Economic Watch

China | How to respond to a new wave of tariffs under Trump 2.0

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The re-election of Donald Trump has sent shock waves among the country's key tradepartners. Even during his campaign, the President-Elect repeatedly threatened to impose 60% tariffs on all imports from China and 10%-20% tariffs on those from the rest of the world. If implemented, this new wave of Trump tariffs is set to spark a new trade war between the U.S and China, the world's two largest country economies. Its spillover effects would translate into a new headwind to the global economy.

We believe that the tariff threat of President-Elect Trump is a credible one rather than a mere bluff in negotiation. First, President-Elect Trump and his inner circle rarely raised specific demands for China during his campaign, which is in stark contrast with the case during his first term of Presidency. Back then, he waved his tariff tool as a leverage to force China to accept certain conditions, including the better protection of U.S. firms' intellectual property, a greater access to Chinese domestic markets for U.S. FDI, and more purchases of U.S. products. This time, President-Elect Trump and his team seemingly hold a strong view that high tariffs, by themselves, are sufficient to bring more manufacturing jobs back to the USA.

Second, the economic policy package of President-Elect Trump also includes aggressive cuts in corporate and individual income taxes, which is to be welcomed by his Republican colleagues in the Senate and Congress. Given the Republican Party's majority in both chambers, it is very likely that his domestic tax cut plan can be put into practice soon. This even makes the implementation of new tariffs more probable, since President-Elect Trump proposed to use the proceeds from additional tariffs to finance the fiscal deficit resulting from domestic tax cuts.

This note examines a range of policy tools that China might adopt in face of the new Trump tariffs and assess the likelihood of their implementation. We acknowledge that Trump's policy agenda is still subject to great uncertainties. That being said, the key assumption of our analysis is that the new Trump administration is to impose 60% tariffs on all imports from China by mid-2025. Analysis from various institutions indicates that this strong external shock could trim China's GDP by 1-2% over the following 12 months.

Notably, the current state of China's economy differs from that in 2018, when the former Trump administration started to hike punitive tariffs on Chinese imports. Nowadays China is grappling with a historic collapse of its massive housing sector, which has evaporated household wealth of trillions of US dollars. Meanwhile, China's local governments are struggling to find additional financial resources to fill the fiscal gap left by plummeting land sales. In sum, China's economy is facing grave domestic challenges, even without the new tariff threat from abroad. This shift in China's position of strength could significantly limit its policy options in responding to the new Trump tariffs.

Exchange rate depreciation

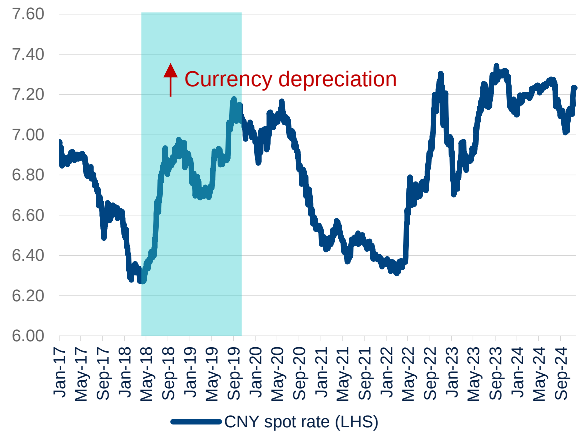
Since the then President Trump started his first trade war against China in March 2018, the RMB depreciated cumulatively by 13% against the USD, from 6.36 to 7.18, in the following 18 months, which largely mitigated the impact of U.S. tariffs on Chinese exports (Figures 1 and 2).

Despite the effectiveness of currency depreciation in countering tariffs, Chinese authorities may be much more cautious in using the policy tool this time. First, the exchange rate of the RMB is already close to its lowest level since 2008. Further depreciation could exacerbate public sentiment and lead to a massive capital exodus. The aversion to financial instability would prevent the authorities from pursuing an aggressive currency depreciation. Second, thanks to the country's unique disinflationary environment following the COVID-19 pandemic, China's exports have gained a significant competitive advantage in international markets over the past few years (Figure 3). This has already led to intensifying trade frictions with important trade partners, other than the U.S. (Figure 4).

In essence, the strategy of currency depreciation aims to expand China's exports to other countries in order to offset the decline in exports to the U.S. As such, a sharp depreciation of the currency is likely to aggravate trade relations with other major partners and could even risk a currency war with them.

