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Exploring the Impact of Tariffs on the U.S. Economy, FDI and Trade: Lessons from China

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Abstract

China's economy has exploded in the last half century and has become a significant global competitor with the United States. In 2018, tensions rose when the United States accused China of stealing intellectual property, unfair trade practices and being a currency manipulator. This resulted in a multi-year trade war and continuing trade deficit between the two countries. This research paper is intended to focus primarily on the relationship between the United States and China regarding the recent impact tariffs havehad on trade and foreign direct investment, with particular emphasis on recent economic impact to both countries, as well as political and humanitarian considerations. This paper will explore the trade war and impact it had on both the United States and China. The conclusions, recommendations and implications reached in this study are generalizable and appropriate for use in developing best practice solutions.

Keywords:*China U.S trade war, trade practices, currency manipulation and Foreign Direct Investment, intellectual property*

Introduction

It is well-known China operates as a Communist State. Prior to 1979, the governing authority in China, the People's Republic of China ("PRC"), did not encourage free trade or foreign direct investment and adopted a 'Soviet-style' economic policy (Morrison, 2019). The PRC's goal was to establish 'a single public ownership' of all economic resources and state-run businesses. The economic policies during that time failed and it wasn't until economic reform change in 1979 that changed China's (economic) course (Doupnik and Perera, 2009). Similar to other communist countries, and in order to carry out its economic and social initiatives, the PRC adopted a policy planning system called the 'Five-Year Plan'. The Five-Year plan is essentially a roadmap to future economic and social goals, dictated by the highest level of government (Hu, 2013). In 1952, it was clear the Chinese wanted to 'intimidate and weaken the business and commercial interests' and try and secure State control over various sectors of the economy (Rosse, 1954).

The first Five-Year Plan was drawn up in 1953 and it was speculated the Soviets were significant contributors to assisting the Chinese in establishing China's first Five-Year plan. The plan was established to procure specific sectors of the economy that would be used to industrialize and grow China's future. These sectors were selected to advance specific goals towards industrialization. The ideology of China's first Five-Year Plan was to change the future landscape of China from an agriculture state to a more industrialized state. The national Chinese newspaper, *The Peking's Daily* was quoted on New Year's Day (1953) as describing the Five-Year Plan '…to transform China step by step from a backward agricultural country into a powerful industrial country" (Rosse, 1954). Since 1979, and in an effort to attract foreign sponsors, the Chinese government introduced significant economic reform to increase and garner interests specifically related to foreign direct investment and opening free trade (Morrison, 2019).

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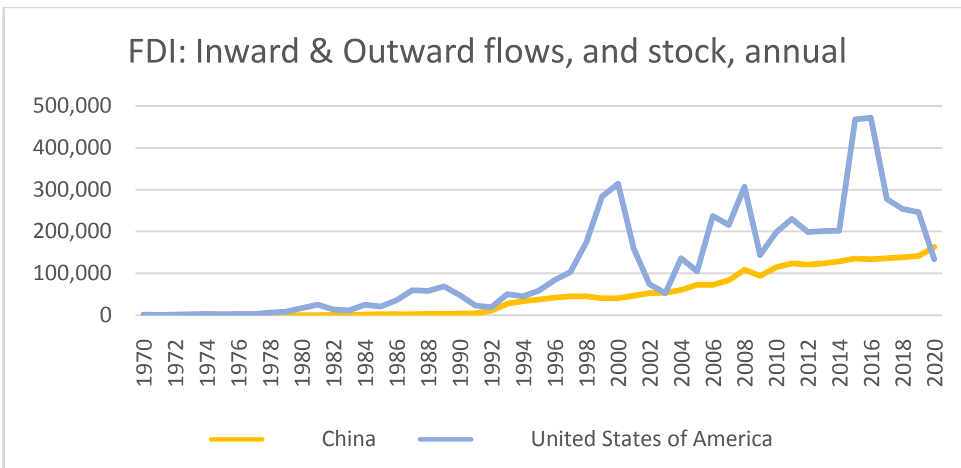
Some of the reforms that contributed to this growth were the government designating special economic areas for foreign investment, opening coastal areas for trade and development, launching incentives for farmers to trade in the free markets, and importing high technology products (Morrison, 2019). One of the most pivotal reforms in 1979, was the 'Law on Equity Joint Ventures ("LEJV"). LEFJV completely reversed China's ban on foreign direct investment and opening up free trade (Pomfret, 1989). After implementing LEJV and other significant reform plans in 1979, foreign direct investment began flowing into the Chinese markets (Doupnik and Perera, 2009). The amended reform policies allowing more investment from foreign firms, as well as trading and technology transfer opportunities with China, resulted in an explosion in growth of foreign direct investment in China from the early 1980's to the 90's (Tsai and Yuan, 2000).

