

# SINO-U.S. TRADE WAR

IMPLICATIONS FOR THE PHILIPPINES

AARON JED RABENA, Ph.D.





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# Executive Summary

The Sino-U.S. trade war is a symptom of strategic rivalry and great power transition. The trade war has both risks (loss of profit margins for intermediate goods) and opportunities (trade diversion) for the Philippines. The Philippines needs to diversify commercial markets and intensify free trade agreements to buffer the impact of trade wars. The Philippines should also employ means to make the country a more attractive investment destination. The Fourth Industrial Revolution in conjunction with the trade war is another major disruptor that the Philippines should anticipate.

The ongoing Sino–United States trade conflict affirms that war, economic or otherwise, is an extension of politics. In an actual warfare, the weapons are firearms; in a trade war, firepower come in the form of tariffs and non-tariff measures such as investment restrictions, quotas, export controls, and administrative encumbrances. From the Cold War to the present, the normative, political, and strategic outlooks of China and the United States (U.S.) continue to be markedly divergent. This was the case during the Korean War in the 1950s, and presently, in Taiwan and in the South China Sea.

The current Sino-U.S. economic conflict shows that the state of economic interdependence and international institutionalism can be reversed by the occurrence of political or power struggle. Furthermore, it cannot be discounted that the trade war may escalate as economic belligerents, with competing political systems, use more of their visible hand on each other. Potential scenarios include more goods subjected to tariffs, drastic reduction in China-U.S. two-way investment, and unilateral suspension of high-level bilateral mechanisms and exchanges, among

others. All these, in one way or another, would cause a closed international market or production network and render extant international regimes less credible.

To this end, the policy recommendations of certain Philippine economists are worth considering, particularly regarding attitudes towards the region at large and not just in dealing with the U.S. and China. For example, for the Philippines to be an investment haven and attract more foreign capital, it needs to ensure a better investment climate and regulatory environment for investors. To better weather externalities, including the emergence of the Fourth Industrial Revolution, the country needs to move up the value chain and achieve a more sustainable economy. Other potential internal development measures consist of enhancing human capital skills (to increase domestic employment) and the rapid expansion of rural development throughout the country.



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# Sino-U.S. Trade War: Implications for the Philippines

Aaron Jed Rabena, Ph.D.

The ongoing Sino-United States (U.S.) trade conflict affirms that war, economic or otherwise, is an extension of politics. In an actual warfare, the weapons are firearms; in a trade war, firepower comes in the form of tariffs and non-tariff measures such as investment restrictions and export controls. From the Cold War to the present, the normative, political, and strategic outlooks of China and the U.S. continue to be markedly divergent. This was the case during the Korean War in the 1950s, and presently, in Taiwan and in the South China Sea. Moreover, in recent years, the United States has pulled no punches in accusing China of cyber warfare (e.g., 2015 OPM Hack), waging currency wars (by engaging in currency manipulation), and instigating spy wars or intelligence operations against U.S.' critical and strategic industries, which indicate that both major powers also have an adversarial economic relationship.<sup>1</sup>

What are the features of this Sino-U.S. trade conflict and how will the Philippines be affected?

## **Significance of U.S. Actions**

In the past, the U.S. has demonstrated ways of shaping the political behavior of certain states through punitive economic measures (e.g., Cuba,

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Iran, Myanmar, North Korea, and Russia, among others). However, the recent declaration of a “State of Trade War,” by virtue of Section 301 of the 1974 Trade Act, against China by U.S. President Donald Trump is by far the world’s largest economic sanction ever unleashed, and arguably the gravest manifestation of economic nationalism. In July 2018, the U.S. imposed 25 percent tariff on 800 categories of Chinese industrial goods worth \$34 billion, covering steel, aluminum, automobiles, plastics, aircraft parts, chemicals, machinery, boat parts, hard drives, thermostats, LEDs, radio transmitters, batteries, and remote controls, among others.