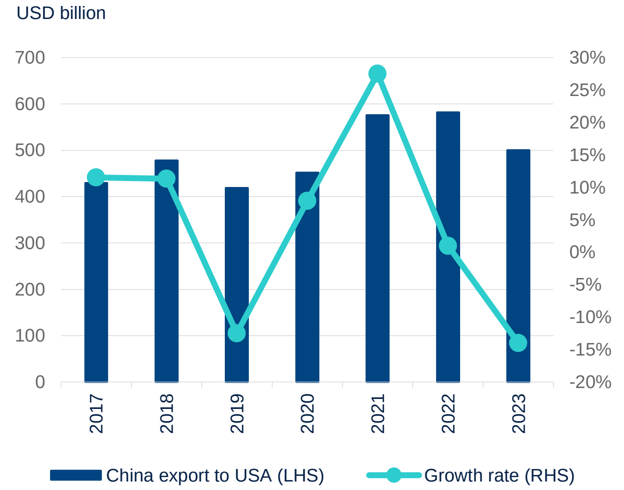
That said, authorities cannot rely on currency depreciation to mitigate the new tariff shocks. Instead, the authorities may need to intervene painstakingly in the foreign exchange market to prevent a freefall of the currency if market sentiments deteriorate sharply.

Figure 1. **RMB DEPRECIATED BY 13% FOLLOWING 18 MONTHS SINCE FIRST ROUND OF TRUMP TARIFF**



Source: Bloomberg and BBVA Research

Figure 2. **CURRENCY DEPRECIATION HAD HELPED TO STABILIZE THE EXPORTS TO US**



Source: BBVA Research and CEIC

Figure 3. **CHINA'S DEFLATIONARY ENVIRONMENT HELPED TO MAINTAIN COMPETITIVENESS OF CHINA'S REAL EFFECTIVE EXCHANGE RATE**

Source: Bloomberg and BBVA Research

Figure 4. **TRADE FRICTIONS WITH OTHER COUNTRIES APART FROM US**

Country/Region	Details	Tax rate
EU	The EU imposed tariffs on Chinese EVs, citing concerns over state subsidies and market distortions.	17% to 35.3%
Indonesia	Indonesia has announced plans to impose import tariffs on various Chinese goods imports, includin'g footwear, clothing, textiles, cosmetics, and ceramics.	100% to 200%
Brazil	Brazil raised tariffs on battery electric vehicles from China to protect its domestic industry.	18%, increasing to 35% by 2026
Turkey	Turkey announced additional tariffs on vehicle imports from China to protect domestic production.	40% or minimum $7,000 per vehicle
Canada	In August 2024, Canada announced a 100% tariff on imported Chinese electric vehicles.	100%
India	India has raised import duties on Chinese electronics and solar equipment.	20%-40%

Source: BBVA Research according to news on tariffs

Export Tax Rebate

The value-added tax (VAT) export rebate is another important policy tool that China's government frequently resorts to in face of external headwinds. For example, in September 2018, after the U.S. imposed additional tariffs on $200 billion of China's exports, Chinese authorities responded by increasing the VAT export rebate rate from 13% to 16% for certain mechanical and electrical products.

Nevertheless, we question whether this policy tool could be re-employed on a large scale this time. The issue also lies in the increasing trade tension between China and its major trade partners. To a large extent, the adjustment of export tax rebates is another form of Beggar-Thy-Neighbor policy, similar to currency depreciation. By the same token, it is likely to spark further trade frictions if implemented.

In this context, China's finance ministry recently announced an adjustment to export tax rebates for a wide range of commodities and other products, effective December 1, 2024. Specifically, the export tax rebate rate for certain refined oil products, photovoltaics, batteries, and certain non-metallic mineral products will be reduced from 13% to 9%, while the rebate for aluminum and copper products, as well as chemically modified animal, plant, or microbial oils and fats, will be cancelled. The move is widely interpreted as China's attempt to ease trade tensions with its partners. It also suggests that the tool of export tax rebate adjustments may be shelved in the face of a new wave of U.S. tariffs.