Although no data is available for China's foreign direct investment prior to the 1970's, recent historical trends show a relatively steady increase of foreign direct investment since the major overhaul of economic reforms made by the Chinese in the early 1970's. In present day, China is currently leading the international community as the top recipient for foreign direct investment, whilst the United States suffered a 79% decrease in foreign direct investment in 2020 (BBC, 2021). From the illustration below China has remained relatively steady regarding foreign direct investment growth whereas the United States has shown volatility in its foreign direct investment growth.



Some contributing factors to the downturns in the United States in foreign direct investment may have been a result of the early 2000's recession, the 9/11 terrorist attacks on the World Trade Center and the subsequent wars to follow, and the financial crisis beginning in 2007 leading to the Great Recession. Most recently, the Coronavirus pandemic which has created volatility in all economic and FDI indicators.

In order to illustrate the effects of the economic reforms, the PRC's decisions prior to 1979 or from 1953 to 1978, China's GDP is estimated to only have grown by an annual average of 4.4%, compared to the last four decades, where China's GDP grew at an average annual rate of 10%. (Morrison, 2019). Post reforms, China has experienced significant economic growth, since allowing foreign direct investment and opening the doors to foreign trade. As mentioned earlier, China's gross domestic product has grown at 'an average annual rate of nearly 10%' from 1979 to 2017 (Morrison, 2019) and China has become the United States largest importer of goods which has resulted in an enormous trade deficit between the two countries. The historical trade deficit between the United States and China since 1985 is illustrated below:

Source: U.S Census Bureau

Trade war between China and the United – Historical View

As early as a 2016 campaign rally, President Trump began to layout plans to curb the enormous U.S.-China trade deficit and called for tighter and more fair practices with and from China. In mid-August 2017, President Trump began the 'Section 301' investigation into 'alleged Chinese intellectual property theft' (Reuters, 2020) which was later published later in March 2018. According to Bown and Kolb (2021) the trade war drums officially began beating between the United States and China as early as 2017 and involved 'multiple battles with US allies and others alike.'

In late October 2017, representatives from the solar panel and washing machine industries filed complaints with the U.S. Trade Commission that imports in their industry were damaging to the domestic industry. In response to this, in January 2018, President Trump approved tariffs on solar panels and washing machines for $8.5B and $1.8B, respectively. These tariffs impacted not only China but South Korea as well. The Chinese responded to the solar panels and washing machines in April 2018, with a protectionist tariff of 178.6 percent on sorghum, a grain exported by the United States, but these were quickly halted by the Chinese in May 2018 (Bown and Kolb, 2021).

On March 1, 2018, President Trump, under 'national security grounds' announced tariffs on steel and aluminum on all trading partners of 25 and 10 percent, respectively. The tariffs would impact an 'estimated $48B of imports' mostly from Canada, Europe, Mexico, South Korea and China. At time China only accounted for an estimated 6 percent of imports or $2.8B out of the total $48B. Outcries from allies resulted in President Trump issuing exemptions for Canada, Mexico, Europe, South Korea, Brazil, Argentina, and Australia and set new quota limits for each country. On April 2, 2018, China retaliated and slapped tariffs on 'aluminum waste and scrap, pork, fruits and nuts, and other US products' worth up to an estimated $2.4B. This was to match the 6 percent or $2.8B of tariffs on steel and aluminum in 2017 (Bown and Kolb, 2021).