It was accompanied by the White House’s Decision to block firms with at least 25 percent Chinese ownership from buying U.S. companies involved in “industrially significant” technologies.<sup>2</sup> Moreover, the U.S. National Security Council and Commerce Department plans to implement “enhanced export controls” in order to restrict China’s access to certain technologies on grounds of “national security”, as stipulated in the International Emergency Economic Powers Act of 1977.<sup>3</sup> The U.S. side has likewise announced plans that it will make policies stricter for Chinese students who want to enroll in STEM [Science, Technology, Engineering, Mathematics] subjects.<sup>4</sup> To make matters worse for Beijing, Trump unveiled another trade threat of slapping tariffs on as much as \$500 billion worth of Chinese goods. Chinese companies (e.g., ZTE, Ant Financial, HNA Group) have begun to suffer economic collateral damage as they got caught in the crossfire due to the tougher regulatory environment upheld by the bipartisan Committee on Foreign Investment in the United States (CFIUS).<sup>5</sup>

Relatedly, the U.S. in August passed the Foreign Investment Risk Review Modernization Act of 2018 or “FIRRMA,” which aims to strengthen the oversight capacity of CFIUS in screening mergers and acquisitions by foreign investors. The U.S. and China are each other’s largest trading partners. As per 2017 data, the U.S. is China’s largest export market (19 percent of total Chinese exports) and third largest import source (9.2 percent of total imports), while China is the U.S.’ third largest export market (8.4 percent of total American exports) and largest import partner (22 percent of total imports). With respect to investments, China ranks as the

U.S.' 15th largest investor and the U.S. is China's sixth largest. The two major powers account for around 40 percent of the global economy.

In Trump's view, the economic war had long been initiated by China, resulting in cumulative frustrations and injurious consequences for U.S. interests: the multi-billion dollar trade deficit (\$375 billion in 2017), systemic intellectual property (IP) theft of U.S. industrial secrets, discriminatory compliance with World Trade Organization (WTO) commitments, or unfair commercial practices (e.g., insufficient market openness, enormous state subsidies, massive dumping, and forced technological transfers). In other words, Trump sees trade as a zero-sum (rather than a win-win) situation because a rising China, even if it rises peacefully, has come at the expense of U.S. comparative advantage- a problem which cannot simply be addressed through the WTO.

Beyond trade, however, are other likely factors. The United States has apparently come to realize that after decades of U.S. constructive engagement with China and encouraging China's integration with the international liberal order, the latter has not fully liberalized (deregulated and privatized), let alone democratized. In fact, engagement and integration only led to the accumulation of more Chinese economic, scientific, and military power, which now threaten American dominance and competitiveness in these areas. This is noticeable because China, under President Xi Jinping, has become more assertive and confident in safeguarding and defining Chinese national interests, including ambitions to make China a technological powerhouse.

Consequently, this has started to manifest in a Sino-U.S. "tech race" in artificial intelligence, robotics, data management, quantum science, 5G technology, and supercomputers. It should therefore not come as a surprise if the U.S. economic battle plan aims to target the "Made in China 2025" program – a state-led industrial plan to lead in advanced technologies that have dual-use (civil-military) functions (e.g., advanced IT, aerospace, marine engineering, energy vehicles, robotics, etc.). Essentially, the U.S. is attacking the key driver that has enabled China to promote its own position in a new hierarchy: the international economy. It may even be argued that Trump's trade war is also meant to rattle the Chinese domestic economy in order to create political pains for Xi.<sup>6</sup>

Given these, the U.S. is also caught in a bind. On one hand, should the current state of affairs– i.e. continued engagement and integration of China –hold, Chinese growth will only accelerate the redistribution of power and benefits or the power shift between China and the U.S, thus resulting in more U.S.economic losses and diminished freedom of action over the long-term. On the other hand, if the U.S. penalizes China now, the bilateral and global trading system will be disrupted and the U.S. will sustain reputational costs as a neo-mercantilist and anti-globalization nation. Apparently, for the Trump administration, the policy decision to confront China seems to be “now [while U.S. still has the upper hand] or never.”

