companies
- Intellectual property protection changes in Chinese law and enforcement
- Regulations requiring technology transfer to be modified or eliminated
- Changes to US tariffs and investment rules
- Enforcement of the Agreement

Some of the items mentioned above are straightforward, less controversial, and likely have been agreed to. For example, a recent announcement by China that it would ban all variants of the opioid fentanyl, a U.S. request, is an easy concession to make. The purchase of more U.S. agricultural produce (at the expense of other countries' farmers) is also relatively easy. These are signals of goodwill that China is likely hoping will bring the negotiations to a mutually beneficial close.

On the other hand, as we have discussed in previous reports, controversial demands on the part of the Trump Administration, which go to the heart of Chinese domestic economic policy, will be difficult if not impossible to resolve including:

- A difference of views on the state’s role in the economy. China believes that the State and the Party should play an active role in economic growth by helping its industry succeed. This was clearly stated in the 2015 “Made in China 2025” program, and in subsequent speeches by President Xi Jinping. The U.S. demand is for the Chinese government to, at most, play a passive role in industry and business. There is not much room for compromise on the Chinese side on this issue.
- The WTO has specific rules regarding state subsidies when it comes to industries where foreign exporters are damaged in domestic markets. Each case requires a filing with the WTO, and normally is litigated over several years. The U.S. is asking China to resolve U.S. complaints about violations of WTO rules outside of the WTO process and to drop China’s complaints against the U.S. with the WTO. China desires to stay within the WTO framework, and has balked at the asymmetry of the U.S. position.
- It is said that the U.S. wants to establish an enforcement mechanism such that, if China were to violate a new agreement, certain penalties, e.g. tariffs, would be triggered automatically. According to reports, the U.S. wants the ability to re-establish tariffs without China responding. Since the U.S. would be the sole arbiter as to whether or not China was living up to the agreement, this demand has been rejected. The reported response is to make such enforcement reciprocal, a demand the U.S. has rejected.

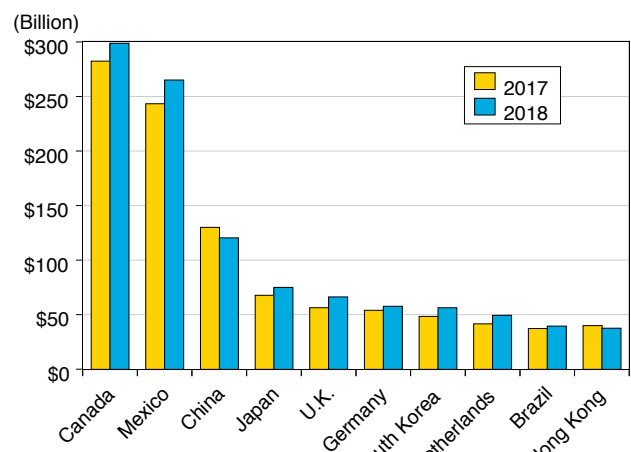
In a commentary in Xinhua, as reported by the South China Morning Post, Chinese officials view the remaining issues as “tough nuts to crack.” We agree, but expect both countries to find some common ground in order to close a trade deal in the near term, and agree to continue talks on other issues in the future.

But, keep in mind that a new trade agreement does not mean there will be no tensions nor disputes between these, the two largest economies in the world, in the coming years. As we mentioned in previous reports, the world is in a new era of strategic competition between the U.S. and China, particularly in the fields of science and technology. For example, last month the U.S. Chairman of the Joint Chiefs of Staff told a U.S. Senate panel that Google’s work in China has been directly benefiting China’s military. In response, Google said it had dropped some ideas it had been pursuing with the Chinese government. We expect more of this state scrutiny and regulation with respect to technologically sophisticated products and services in the future.

