China Is Bluffing in the Trade War

Chinese leaders say they can effectively retaliate against Trump’s tariffs. They’re wrong.

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U.S. President Donald Trump’s trade war with China is about to get real. Until this point, not much has happened, because the 25 percent tariffs on Chinese goods that the Trump administration announced in May did not apply to goods already in transit. That created a four- to six-week window of opportunity for U.S. and Chinese negotiators to come to an agreement and avoid the implementation of the duties.

That window is now closing, and with no deal in sight, speculation has turned to how China might respond. With Chinese official media vowing no compromise in negotiations with the United States, the country seems to be settling in for a protracted siege.

Considering that China ran a trade surplus of $420 billion with the United States last year, it is obvious that it can’t come close to matching the United States in terms of tit-for-tat tariffs. But it does have other arrows in its quiver. Expert commentary and internet speculation have focused on three: an embargo on imports of soybeans from the United States, an embargo on exports of rare earth metals to the United States, and the diversification of China’s currency reserves away from the dollar.

Fortunately for the United States—and for the health of the global trading system—each of these would be an empty threat.

In 2018, as rhetoric about the trade war took off in earnest, China slapped a punitive tariff of 25 percent on American soybeans. Soybeans are the United States’ biggest farm export, and they are important crops in the Midwestern states that swung to elect Trump in 2016. The 25 percent duty has been widely cited as the root cause of low prices that have led to a wave of farm foreclosures across the U.S. heartland.

The United States’ largest competitor in the global soybean market is Brazil, so one might expect Brazilian farmers to be jumping with joy as they see more demand for their produce. But Brazilian soybean prices
have fallen almost 20 percent since April 2018, almost exactly matching the slightly over 20 percent fall in U.S. soybean prices for that period.

The reason is simple: Soybeans are fungible. When China buys Brazilian soybeans instead of American ones, Europeans have to turn to soybeans from the United States to replace their usual Brazilian supplies. There is one, single, undifferentiated global market for soybeans. Squeeze it in one place, and it just pops out in another.

Indeed, the decline in soybean prices is global, and it has nothing to do with the U.S.-China trade war. It’s all about the African swine fever. The majority of the world’s soybeans feed pigs and other animals, not people, and China’s pork producers have been hit with a nationwide fever epidemic.

As a result, Chinese purchases of U.S. soybeans have now stopped completely. That may look like a total soybean embargo. But the reality is that China just doesn’t need as many soybeans, because it doesn’t have as many pigs to feed. As the swine fever continues to rage, look for U.S. exports of pork products to boom.

China is by far the world’s largest producer of rare earth metals: elements such as neodymium, europium, terbium, and dysprosium that are crucial to the production of some advanced materials and electronics. Despite their name, rare earths really aren’t so rare, and, in fact, the United States was the world’s major producer until cheap Chinese sources undercut the market in the 1980s.

The United States still has plenty of rare earth metals, but the environmental costs of extracting them from the underlying ores are too high to make production economic. Refining the minerals is only cheap in China because of the country’s lax environmental standards. If China does place a global embargo on the export of rare earths, prices will go up to reflect the metals’ true economic costs, which would actually be a good thing (from an environmental perspective).

Anything less than a total global embargo, however, would be useless, since, even more so than soybeans, rare earths are entirely fungible. China found that out in 2010, when it slapped an embargo on rare earth exports to Japan. Analyses a few years later found that the export ban had virtually no ill effect. If China sells them to anyone, U.S. companies can just buy them secondhand or switch to alternative inputs to their industrial processes.

China holds an estimated $1.1 trillion of U.S. government bonds, out of a total foreign currency reserve of around $3 trillion. That sounds like a lot of
money, but in comparison to the size of its economy and levels of international trade, China’s reserves are **roughly in line** with those of other developing countries. It’s also not a particularly large proportion of the roughly $22 trillion total U.S. government debt to the world outstanding.

Alarmists warn that a Chinese dollar dump could send U.S. interest rates soaring and the U.S. economy crashing down. Just about everyone else understands that the huge market for U.S. Treasury securities, with an average daily trading volume of $500 billion in the **spot market**—and many times that in swaps, options, and futures—could easily absorb China’s entire reserves.

Ironically, the biggest victim of any Chinese liquidation of U.S. dollar holdings could be the European Union. Any reduction in China’s dollar reserves holdings would have to be matched by a corresponding rise in its holdings of other currencies, and the euro is the most likely alternative. But eurozone government bond trading is much thinner and more fragmented than the U.S. Treasurys market. A massive Chinese shift into euros could see that currency skyrocketing, placing a massive drag on Europe’s big industrial exporters.

The truth is that China has very little leverage in a trade war with the United States. Given Beijing’s bluster, it can be easy to forget that China is still a relatively poor country with a GDP per capita less than one-sixth the U.S. level. Compared to the America’s, China’s economy is relatively inefficient and undifferentiated, and its markets are poorly developed.

The simple fact is that China needs the United States more than the United States needs China. In itself, that’s no reason to start a trade war. But if the trade war really does heat up, there’s little doubt who will win.