It should be noted, though, that Trump’s industrial policy towards China may be structural in cause. Not too long ago, the Obama Administration implemented the U.S. policy of “Pivot to Asia”, whose economic component – the “Trans-Pacific Partnership” (TPP)– was seen by some as an “economic NATO” or “economic containment” meant to break open China’s economy and counter its rising economic influence.<sup>7</sup> Similarly, in the 1980s, Japan’s economic rise caused insecurity in the U.S., and prompted the latter to press the former, as the immediate competitor, to adopt structural policy adjustments and abort proposals for an Asian Monetary Fund (AMF).<sup>8</sup>

## **Is China Ready for a Protracted Trade War?**

Like the U.S., China is no neophyte in wielding economic muscle for the attainment of political objectives. In recent years, Chinese sanctions had been applied against Norway, Japan, and South Korea, among others. But in response to American unilateralism and protectionism, and in a bid to safeguard Chinese economic sovereignty, Beijing resorted to a range of counter-attacks by means of counter-duties, legal action, internal adjustments, and proactive diplomatic engagements with third-party states. First, China specifically imposed 25 percent tariffs on \$50 billion worth of U.S. goods (e.g., soy beans, cars, sorghum, pork, seafood, whiskey, lobster, salmon, cigars). Many argue that these products were targeted because most of them come from the Republican (GOP) states that served as Trump’s political base during the 2016 presidential elections and hence

doing so would create potential political costs for Trump and the GOP, especially in the upcoming midterm elections in November.<sup>9</sup> And like China, American companies such as Ford and Qualcomm have also taken a hit due to higher input costs and tighter compliance supervision caused by the trade war.

Second, China sought legal remedies by filing a case at the WTO against Trump's threats to press additional tariffs on Chinese goods. Third, China pledged to ensure lower tariffs, stronger IP protection, and greater openness and broader access for foreign investors in certain industries in China (e.g., automobile, shipbuilding, aviation, and finance). Fourth, to cushion the impact of and vulnerability to Trump's trade war, Beijing made quick maneuvers to drive a wedge in a possible U.S.-led trade alliance – and avoid fighting on many fronts –by strengthening economic relations (through tariff cuts and free trade negotiations) with Japan, South Korea, India, and ASEAN, while diplomatically working with the European Union (E.U.) for a collective front in calling for the preservation of the multilateral trading system and a rules-based international order.

Beijing has also projected the narrative that Trump's trade war is not just against them, but implicates the whole world into a “Mutually Assured Economic Destruction” or “MAED.”<sup>10</sup> Other implicit counter-measures taken by China include investment restrictions to the U.S. and currency devaluation.<sup>11</sup> Notably, in the wake of the trade war, China issued a travel advisory—allegedly to curtail outbound tourism to the U.S. –citing “unsafe public security.”<sup>12</sup> And because of Trump's threats, China showed its resolve to impose additional tariffs of 5 to 25 percent on \$60 billion worth of American goods.

Nonetheless, China knows that it needs more time and a calm external environment to strengthen all the elements of its national power, which is why they have consistently pushed for compromise and continue to extend conciliatory gestures toward the U.S. such as offers to reduce the trade deficit by importing more U.S.goods, including U.S. gas. Like the U.S., China considers the current trade war as more an issue of politics (or geopolitics) than it is about trade imbalance or illegal business practices, considering their long-held view of the “U.S. threat” whereby Washington intends to stall

the rise of any potential rival. The trade war now appears to many Chinese to be a “Century of Shame and Humiliation with 21<sup>st</sup> Century Characteristics” intended to “make China weak again”.

### **The Philippines in the Sino-U.S. “War by Other Means”**

Just as in any war, the Sino-U.S. trade war will inflict economic costs on both sides; Chinese producers and exporters would lose a large market while American retailers and manufacturers will be hurt by loss of market access to affordable goods. As a consequence, inflationary pressures will come about and mutual losses will be incurred in terms of output (trade volume), profit, employment, and investment flows. The trade war is a classic case where consumers, firms, and businessmen can directly relate to great power politics. This holds true even for third-party trading partners given the era of closely-knit global supply chains. The World Bank, for instance, sees that about two-thirds of U.S.’ targeted Chinese tariffs have value chains that include ASEAN countries’ electrical equipment and machinery products, particularly from the Philippines, Malaysia, and Vietnam.<sup>13</sup> In the case of the Philippines, with China and the U.S. as its major trading partners, there will be sector-specific risks and opportunities given the types of goods that were subjected to tariffs by both economic powers.

In 2016, China was the Philippines’ number one trading partner, largest import source, and third largest export market, accounting for 15.5 percent of the Philippines’ total trade.<sup>14</sup> The bulk of Philippine exports to China were storage units, digital monolithic integrated circuits, nickel ores and concentrates, semi-conductor devices, and coal. The U.S., in contrast, was the Philippines’ third largest trading partner, third largest import source and second largest export market, accounting for 11.6 percent of the country’s total trade. Most exports to the U.S. were in electronic products, apparel articles, and clothing accessories.