INTERNATIONAL TRADE UPDATE

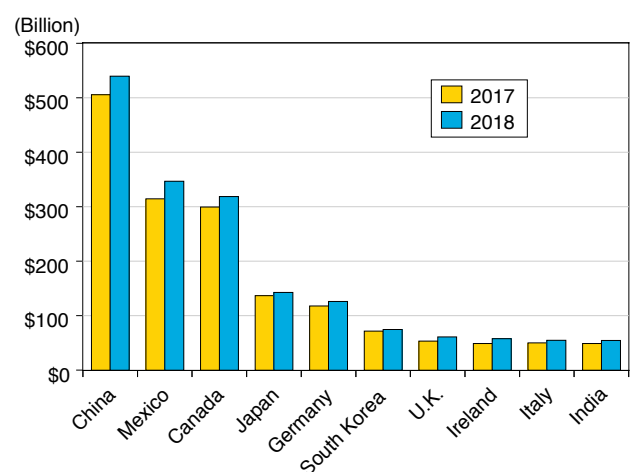
Figure 2 displays the top ten trading countries for U.S. goods exports in 2017 (yellow bar) and 2018 (blue bar). All of the trading partners have seen U.S. exports increase with the exception of China and Hong Kong. The obvious reasons are China’s retaliation against the U.S. tariffs, and the slowing growth of China’s economy. The top three countries for U.S. exports in 2017, Canada, Mexico, and China, are the top three in 2018. Figure 3 displays the top ten trading countries for U.S. goods imports in 2017 and 2018. U.S. imports from all of its top trading partners increased last year. This includes China despite tariffs imposed on \$250 Billion of Chinese imports. At least for now, the tariffs represent a tax on American consumers and not on Chinese producers.

Figure 2. Top Ten Trading Partners with the U.S. By Goods Exports Value



Source: U.S. Census

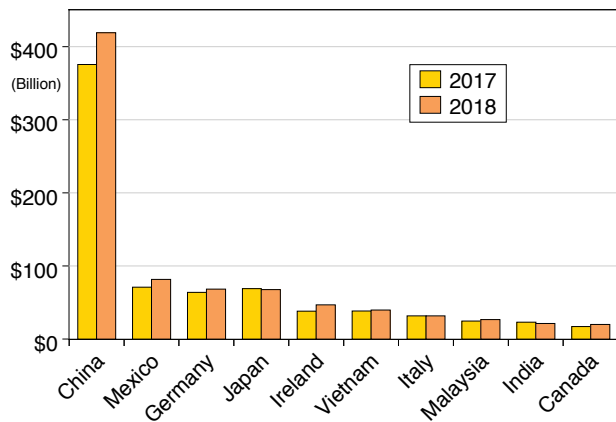
Figure 3. Top Ten Trading Partners with the U.S. By Goods Imports Value



Source: U.S. Census

Figure 4 shows the top ten countries with trade deficits with the U.S. by the size of the deficit. China has the largest deficit accounting for about half of the total deficit. The China trade deficit increased from \$376 billion in 2017 to \$419 billion in 2018. While this is not surprising given that job growth and consumption are growing in the U.S., and given that the U.S. government's fiscal deficit is expanding rapidly and needs financing, it is in the opposite direction from the goal stated by the Trump Administration.

