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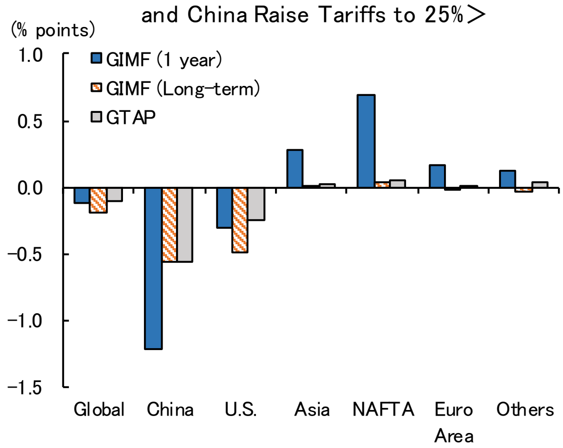
Topics *To what extent will China's exports to the U.S. be replaced?*

The trade disputes between the U.S. and China are anticipated to lead to the reorganization of global value chains and increase exports to the U.S. from surrounding Asian countries. However, given the scale of Chinese exports to the U.S., this reorganization is not likely to progress overnight.

■ China's growth rate will be pushed downward by 0.6% to 1.2% as a result of the fourth round of U.S. tariffs on Chinese goods

<Impact on Real GDP If Both the U.S. and China Raise Tariffs to 25%>



Source: The Japan Research Institute, Ltd. based on IMF "World Economic Outlook (April 2019)"
Note: NAFTA: North America Free Trade Agreement

The trade friction between the U.S. and China has shifted towards the worst-case scenario. The U.S. government raised tariffs on $200 billion worth of Chinese goods from 10% to 25% on May 10. In accordance with this movement, the Chinese government announced it will take a retaliatory measure by further raising the tariffs on $60 billion worth of U.S. goods, for which tariffs had been raised in September 2018, by 5% to 25%. The two government will likely pursue some compromise at the summit meeting scheduled for the end of June. However, the U.S. government has been increasing pressure on China by taking measures to prohibit transactions with China's leading telecommunications company due to concerns over national security, on top of the announcement of the fourth round of tariff hikes on approximately $300 billion worth of Chinese goods, which had been excluded from the scope of retaliatory tariffs, to 25%. Given these movements, it is unclear if the two countries will be able to pave the way towards the normalization of their trade relationship at the summit meeting.

In line with the increasing possibility of prolonged trade friction, concerns over the slowdown of the global economy have been growing. In the "World Economic Outlook" published by the International Monetary Fund (IMF) in April, it was estimated how much the actual GDP growth rates of respective countries would decrease if both the U.S. and China raise tariffs on all imported goods to 25%, by using the IMF's original forecasting model called GIMF (Global Integrated Monetary and Fiscal model) and the GTAP (Global Trade Analysis Project), a standard analysis tool widely used for analyzing the impact of tariff fluctuations on the global economy. According to these estimates, GDP growth will likely be pushed down by 0.6% to 1.2 % points for China and by 0.3% to 0.5% points for the U.S. China will be more significantly affected by the tariff hikes than the U.S. because China's trade dependency is higher.

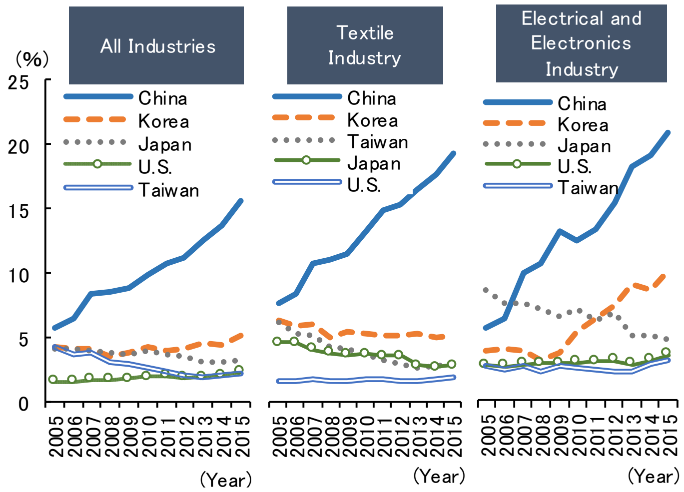
Meanwhile, the IMF forecast that the downward effect on the growth of the world economy will be limited to 0.1% to 0.2% points as the retaliatory tariff hikes by the two countries will likely boost the growth of other regions, which is expected to offset the downward effects on the U.S. and China. Since these results are the estimates of the pure impact of the tariff hikes and the downward effects for China will likely be offset by aggressive economic stimulus measures by the Chinese government, the actual impact may be smaller than the estimates by the IMF.