Three countries, Argentina, Australia and Brazil all received 'indefinite' exemptions in April 2018 and by June 1, 2018, the United States set quotas for all, except Australia who remained the *only* trading partner of steel and aluminum without restrictions. The United States also ended tariff exemptions for EU, Canada and Mexico which resulted in retaliations by Europe and Canada with retaliatory tariffs. On July 24, 2018, President Trump announced the US government would 'subsidize American farmers for up to $12B for their lost export sales'. In August 2018, the United States significantly increased the tariffs on Turkey's imports from 25 to 50 percent to account for the Turkish lira depreciation. In retaliation, Turkey created a new tariff on imports from the US, including automobiles, alcohol, and tobacco. (Bown and Kolb, 2021)

By the end of 2018, developing country exporters of steel felt a tremendous decline in export volumes to the United States resulting in '15.5 percent less revenue' in the six months prior to the tariffs. Although the tariffs also resulted in higher steel prices it created '8,700 jobs in the US steel industry. By 2019, President Trump removed the steel and aluminum tariffs for Canada and Mexico however implemented trade quotas for specifically Canada.

On January 24, 2020, in order to help industries impacted by other tariffs the United States government imposed new tariffs on steel and aluminum impacting almost $450MM of products from Taiwan, Japan, Europe and China.

In March 2018, the United States published its findings into the investigation of China's Act's, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation under Section 301 of the Trade Act of 1974. The United States had officially accused China of unfair trading practices, intellectual property theft, and a growing trade deficit, as well as labeling China as a currency manipulator. These events later led to the United States implementing additional tariffs on industry specific products with China in order to retaliate for the unfair practices founded in the published findings. In early to mid-2018 the United States and China began to go back and forth with threats of new tariffs (Bown and Kolb, 2021).

On July 6, 2018, the United States began its first phase of two to impose 25 percent tariffs on $50B of US imports from the Chinese. This included imports from sectors such as aerospace, information technology, robotics, machinery, mechanical appliances, electrical equipment and industrial. The first phase was imposed on $34B, from the total $50B imports identified. The remaining $16B of tariffs would into effect on August 7, 2018. Simultaneous to the United States moving to implement tariffs in July and August 2018, the Chinese matched with 25 percent tariffs on goods such as agriculture, automobiles, mineral fuels, consumption goods and medical equipment. The initial tariffs resulted in the United States having to assist American farmers who had lost $12B of sales resulting from the tariffs for products such 'soybeans, corn, nuts, fruits, and beef' (Bown and Kolb, 2021).

On September 24, 2018, the United States set a new 10 percent tariff on a list of $200B imports from China. Imports impacted were related to mostly intermediate goods, 'like computer and auto parts,' and consumer goods. As retaliation, China implemented the same 10 percent tariff on $60B of US exports. Tariffs were mainly placed on 'intermediate inputs and capital equipment.' From the last quarter of 2018 to the first half of 2019 (May) the United States and Chinese continued discussions to try and come to an agreement. Assumingly, these discussions between the two states were not progressing and on May 10, 2019 the United States increased tariff rates on the September 2018 imports, from 10 percent to 25 percent. The next month in June 2019, the Chinese retaliated with a similar rate hike on the $60B of goods from September 2018. (Bown and Kolb, 2021)

In the last six months of 2019, negotiations resumed between the two nations. In June 2019, China excluded 16 products or $2B of US exports such as 'animal feeds, chemicals and petroleum products.' As discussions continued China and the United States signed the official 'Phase One Deal' January 15, 2020, with an effective date February 14, 2020 (Bown and Kolb, 2021). According to the Economic and Trade Agreement between the United States of America and The People's Republic of China' Fact Sheet published by the Office of the United States Trade Representative on January 15, 2020, the Phase One trade deal focused the issues addressed in the 2018 findings concerning, intellectual property concerns, technology transfer, agriculture, financial services, transparency regarding currency, expanding trading commitments, as well as, a chapter dedicated to resolving future disputes. As part of the arrangement China had agreed to buy at least $200B more in U.S. goods and services in 2020 and 2021. As of February 2021, China has not hit the agreed upon targets of the Phase One Deal in either 2020 or 2021 (Bown, 2021).