The official stance of the Philippine government on the Sino-U.S. trade war is that it would not take sides, but President Duterte has called on China “to protect the East” in the name of globalization, trade liberalization,

and the world trading system.<sup>15</sup> More broadly, there are mixed sentiments in the Philippines on the trade war. As in any political volatility, Philippine shares were naturally dampened as the trade war kicked off, but the government's economic managers put forward the assessment that the Philippines is insulated because it is not trade-dependent and currently has a growing domestic market coupled with a strong external payments position, stable banking system, bullish investments, and higher economic growth. A similar assessment was published by Moody's Investor Service. The World Bank forecasts that the Philippine economy is poised to grow by 6.7 percent this year and next year.<sup>17</sup>

However, there are also economic managers who believe that there will be indirect consequences for the Philippines in terms of the potential decline in global economic growth which may constrain the importing capacity of the country's export markets.<sup>18</sup> For local domestic producers such as the Semiconductors and Electronics Industries of the Philippines (SEIPI) and the Philippine Exporters Confederation Inc. (PHILEXPORT), many Philippine electronic companies export to both China and the U.S., and Philippine exports to China become inputs in Chinese exports to the U.S..<sup>19</sup> According to SEIPI, China and the U.S. are the second and third largest export markets, respectively, of the electronics industry, making up around half of all outbound goods, with each country accounting for 12 percent of market share. For example, based on 2016 data, estimates of Philippine exposure to the trade war in terms of total shipments to China vary from 11 percent (Philippine Statistics Authority) to 16.9 percent (Bloomberg).<sup>20</sup>

While there are risks, there are also strategic opportunities for the Philippines in terms of emerging industrial markets, trade (and investment) diversion, and trade policy adjustments. First, China, being one of the biggest markets for the automotive industry owing to its growing numbers of young professionals, provides an opening for the Philippine semi-conductors industry to supply sensors and electronics for modern cars.<sup>21</sup> Second, the Philippines can benefit from trade and investment diversion as businesses look for new markets and shift their production bases to circumvent the heavy tariffs enforced in China and the U.S. In particular, the Philippines

can gain from the potential slump in the price of Chinese steel exports as China seeks to divert its export markets, which, in turn, can benefit the Philippine government's Build Build Build Program.<sup>22</sup>

Currently, the Philippines enjoys the General System of Preference (GSP) privilege with the U.S. where 3,500 product lines (70 percent of Philippine exports) can enter the American market without duties. It even has existing Free Trade Agreements (FTAs) with other countries, including one with China through ASEAN, where 90 percent of product categories that goes into China either have low or zero duty.<sup>23</sup> Interestingly, as Trump is turning illiberal and unilateralist toward China, the U.S. seems to be more receptive to negotiating an FTA with the Philippines.<sup>24</sup> The Asian Development Bank (ADB) suggests that the Philippines could secure more competitive export opportunities if it becomes a producer of goods that the U.S. and China have placed tariffs on vis-à-vis the other.<sup>25</sup>

## **Anticipating Broader Risks and Conflict Escalation**

The current Sino-U.S. economic conflict shows that the state of economic interdependence and international institutionalism can be reversed by the occurrence of political or power struggle. Furthermore, it cannot be discounted that the trade war may escalate as economic belligerents, with competing political systems, use more of their visible hand on each other. Potential scenarios include more goods subjected to tariffs, drastic reduction in China-U.S. two-way investment, and unilateral suspension of high-level bilateral mechanisms and exchanges, among others. All these, in one way or another, would cause international markets or production networks to close and render less credible extant international regimes. Notwithstanding this, it remains yet to be seen whether China will dump its U.S. treasury bills, hit American companies in China, and/or use its alleged economic "nuclear option" of withholding rare earth mineral exports (e.g., europium and tungsten, of which 90 percent of global supply is controlled by China).<sup>26</sup>