■ Regions other than the U.S. and China will enjoy positive growth effects

Asia and NAFTA will likely enjoy positive growth effects as China's export to the U.S. is expected to shift to ASEAN countries and Mexico. If 25% tariffs are imposed on Chinese goods, the price competitiveness of Chinese products in the U.S. market will be significantly impeded. As companies will look for production bases to replace China and export products to the U.S. from there, China's exports to the U.S. will be replaced by exports from third countries. This is called a trade diversion effect. The IMF estimates using the GTAP that exports to the U.S. will increase by 10.6% from Asia, 8.4% from the Euro zone and 7.5% from NAFTA while China's exports to the U.S. will decrease by 71.3%.

The review of global value chains (GVCs) in East Asia, which set China as the final destination for exports to the U.S., had started even before the emergence of the U.S.-China trade friction. For instance, the movement of procuring intermediate goods such as raw materials and parts from China and exporting products to the U.S. has already emerged in Vietnam, which has been gaining attention as a strong candidate for "China plus One." According to the TiVA (Trade in Value Added) statistics by the Organization for Economic Cooperation and Development (OECD), which indicates the added value of goods and services traded across international borders derives from which industries and which countries/regions, the added value of China in Vietnam's exports to the U.S. increased to 15.7% in 2015 from a mere 5.8% in 2005. This trend is especially apparent in the textile industry and the electrical and electronics industry which are the two largest exporting industries in Vietnam.

<Ratio of Countries/Regions with Higher Added Value included in Vietnam's Exports to the U.S. (Top 5 Countries/Regions)>



Source: The Japan Research Institute, Ltd. based on OECD "TiVA (December 2018)"

China's added value included in Vietnam's exports to the U.S. is not necessarily limited to that of local Chinese companies. Looking at the breakdown of the cumulative approved amount of Vietnam's foreign direct investment by country and region during the period from 2002 until April 2019, the $9.6 billion from China is much less than the $40.5 billion from Korea, $37.0 billion from Japan and $28.2 billion from Singapore. This indicates that foreign-funded companies such as Korean and Japanese companies which have businesses in Vietnam are procuring intermediate goods from affiliated foreign-funded companies with business foundations in China. This trend will likely expand not only within Vietnam but also in other ASEAN countries and India if the trade disputes between the U.S. and China are prolonged. While companies that set China as the final destination for exports to the U.S. can mitigate the negative impact of the U.S. tariff hikes, the position of China, which had demonstrated an overwhelming presence as the final destination for exports to the U.S. in the past, will be relativized gradually in the future.

■ China's exports cannot be easily replaced due to their scale

The trade disputes between the U.S. and China will lead to the reorganization of GVCs in East Asia which set China as the final destination for exports to the U.S. However, the IMF's estimate that countries other than the U.S. and China will not be negatively affected by the fourth round of the U.S. tariff hikes as a result of this reorganization seems rather optimistic. As the speed of the GVC reorganization depends on the cost of diversification of production bases which varies among industries and the capacity of applicable countries and regions subject to the diversification including labor force, the reorganization will not likely progress as smoothly as the IMF anticipates.

In fact, the scale of China's exports to the U.S. is too large to be easily replaced by third countries. According to TiVA, China accounted for 25.5% of exports to the U.S. on an added value basis for the global manufacturing industry in 2015, significantly exceeding other countries such as India (2.6%), Taiwan (2.2%), Vietnam and Thailand, (1.2%), Malaysia (0.9%), Indonesia (0.8%), Singapore (0.7%) and the Philippines (0.5%). China's manufacturing industry employs approximately 100 million workers. Even if assuming that other Asian countries and regions will take over the final processes such as assembly instead of the entire production bases, it is unrealistic to expect that China's production capacity will be smoothly replaced by other countries and regions within a short period of time.