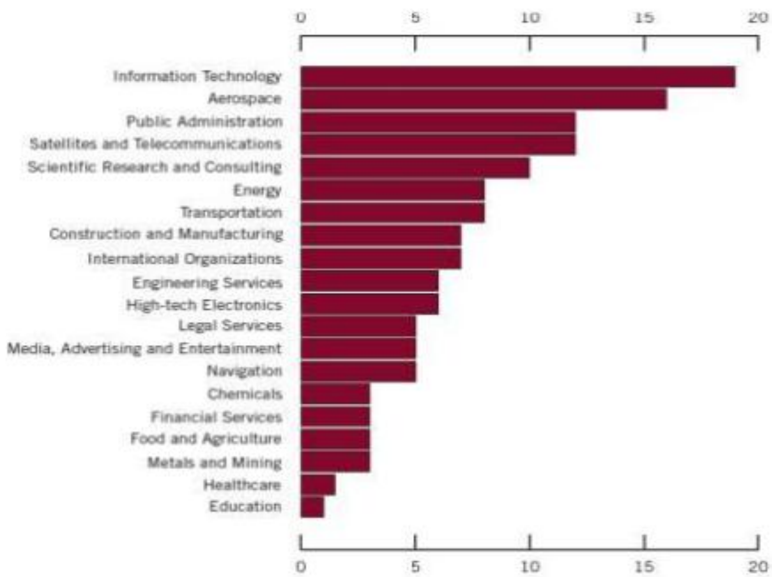
As of today, and with the exception of the UAE, the remaining tariffs from the Trump Administration, including steel and aluminum, remain in good standing and have not been touched since the turnover of Trump's administration. Trump did attempt to remove aluminum tariffs on the UAE on January 19, 2021, however newly elected President Joe Biden reinstated the 10 percent tariffs on the UAE on February 1, 2021 (Bown, 2021). President Biden immediately reinstated tariffs on aluminum with the UAE citing 'national security' threats. (Beech and Shalal, 2021). President Biden had been cited that he will pledge to 'maintain the tariff protections for the steel and aluminum industries until the problem of global excess production capacity - largely centered in China - can be addressed' (Lawder and Singh, 2021).

INDUSTRIES IMPACTED BY TARIFFS

One of President Trumps initial goals was to use tariffs to target specific industries important to the Chinese in order to prevent further industrialization and to decelerate the Chinese economy. (Bown and Kolb, 2021) China has continuously set the foundations and disclosed their economic and social goals in their Five-Year Plans, as well as other initiatives such as the 'Made in China 2025' plan. China has been very vocal about its goals to become more self-reliant on itself for goods and services, especially in specific sectors.

It was clearly evidenced in the 'Made in China 2025' initiative that China actively proposes being more self-reliant in a number of specialized sectors, including but not limited to, information technology, aerospace equipment, electrical equipment, medical devices, farming machines, to name a few (Cyrill, 2019).

According to findings of the Section 301 investigation published on March 22, 2018, by the Office of the United States Trade Representative – Executive Office of the President, China was found to have committed multiple acts of cyber theft and countless examples of unfair trade and business practices in order to gain traction in industries of 'interest'. In one case, a unit of China's People's Liberation of Army (PLA) was known to have stolen data from at least 141 organizations, of which 115 were based in the United States.The below table illustrates the number of victims in each sector:



Source: MANDIANT APT1: EXPOSING ONE OF CHINA'S CYBER ESPIONAGE UNITS

The graph was taken from the investigation of findings report published in March 2018 by the Office of the United States Trade Representative. All of the industries shown have been identified by China as a priority to their future initiatives in the 'Made in China 2025' plan to become more self-reliant and more of a competitor in the world trade markets. These cyber intrusions proved to be 'conducted and supported' by the Chinese government to target specific industries.