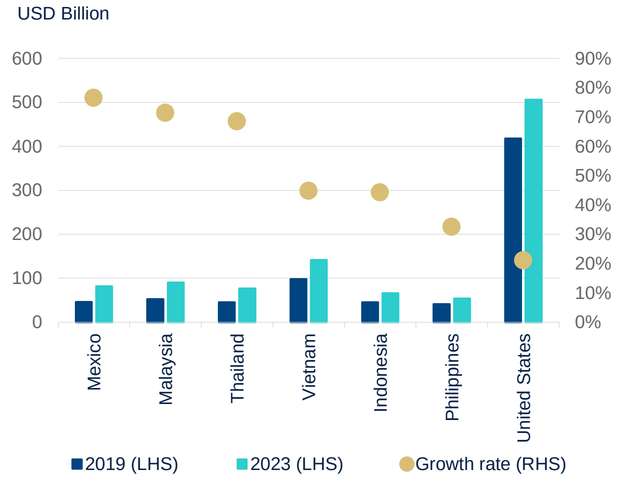
Re-export to the US through other countries

After the outbreak of U.S.-China trade war in 2018, both Chinese exporters and multinational corporations (MNCs) began changing their business patterns to adapt to the new environment. Instead of directly exporting their products to the U.S., they relocated the final stages of their supply chains to other countries in order to circumvent the increasing U.S. tariffs. Meanwhile, they increased exports of intermediate goods from China to these new manufacturing bases (Figures 5 and 6).

The Biden administration welcomed this industry relocation and even touted it as the success of nearshoring or the China+1 strategy. However, under Trump 2.0, this circumvention strategy might not be as effective as before. It seems that Trump's ultimate goal is to attract manufacturing jobs back to the U.S., rather than to other economies outside China. To this end, President-Elect Trump has already indicated plans to impose a general tariff of 10%-20% on U.S. trade partners other than China. Meanwhile, the new administration is likely to tighten regulations on imports with a significant share of added value from China. Some countries, such as Mexico, are attempting to cater to U.S. demands to reduce their bilateral trade tensions.

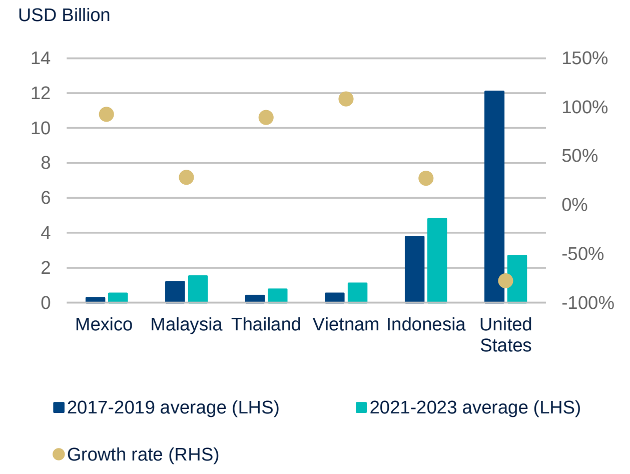
All in all, MNCs and China's exporters will find it increasingly difficult to export their products under the guise of nearshoring or the China+1 strategy under Trump 2.0.