If the fourth round of the U.S. tariff hikes is initiated under such circumstances, not only will the trade diversion effect remain unfulfilled as much as anticipated but also the cost of the tariff hikes will have to be borne by (i) Chinese companies including foreign-funded companies, (ii) importing companies in the U.S. or (iii) U.S. consumers. As a result, both the U.S. and China will likely face stronger negative growth effects than estimated by the IMF. As the effects of the tariff hikes on each country and the global economy depends on the progress of the GVC reorganization, it seems necessary to closely watch the trends of foreign direct investment and of trade between China and countries including Vietnam, Indonesia and India, which are promising candidates for the diversion of production bases.

(Yuji Miura)

Topics India also faces trade disputes with the U.S.

While the U.S.-China trade war has been gaining attention, a similar movement has been expanding into the relationship between the U.S. and India.

■ Trade friction has been intensifying between the U.S. and India

Since the U.S. government decided to impose additional tariffs at a higher rate on the imports of some steel and aluminium products in March 2018, trade conflict has been intensifying between the U.S. and other countries. A similar movement has been expanding into the relationship with India.

With regard to the additional tariffs imposed by the U.S., the Indian government appealed to the World Trade Organization (WTO) in May 2018 and announced its policies to introduce retaliatory tariffs on imports of large motorbikes, almonds and apples. Following these movements, high-level consultations of government officials were held in order to avoid further intensification of the disputes, and the Indian government repeatedly postponed the deadline for introducing retaliatory tariffs. However, as the trade negotiations between the U.S. and India contained various conflicts, no significant progress was observed. Amid such a situation, on March 4, 2019, the U.S. government announced a policy to terminate the GSP (Generalized System of Preference) designation of India. GSP is a preferential tariff measure in order to support the economic development of low-income countries through exports. Not only the U.S. but also Japan and the EU have adopted a similar system for low-income countries including India. The exclusion of India from the scope of application of GSP will commence following the U.S. presidential proclamation when 60 days have elapsed after the notification to India. While bilateral consultations will be held during this period, it is difficult to ensure the continuation of policies given the results of the general lower house election which took place from April to May. Therefore, the U.S. is expected to make the final decision in light of the consultations with the new administration which will be formed following India’s general election.

＜Recent Movements of the U.S.-India Trade Frictions＞

Timing of announcement	Details
March 2018	The U.S. decided to impose additional tariffs on some steel and aluminum products by 25% and 10% respectively targeting countries including India.
April	The Reserve Bank of India issued a notice to require all settlement data to be retained in India.
May	India appealed to the WTO (World Trade Organization) with regard to the tariff hikes by the U.S.
June	The U.S. and India conducted high-level consultations of government officials regarding trade issues.
August	India postponed the deadline for introducing retaliatory tariffs on the U.S. goods (thereupon, it has been postponed repeatedly until now).
September	The U.S. and India held the first high-level ministerial consultations on foreign affairs and defense matters and discussed the exports of arms and weapons from the U.S. to India as well as India's imports of crude oil from Iran.
December	In order to prevent a monopoly by leading EC operators, India announced a policy to introduce regulations that prohibit the sale of products by retailers invested in by EC operators as well as exclusive contracts with sellers in February 2019.
	The U.S. demanded that India eliminate/reduce tariffs on ICT related products (according to media reports).
April 2019	The U.S. announced that it will end waivers that allow some countries and regions including India to import Iranian crude oil on May 1.
	The U.S. published the 2019 edition of the "Special 301 Report" that compiles unfair business practices against the U.S. In the report, the U.S. government continued to keep India on its Priority Watch List and expressed concerns over the infringement of intellectual property rights in fields including pharmaceuticals and chemical products.

Source: The Japan Research Institute, Ltd. based on various media reports

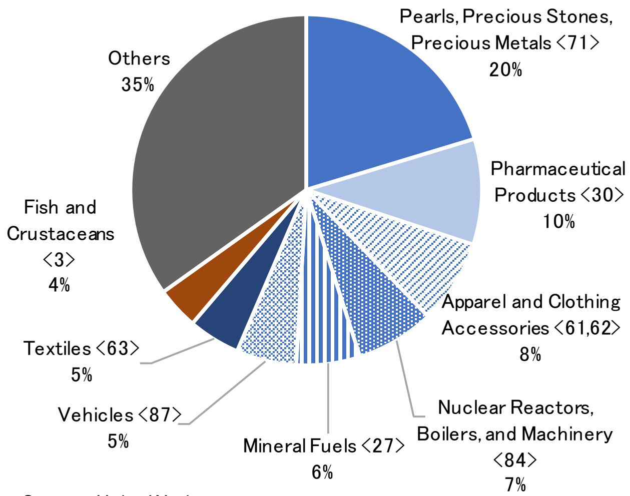
■ Why is the U.S. terminating GSP designation of India?