Technology

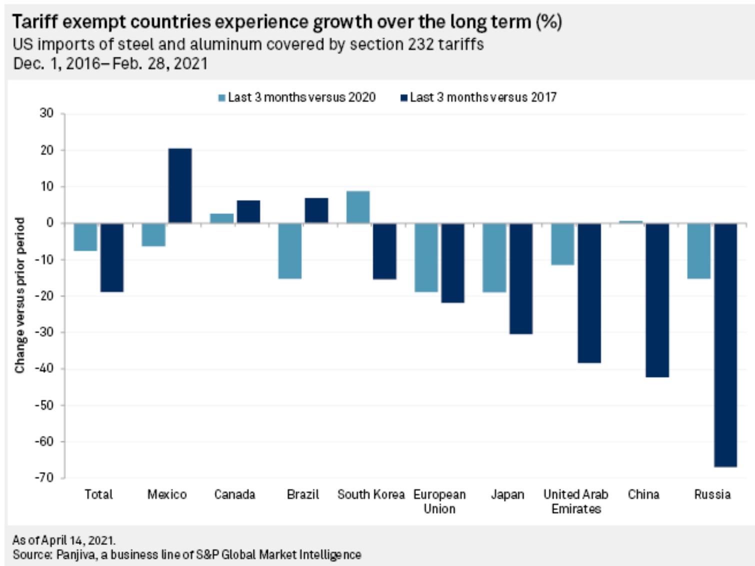
American information technology companies were the most hacked out of all industries. It's no secret China's goal is industrialization and to evolve in certain sectors, especially information technology. Technology transfer has been a major contention between the United States and China and has only been exhausted by the consistent cyber theft of proprietary information and intellectual property between the two states. According to Liao (2016), both China and the United States have been invading each other's networks for decades and there is no punishment for either side. In 2015, President Obama and the Chinese President Xi Jinping agreed to 'abstain from cyber espionage in the commercial areas' however shortly after that meeting it was confirmed 'five U.S. technology companies and two pharmaceutical companies had been hacked by Chinese sources" (Liao, 2016).

China has used many different methods to transfer technology and intellectual property. China has not only used cyber espionage to steal but also has utilized other methods to do so, for example, setting up front companies to acquire companies of interest, utilizing native born citizens working in the industries in the United States to transfer information, and even as simple as purchasing American technology companies to acquire their technology.

It is estimated China has cost American companies nearly $300B in revenues and 'over 2 million jobs' from these types of schemes (Levine, 2020). The continued attempts by China to unethically gain technology secrets and intellectual property has played a pivotal role especially in the start of the trade war.

Steel and Aluminum

Steel and aluminum are currently the most pivotal of all the sectors and imports and is the area where the United States believes it can make the most impact and progress with its Chinese counterparts. The steel and aluminum tariffs are still considered a continued threat to 'national security.' Steel and aluminum tariffs did not make an immediate impact however, the long-term data shows that the tariffs have 'succeeded in depressing imports' as illustrated in the chart below (Holzman, 2021):

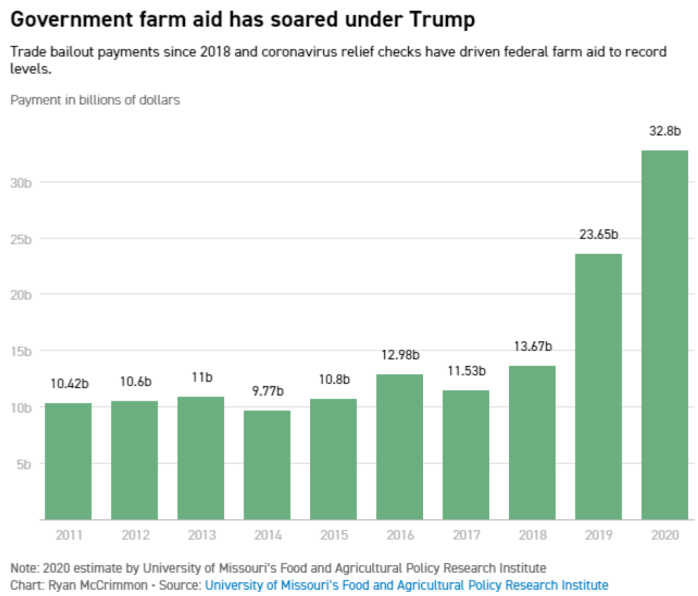


Although, American producers of steel and aluminum are facing other challenges, they have indicated, since the tariffs began in 2018 it has leveled the playing field' on an international and domestic level. American producers have also provided future plans to 'invest more than $15.76B' in new or upgraded facilities in the United States and create an estimated 3,200 jobs in the country (Holzman, 2021). Unfortunately, the imposed tariffs have not benefited all industries and manufacturers however the tariffs are necessary, especially the steel and aluminum to correct the problems with China (Lawder and Singh, 2021).