Figure 5. **CHINA'S EXPORTS TO OTHER COUNTRIES GROW FASTER THAN TO THE USA…**



Source: Bloomberg and BBVA Research

Figure 6. **…EVEN MORE SO IN CHINA'S OUTWARD INVESTMENT (OFDI)**

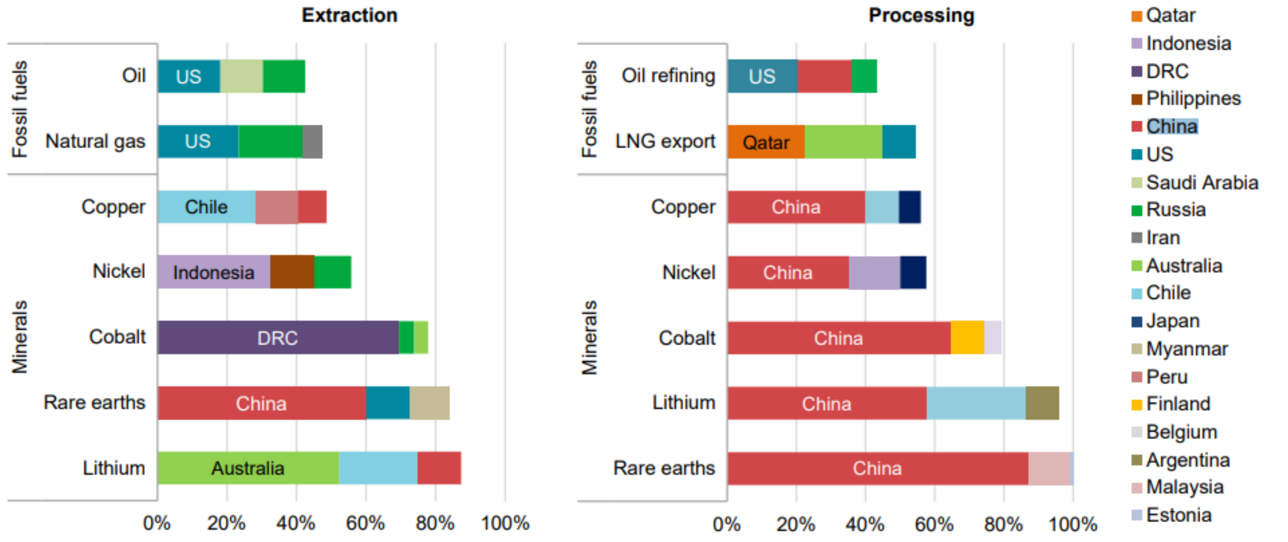


Source: China Global Investment Tracker and BBVA Research

Export Ban of critical metals or minerals

China currently dominates the production and processing of rare earth elements (REEs), as the country is home to some of the most productive and lowest-cost REE-containing geological formations. REEs are widely used in a variety of applications, including energy storage, permanent magnets (along with defense applications), and in permanent magnets for electric vehicle (EV) motors (including hybrid vehicles) and wind turbines (Figure 7).

Figure 7. **SHARE OF TOP THREE PRODUCING COUNTRIES IN PRODUCTION OF SELECTED MINERALS AND FOSSIL FUELS, 2019**

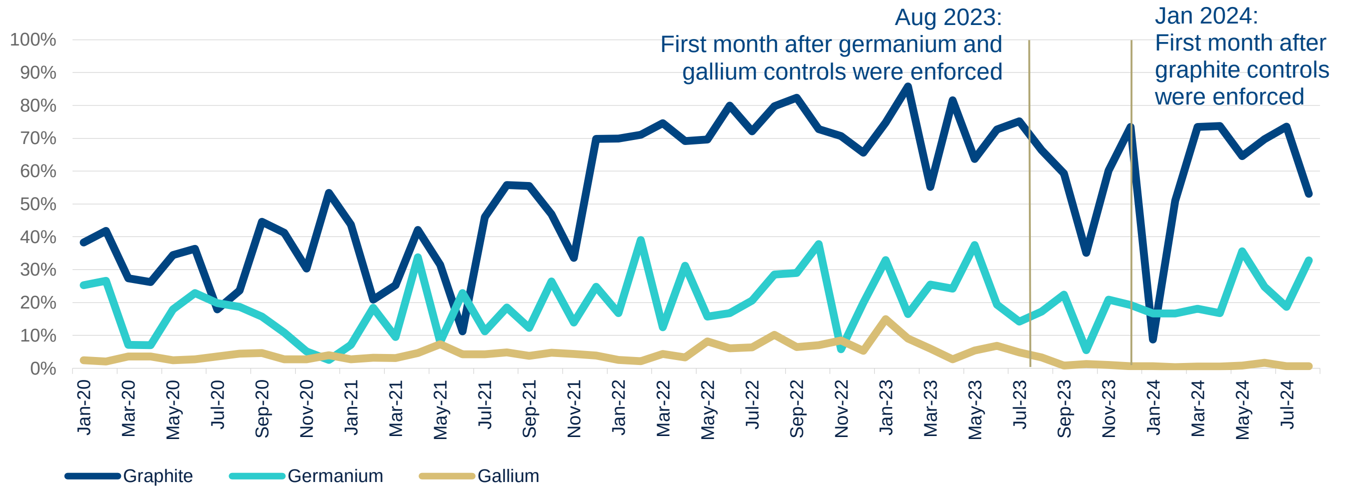


Source: IEA: The Role of Critical Minerals in Clean Energy Transistions, IEA (2020a); USGS (2021), World Bureau of Metal Statistics (2020); Adamas Intelligence (2020)
Notes: LNG=liquefied natural gas; US=United States. The values for copper processing are for refining operations.

Taking advantage of its dominance in REEs, China announced export controls on gallium, germanium, and graphite in July and October of 2023 as part of a tit-for-tat response to the U.S.'s ever-escalating embargo on advanced semiconductors. However, some researchers have found that the actual impact of China's export controls has been insignificant, given that China's share of total U.S. imports of these commodities has not changed significantly thus far (Figure 8).