Since India’s nominal GDP per capita is approximately $2,000, the graduation from GSP is premature from the perspective of income level. Nonetheless, the U.S. side decided on the termination of GSP designation of India because it regarded the lack of “fair and reasonable access” to the Indian market as a problem. While specific reasons have not been revealed, India’s restrictions on foreign participation in the retail industry and concerns over the infringement of intellectual property rights are presumed to be the principal reasons.

Since the advent of the Modi administration in 2014, the Indian government has been working on deregulation for foreign companies in various industries with the aim of creating employment by boosting foreign direct investment. However, from the perspective protecting small retailers, the Indian government has maintained strict entry regulations for general merchandise stores that have multiple brands. In addition, the Indian government has obliged retail operators with a single brand to maintain a local procurement rate of 30%. In terms of EC (electronic commerce), in order to prevent a monopoly by leading EC operators and the sale of products at cheaper prices, the Indian government prohibited the sale of products by retailers invested in by EC operators in December 2018, and at the same time announced a policy to introduce restrictions on exclusive contracts with sellers. As U.S. companies are key players in the EC market in India, they have expressed dissatisfaction with such measures. In addition, in its “Special 301 Report” that compiles unfair business practices of various countries, the U.S. government continued to keep India on its Priority Watch List and expressed concerns over the infringement of intellectual property rights in fields including pharmaceuticals and chemical products. Meanwhile, in the international rankings for intellectual property rights protection by the U.S. Chamber of Commerce, India ranked in 36th place in 2019 out of 50 countries and regions, significantly improving its ranking from the previous year (44th place). While these indicates progress in measures towards improvement, India’s ranking still remains low.

■ Impact of termination of GSP designation will be limited

＜India's Exports to U.S.(2018)＞



Source: United Nations
Note: Figures in parentheses show 2 digits HS code.

Looking at future prospects, in light of the fact that the creation of employment has become an imminent challenge for India, it seems extremely unlikely that the Indian government will deregulate foreign capital investment in the retail and other sectors by giving concessions to the U.S. side. Therefore, it is likely that no significant progress will be made at the bilateral consultations after India’s general elections and that the termination of GSP designation will be confirmed.

In terms of the impact of the termination of GSP designation on the Indian economy, the downward effects through exports will likely remain minimal in light of the fact that (i) the ratio of India’s exports to the U.S. is less than 2% of India’s nominal GDP and that (ii) GSP is not applied to jewelry including diamonds and gold which are major export goods. However, since the GSP designation has become a factor for determining the location of production bases for labor-intensive industries for global enterprises along with labor costs, the termination of GSP designation by the U.S. is anticipated to weigh on the economy from the perspective of a decline in foreign direct investment by foreign-funded companies with an eye to exports to the U.S. The U.S. has announced a policy to review the GSP designation not only of India but also of several other emerging countries including Indonesia and Thailand. Japan also fully terminated GSP designation of China, Thailand and Malaysia in April 2019. Given the foregoing, attention must be paid to the fact that the impact on India’s foreign direct investment will depend on factors including the GSP designation of other countries, the existence of alternative preferential tariff treatment after the termination of GSP designation, and the status of progress in trade negotiations towards the conclusion of an FTA.

However, there is still a possibility that further intensification of trade friction between the U.S. and India will be avoided in the future if the U.S. side highly evaluates India’s move to follow the measures by the U.S. government to ban imports of Iranian crude oil. Meanwhile, there is a risk that the conflicts between the U.S. and India will further intensify as a result of the termination of GSP designation and the introduction of retaliatory tariffs imposed by the Indian side. In this scenario, negative effects will spread across the trading and investment systems in Asia in line with the intensification of the U.S-India disputes.

(Shotaro Kumagai)