Agriculture

Since the inception of tariffs in 2018, United States agriculture suffered almost instantly as China was the 'biggest buyer' of a number of U.S. agriculture products including 'soybeans, grain sorghum, cotton, and cattle hides' (Qu, Rodriguez and Zhang 2019). This is the reason agriculture still remains a main focus of the trade war. Interestingly, results from the Findings of the Section 301 publication in March 2018, showed United States agriculture did not seem "as" targeted by the Chinese in their cyber security invasions as other sectors and but was more subject to unfair trade practices. The Phase One Deal however seemed to have turned things around for United States agriculture. According to the 2021 Trade Policy Agenda and 2020 Annual report published in March 2021 by the Office of the President of the United States, in 2020 the U.S. was 'the world's largest exporter and importer of agricultural products,' as well as being labeled the most efficient agriculture provider in the world.

Throughout the trade war, the United States was forced to provide huge relief packages to the agriculture industry and Farmers who had been impacted (Mccrimmon, 2020). Bailout packages related to reliefs related to the impact on tariffs, were given in 2018 and 2019, in the form a $12B and $16B, respectively (Bryan and Heeb, 2019). Since then, the United States government has continued to cut checks to farmers in aid in relief from tariff impact and the Coronavirus and 'have surged to historic levels' (Mccrimmon, 2020). The chart below (Mccrimmon, 2020) illustrates the amount of funding the agriculture industry has received historically:



According to the 2021 Trade Policy Agenda and 2020 Annual Report, even though China has not met and is not on target of the Phase One deal, China still has imported record high imports from the United States of pork, beef, and poultry. Additionally, the Coronavirus pandemic cannot be ruled out in 2020 as not having an impact on U.S. Agriculture as much of the United States was shut down, including sever restrictions on service industry related institutions i.e., restaurants and eateries.

Growth, trade and FDI impacts

The United States and China are the two largest economies in the world, with China being one of the fastest growing. Some economic indicators like GDP growth indicate tariffs have had the opposite intended effect. Former President Trump intended to use the trade war to weaken China's economy and correct the challenges plaguing the China-US relationship including the following:

1. China manipulating currency
2. Stealing intellectual property
3. Provide more fair and balanced trade practices
4. Narrow the existing trade deficit
5. More commitment from China to assist in resolving political and foreign relation issues with North Korea
6. Resolve humanitarian issues

In support, Worland (2019) suggested in January 2019 the United States had been using the trade war to weaken China's economy in order to gain traction 'with agricultural products, intellectual property protection, currency manipulation and forced technology transfers.' The impact of the trade war on the US-Chinese relations is conflicted however considering recent statistics. At first glance, the intended impact of the tariffs, so far have not been accomplished. According to recent GDP reports China is estimated to surpass the United States economy a few years earlier than expected, potentially by 2026 (Cheng and Nee Lee, 2021). Also, China's economy grew by a record 18.3 percent in 1Q 2021 (He, 2021) versus the United States first quarter growth at 6.4% narrowing the gap of GDP levels between the two countries. (Cox, 2021).

Foreign Direct Investment:

Foreign direct investment (FDI) inflows for the two countries shows in 2020, China had a 4% increase (at $163B) in foreign direct investment inflows becoming the world leader of FDI inflows and the United States suffering a decrease of 49% of FDI inflows at $134B (UNCTAD, 2021). Overall total global FDI dropped significantly by 42% in 2020. This increase for China comes on the heels of the Trump Administration encouraging American companies to move their operations away from China and bring them back to the United States (BBC, 2021).

In late 2020, The United States Commerce Department took further steps to deter American investors and companies from doing business with specific state-owned companies by issuing a list of Chinese companies that are suspected or known to be military sponsored. Huawei Technologies, ZTE Corp, SMIC are a few names that appeared as blacklisted (Alper, Pamuk and Shepardson, 2021).