The failure of these Chinese export controls raises questions about the effectiveness of similar bans on REE exports in countering the new wave of Trump tariffs. President- Elect Trump has no interest in the global campaign against climate change or the associated green energy transition. Therefore, an export ban on REEs is unlikely to hurt him or prompt him to reconsider his tariff policy. Moreover, REEs are also found in other countries. China's dominance in this area is primarily due to its ability to produce REEs at lower prices. If China were to impose strict restrictions on REE exports, it would drive up global prices and encourage other countries to tap into their own REE reserves. Having said that, the impact of REE export bans could be even smaller under the new Trump administration.

Figure 8. **US IMPORT SHARES FROM CHINA FOR EXPORT CONTROLLED CRITICAL MINERALS, JAN 2020-AUG 2024**



Source: PIIE based on US Customs data, provided by the US Census Bureau

Tariff Retaliation

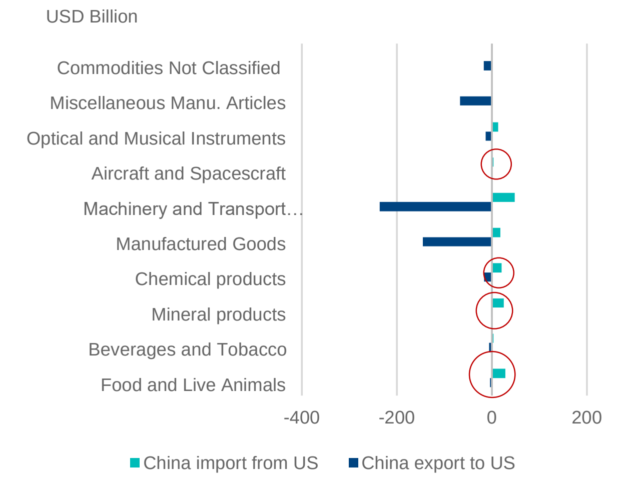
When President Trump implemented tariffs against China during his first term, China responded by increasing tariffs on some U.S. imports as a tit-for-tat measure. To a certain extent, this tariff retaliation successfully brought Trump and his team back to the negotiation table, leading to the Phase One trade agreement between the U.S. and China in 2020.

It is almost certain that China will retaliate again if Trump raises tariffs further. However, it seems that pure tariff retaliation may not be as effective as it was last time in terms of facilitating a new trade deal. As discussed earlier, President-Elect Trump now appears to have an unwavering commitment to tariffs, believing in their effectiveness in bringing millions of manufacturing jobs back to the U.S.

Moreover, the structural imbalance in bilateral trade between the U.S. and China significantly limits China's options for tariff retaliation. For example, some key components of China-made large passenger aircraft, such as the C919, still rely on U.S. imports. If China were to bluntly increase tariffs on all U.S. imports in retaliation, it could negatively impact its emerging industries and high-tech sector. Therefore, we expect China to carefully select U.S. imports for tariff retaliation. Potential candidates include food and live animals (agricultura products such as soybeans and maiz), mineral / chemical products (energy products such as LNG), and U.S.-made aircraft (Figure 9).

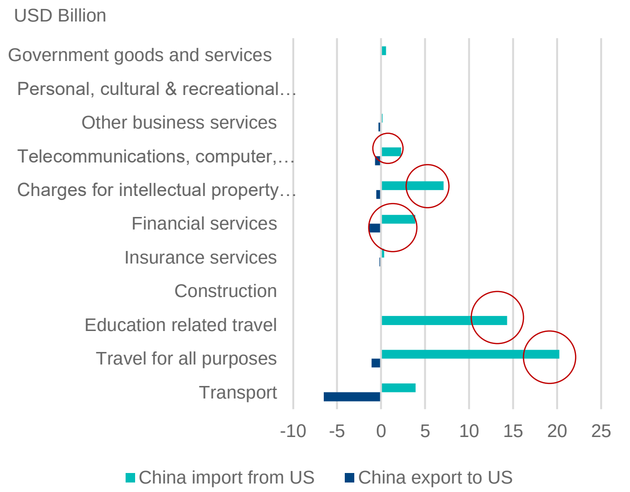
During Trump's first term, some analysts suggested that China could tighten restrictions on Chinese travel to the U.S. (including tourism and education), given that China has a considerable trade deficit in this service category (Figure 10). Unfortunately, this might no longer be a lever, as the U.S. is expected to tighten its immigration policy, particularly for Chinese visitors.

