For EU companies, there may be no avoiding US-China hostilities

Blog post by Senior Associate Guillaume Ferlet, 18 April 2018

As US-China trade hostilities slowly unfold, the EU is currently watching from the sidelines — mostly silently. But impacts in Europe are possible in the coming months, if only because US-China trade flows do not operate in isolation. Barriers between Washington and Beijing are a potential source of deflection towards other destinations and the EU is an obvious candidate for absorption. How material could this diversion be? How will EU businesses and policymakers respond?
First, there is the question of goods trade deflected from the US and China. To understand if this will happen, we need to make some difficult judgements about the US's capacity to absorb new tariffs. The US Trade Representative has carefully and deliberately cast the net very wide – using 1300 tariff lines to get to the arbitrary target of $50bn in targeted trade flows.

Most of these are industrial inputs, chosen for the fungible supply elsewhere in the global economy or in the US. Only 1 targeted tariff line – flat screen televisions – individually represents more than $1.5bn in US imports. The USTR has also deliberately chosen goods embedded in US manufacturing supply chains, where the frictional costs of tariffs are potentially more easily absorbed, so many US firms might pay tariffs rather than switching suppliers. The combination of these factors may make the diversion effect limited, and the EU price effect small or negligible.

However, an expansion of the US tariff list as threatened by the US administration could potentially change this calculus quickly. Adding another $100bn in coverage (as floated by the White House) would make it harder for the USTR to avoid hitting finished goods such as clothing, shoes, leather goods and consumer electronics. Here the scope for diversion towards Europe is potentially wider, as the Chinese price margin in the US is sharply eroded and retailers seek alternatives.

In this scenario, diversion effects are much more likely. In the first instance, this may show up as downward price effects for Chinese inventory. However, many of these consumer goods are politically sensitive in the EU and EU producers will be priming policymakers to consider defensive action. Brussels may reach for safeguard duties (used to respond to sudden surges in imports), or anti-dumping duties if they believe Chinese inventory is being cleared on the EU market below cost. The EU is already preparing such a safeguard investigation in response to the anticipated deflection effect of the US's current Section 232 measures on steel and aluminium.

Practically speaking, EU companies need to be alert for this. It potentially implicates upstream costs for inputs like steel, but also price sensitive consumer goods. If the EU follows through on its own plans to retaliate against US duties with tariffs on US exports, it is obviously EU companies and consumers that will pay these.

Second, there is the question of capital flows diverted from the US and China. As my colleague Stephen Adams blogged this week, an overlooked aspect of the Trump administration's measures against China is a possible retooling of US investment screening mechanisms. The likely aim will be to exert greater control over Chinese acquisitions in the US, but possibly US investment into China as well, whenever valuable technology is at risk of being handed over through licensing arrangements. With the broad discretion the Trump administration is seeking in the process, there is a good chance of a significant deterioration in the investment climate between the US and China.

Squeezing the scope for US-Chinese investment raises the question of where this potential capital might be diverted. Again, Europe looks like a reasonable answer. But the ongoing Franco-German push in Brussels for a stricter screening of state-backed foreign acquisitions and a heightened anxiety about technology transfers to China mean that this may not be smooth or simple, however such flows might benefit the EU economy. The sharp rise in technology-motivated Chinese acquisition in the EU over the last five years is part of what has encouraged some EU politicians to call for greater scrutiny. It will be important to watch how Trump's rearmament strategy for the US screening regime is interpreted by Europe's own China sceptics.

US and Chinese choice may – and probably will – push choices on the EU. There are plenty in the EU who would like to see a firmer line on China. In areas like investment screening, these may be long-lasting, as, unlike tariffs, any overhaul of US and EU investment laws will reset a framework, rather than just adding a short term frictional cost. For EU businesses, this all suggests that there is no real sitting out of the US-China issue.