Trade

Since the tariffs began in 2018, data shows the trade deficit for the United States and China did not narrow in 2019 and 2020. According the 2021 Trade Policy Agenda and 2020 Annual report issued by the office of the President of the United States, in the last 5 years total U.S. imports increased 3.4 percent however imports from 2019 to 2020 decreased by 6.6%. China had one of the smallest decreases year-over-year however the decrease in the last five years with China was 9.9%

Table 4 - U.S. Goods Imports from Selected Countries/Regions

	Value ($Billions)			% Change	
	2015	2019	2020	15-20	19-20
Canada	296.3	319.4	270.4	-8.7%	-15.4%
Mexico	296.4	358.0	325.4	9.8%	-9.1%
China	483.2	451.7	435.4	-9.9%	-3.6%
Japan	131.4	143.6	119.5	-9.1%	-16.8%
European Union (27)	369.8	452.0	415.5	12.4%	-8.1%
Latin America (excluding Mexico)	115.9	108.9	90.7	-21.8%	-16.7%
Pacific Rim (excluding Japan and China)	217.0	251.5	269.7	24.3%	7.2%
FTA Countries	774.6	874.6	787.6	1.7%	-10.0%
Advanced Economies	1,055.0	1,209.8	1,126.5	6.8%	-6.9%
Emerging Markets and Developing Economies	1,192.5	1,286.8	1,209.3	1.4%	-6.0%

Source: U.S. Department of Commerce, Census basis
Advanced Economies and Emerging Markets as defined by the IMF

In 2019, evidenced showed the United States did not want to impose tariffs before the holiday season implying the trade war had impacted consumers. In August 2019, Trump also indicated he would be looking to cut taxes by the number of tariffs imposed, implying the trade war has already impacted American consumers (Bryan and Heeb, 2019).

Humanitarian and political concerns

China has been marred for years in humanitarian and political strife. Human Rights and politics have been an enormous challenge in the last few decades and have often gone hand-in-hand. As an example, the 1989 Tiananmen Square massacre. This pro-democracy protest ending in massacre and repression of protestors, on coincidentally the tenth anniversary of the 1979 law opening the trade markets and foreign direct investment (Pomfret, 1989). China has always asserted it will not tolerate its citizens or any other entity and individual to speak out against its government (Lemon, 2021). More recently, China has faced heavy scrutiny from World Leaders surrounding the issues of genocide in the Xinjian province of the ethnic Muslim Uighur minorities (Lemon, 2021). Additionally, the oppression of freedoms in Hong Kong, the constant threats to Taiwan, and the handling of the Coronavirus pandemic are also other significant variables that will factor into future business relationships and trade practices between the United States and China.

It has become intuitively obvious that China's Communist Party seeks to control the economy including public and private businesses. The United States has attempted to use the tariffs as leverage for humanitarian concerns however co-mingling tariffs and humanitarian arguments might not be the best idea. Since the early 90's, after the Tiananmen Square massacre, more American companies actively began adopting Human Rights policies to pledge not to do business with countries where human rights issues were apparent (Gelatt and Orentilicher, 1993). According to Gelatt and Orentilicher (1993) the responsibility should not only lie with just World government but also on a corporate level too. There should be a corporate responsibility to not do business with States that do not have a good track record in humanitarian rights.

CONCLUSION

The trade war was initiated between the United States and China in order to create fair trade practices, eliminate cyber theft of intellectual property and trade secrets, prevent China from manipulating their currency, and narrow the existing trade deficit. These objectives were 'in the interest of national security' and some might even argue economic security. Although, some have labeled the trade war as 'Trump's Trade War' one could argue the steps former President Donald Trump initiated to start the trade war, did not come unprovoked. Arguably, critics of the trade war have maintained that the trade war between the United States and China has created more of an economic mess however it is crystal clear in the first 100 days of President Biden's presidency, President Biden has a similar stance as President Trump, since he has not tried to remove the tariffs.

It's difficult to provide a complete analysis since the COVID pandemic began in early 2020. The Phase One Deal signed by United States in China in February 2020, was signed at the very beginning of the pandemic start. By March 2020, much of the United States was in lockdown status and shortages existed in the United States due to pandemic buying. The trade war left a potential shortage of medical supplies when COVID began. There is no doubt that the Coronavirus pandemic threw a wrench in the trade war between the United States and China. Although the pandemic forced US buyers to purchase less from China (Bown and Kolb, 2021) the pandemic has skewed the statistics.

It is unclear from the economic data if the tariffs have accomplished the intended objectives, especially considering the COVID pandemic has skewed much of the data. Regarding China, on the surface the increase in FDI inflows, tremendous growth in GDP and the minimal change in the trade deficit between China and the United States seems to suggest China is benefiting from the tariffs. It could be suggested this is the short-term outcome with larger implications in the future.

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