Figure 9. **IMBALANCE OF CHINA-US GOODS TRADE (2023)**



Source: Bureau of Economics Analysis and BBVA Research *Note: Industries with red circle indicates China's net trade deficit with U.S.

Figure 10. **IMBALANCE OF CHINA-US SERVICE TRADE (2023)**



Source: Bureau of Economics Analysis and BBVA Research *Note: Industries with red circle indicates China's net trade deficit with U.S.

Penalizing U.S. firms in China

U.S. firms have a significant presence in China. As of 2023, accumulated FDI from the U.S. amounted to USD 96.7 billion (Figure 11). Some analysts suggest that Chinese authorities could penalize U.S. firms in China to gain an upper hand in tariff negotiations with the U.S., if any.

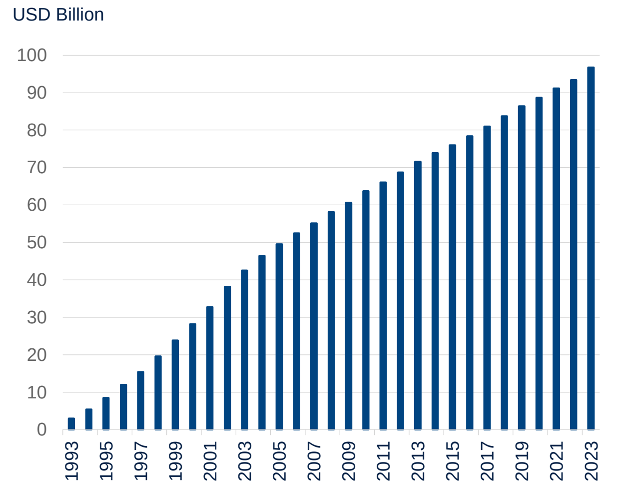
However, these measures also have significant side effects. First, one of the key goals of the Trump administration is to bring U.S. companies back to the U.S. Therefore, by harassing U.S. firms, Chinese authorities would effectively be helping the Trump administration expedite the departure of these firms. Second, these retaliatory measures could create a negative impression for investors from other countries and reduce China's attractiveness as an FDI destination.

Dumping U.S. treasury bonds

Although China is no longer the single largest creditor to the U.S., it still holds a significant amount of U.S. government bonds, with the total amount around USD 96.7 billion, as disclosed by the U.S. Department of the Treasury (Figure 12). The actual figure may be even higher, as China's government also holds U.S. treasury bonds through certain special purpose vehicles (SPVs).

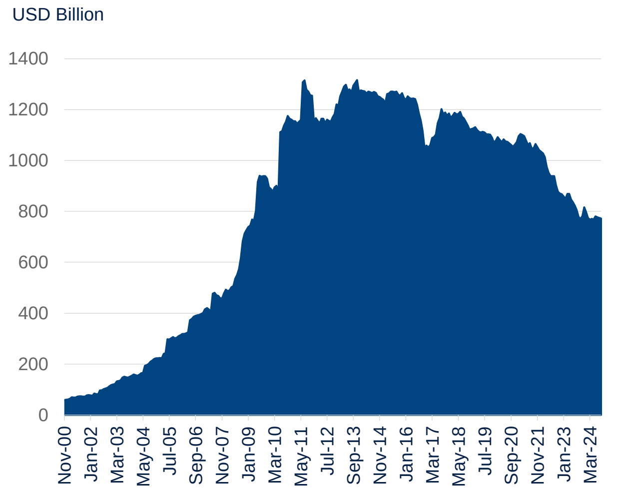
Investors worry that China could dump its holdings of U.S. treasury bonds to retaliate against U.S. tariff measures. Although this action may seem powerful at first glance, Chinese authorities are unlikely to use it because it could escalate the conflict from trade to finance, an area where the U.S. holds certain unchallenged advantages, including control of SWIFT and the USD's dominance in the international monetary system.

Figure 11. **TOTAL FOREIGN CAPITAL UTILIZED FROM US**



Source: CEIC and BBVA Research

Figure 12. **CHINA OWNS A LARGE AMOUNT OF US GOVERNMENT BONDS**



Source: CEIC and BBVA Research

"Set your house in order first"

China's economy is facing enormous domestic headwinds. The real estate sector is still searching for the bottom after the property bubble burst in 2021. Debt-laden local governments have been forced to cut public expenditures due to the slump in land sale revenues. The sentiment of both producers and consumers has now reached a historic low as the economic environment continues to deteriorate.