Figure 4. Top Ten Trading Partners with the U.S. By Trade Deficit Value



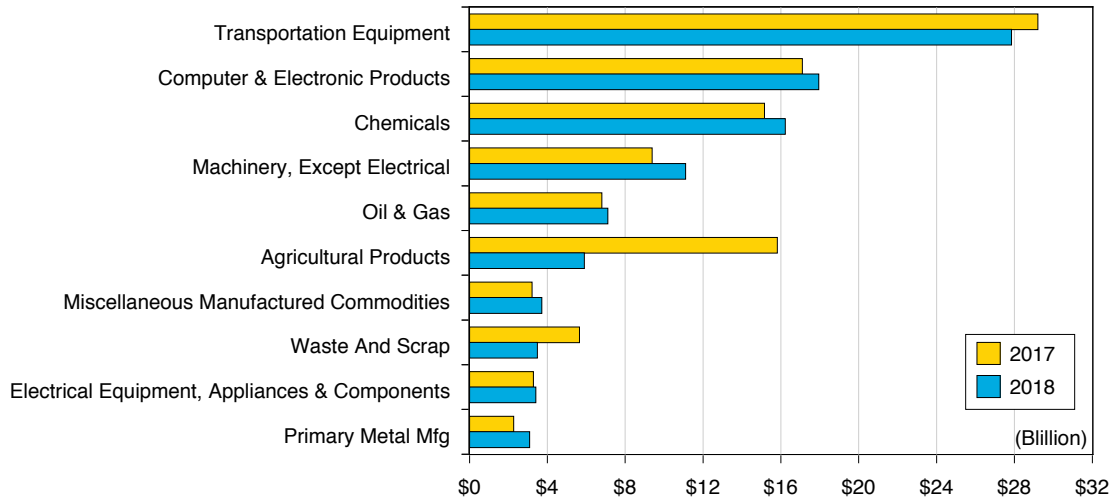
Source: U.S. Census

Figure 5 displays the top 10 U.S. export goods to China in 2017 (yellow bar) and 2018 (blue bar). Only three sectors experienced a decline in exports value in 2018: (1) transportation equipment, (2) agricultural products, and (3) waste and scrap. In particular for agricultural products, its decline from \$16 billion in 2017 to \$6 billion in 2018 was staggering. This is a direct result of Beijing's tariff and purchasing decisions, and as it happens it fell on rural counties in the U.S. where the President's support is the highest. By value (Figure 6) imports in each of the leading import sectors increased over the last year.

SUMMARY

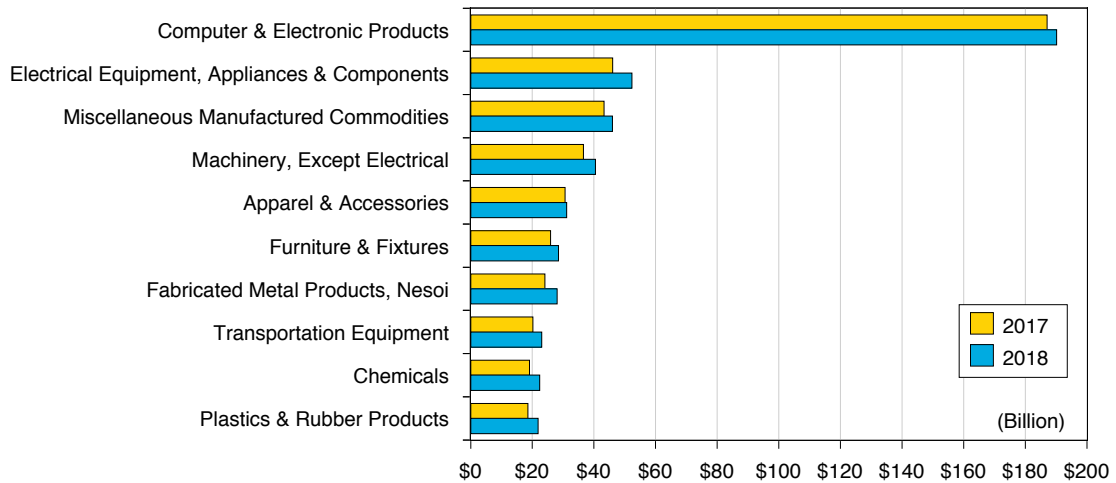
The economic relationship between the U.S. and China may bifurcate into a two-tier trading relationship in the future. One tier, some consumer goods, services, some investment, and tourism, would resume in a relatively free trade environment were new trade agreement to be reached. The other tier, goods and services involving advanced technology, information, communication, and national security, will be governed by strategic competition parameters rather than free trade. The question of this update to the annual Cathay Bank / UCLA Anderson Forecast U.S. - Economic Report remains open. Will there be an agreement? We now have some solid indications that the modest agreement we have been predicting in this series is coming to realization.

Figure 5. Top Ten Exports Goods from the U.S. to China



Source: U.S. Trade Online

Figure 6. Top Ten Imports Goods from China to the U.S.



Source: U.S. Trade Online

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