It is worth recalling that in the prelude to World War II, low practical interaction caused by U.S. economic sanctions on Japan contributed to the rise in strategic tensions between the two industrial powers. While the current trade war may not cause an actual “hot” war, Sino-U.S. relations may nevertheless become more adverse and hostile, similar to the Cold War. But to weather and mitigate the impact of the trade war, apart from seeking tariff exemptions, the World Bank’s suggestion is to bolster regional trade through the ASEAN Economic Community (AEC), Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), and the Regional Comprehensive and Economic Partnership (RCEP).<sup>27</sup>

Intra-ASEAN trade, given its considerable potential, is important because it shields the Philippines from great power dynamics. The CPTPP and RCEP, which exclude China and the U.S., respectively, is crucial for the Philippines as they can serve as alternative markets in the event that the two largest economies of the world experience economic slowdown or get entangled in economic power struggle against each other. To date, the Philippines has an active commitment in the AEC and RCEP, but remains ambivalent on the CPTPP.

To this end, the policy recommendations of certain Philippine economists are also worth considering particularly regarding attitudes toward the region at large and not just in dealing with the U.S. and China. For example, for the Philippines to be an investment haven and attract more foreign capital, it needs to ensure a better investment climate and regulatory environment for investors.<sup>28</sup> To better weather externalities, including the emergence of the Fourth Industrial Revolution, the country needs to move up the value chain to achieve a more sustainable economy.<sup>29</sup> Other potential internal development measures consist of enhancing human capital skills (to increase domestic employment) and the rapid expansion of rural development throughout the country.<sup>30</sup>

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The organization's work focuses on the implications of international and regional developments for the Philippines and its foreign relations. It has dedicated programs which cover international security developments, maritime affairs, connectivity and integration, and China.

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- CHINA PROGRAM

APPROFI's original flagship program focuses on China and Philippines-China relations. The China Program stands on two pillars: (1) promoting better understanding among Philippine stakeholders of the implications of China's emerging role in East Asia and the world, and (2) strengthening linkages and engaging in Track Two diplomacy between these two neighboring countries.

- MARITIME DEVELOPMENT & SECURITY PROGRAM (MDSP)

This multidisciplinary program explores how the Philippines can enhance advantages and minimize threats and risks arising from its maritime strategic environment, looking toward both the internal and external dimensions. MDSP aims to generate timely discussions and appropriate recommendations regarding the strategic implications of Philippine maritime security, marine economic resources, and coastal development.

- REGIONAL INTEGRATION & CONNECTIVITY PROGRAM (RICP)

The RICP promotes a critical understanding of the political economy of regional development, and of economic trends and issues that affect Philippine national and regional interests. It seeks to generate insights and research that will enable the Philippines to strategically navigate through its international economic engagements, and interact beneficially with regional states and multilateral institutions.

- REGIONAL SECURITY ARCHITECTURE PROGRAM (RSAP)

The RSAP examines the evolving security environment, the role of multilateral and other forms of security associations, and institutional developments that affect Philippine and regional security. RSAP will be a hub producing research, intelligent commentary, and policy briefs from leading experts and specialists in the Philippines and the wider Asia-Pacific region.



Closely linked to, but independent from the Christian Democratic Union of Germany, Konrad Adenauer Stiftung (KAS) Philippines is a German political foundation. Established in 1964, KAS Philippines was the first ever KAS office in Asia. Ever since its inception, KAS has been actively working in the Philippines under the principles of freedom, justice, and solidarity.

With the main purpose of developing programs that boost the country's democratic institutions and processes, KAS strongly believes that human dignity and human rights are at the very heart of their work. Thus, KAS regards people as the starting point of its initiatives towards social justice, democratic freedom, and sustainable economic activity. KAS Philippines creates, develops, and sustains networks within the political and economic arenas by bringing people together who take their mandates seriously in society.

Given that KAS provides, not just research, but also robust and dynamic activities, the foundation considers itself not just as a think tank, but a think-and-do tank that works along socially equitable, economically efficient, and ecologically sustainable lines. KAS Philippines' country foci are institutional and political reform, the social market economy, and peace and development in Mindanao. The foundation works with civil society organizations, the academe, governmental institutions, political parties, think-tanks, the media, and decision-makers, creating strong partnerships along the way. Particularly, KAS Philippines aims to increase political cooperation in development cooperation at the national and international levels.

ASIA PACIFIC PATHWAYS TO PROGRESS  
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