The new wave of U.S. tariffs could bring additional headwinds to China's economy. To better offset the impact of U.S. tariffs, Chinese authorities need to boost the domestic economy as soon as possible. In this respect, the authorities should continue loosening monetary and fiscal policies to stimulate domestic demand, particularly private consumption. Targeted policy initiatives should be deployed to stabilize the property sector and restore people's confidence. The central government also needs to extend its support to local governments to make their debt sustainable. At the same time, the authorities should press ahead with key structural reforms to fully unleash China's growth potential.

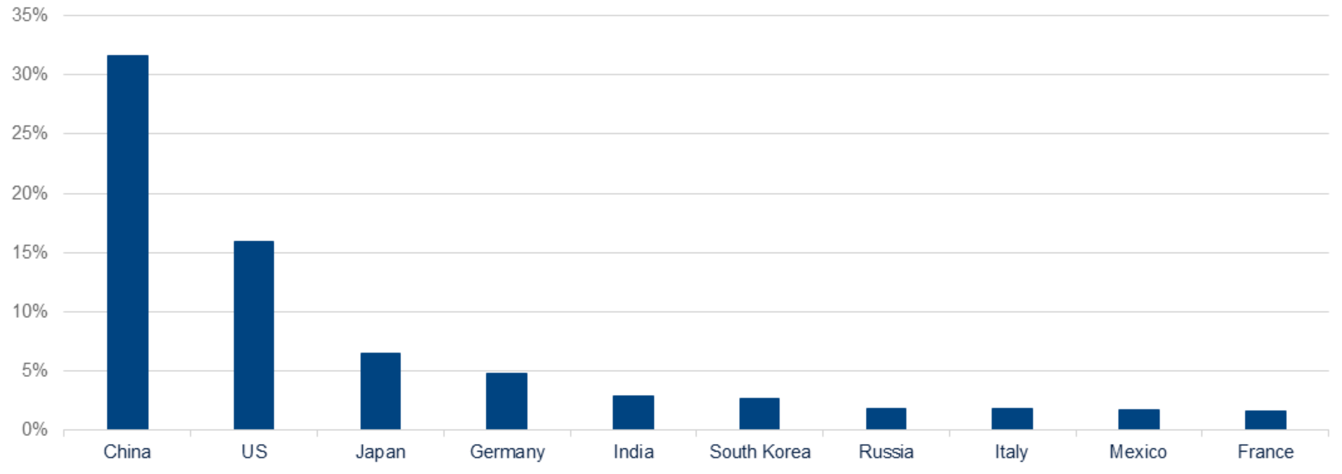
Therefore, China's authorities shouldn't wait for Trump to make his move and then respond. They should start taking action immediately to stimulate the domestic economy and reform its economic structure. Of course, the authorities can leave room for maneuver in their policies. If Trump starts imposing new tariffs, Chinese authorities should respond with a larger stimulus and a faster pace of implementation.

Deeper opening-up to other countries

China's massive manufacturing sector (Figure 13) means that it must continue to promote free trade with countries that hold similar ideals. However, the increasing competitiveness of Chinese products has already led to more trade frictions with many important partners. To counter the new wave of U.S. tariffs, China feels the urgency to ease tensions with other countries. Moreover, to build confidence among these countries in doing business with China, the country needs to further open its domestic market to provide more opportunities.

In this respect, China has already made some gestures, including expanding visa exemptions to many countries, eliminating all restrictions on foreign investment in the manufacturing sector, and continuing to improve the business environment for foreign direct investment (FDI). We expect more measures in this area to be rolled out in the near future.

Figure 13. **TOP 10 MANUFACTURING COUNTRIES IN THE WORLD IN 2024**



Source: BBVA based on data from World Bank

Conclusion

After reviewing a number of methods that China could use to counter the new wave of U.S. tariffs, we find that China's policy options are quite limited. In sum, China needs to address its domestic challenges first in order to enhance its resilience to external shocks. Furthermore, more unilateral opening-up measures are needed to solidify its relations with other important trade partners. China has been one of the largest beneficiaries of free trade and globalization. To uphold global free trade, China must demonstrate to its trade partners that they can prosper through it as well.

Creating Opportunities

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