

## CHINA: FROM PARTNER TO COMPETITOR TO ADVERSARY

**A *Washington Post* story reported the Trump administration is considering a range of punitive measures targeting China and President Trump threatened more tariffs on China in his press conference yesterday. Many of the ideas being circulated inside and outside the White House are counterproductive and unlikely to be enacted. That said, the debate in the US regarding China is undergoing what is likely to be a profound and lasting shift. Support for more of a decoupling from China is growing and it is a trend likely to last for years. More broadly, a robust debate over US industrial policy is also just getting underway. In the near term, Trump could raise tariffs on China, but a big tariff hike is not the base case right now.**

Even before the coronavirus, views among policymakers in both parties had been evolving because of a growing realization Xi Jinping has moved China away from economic liberalization and shown no steps toward democratization. President Trump has accelerated the policy and political shift. In addition to tariffs, the administration has been taking steps to reduce US reliance on China tech imports and limiting the export of sensitive technologies, among other things.

“Everybody I talk to in the Senate is thinking about how Communist China has treated America as an adversary. Even the globalists, even those who say we need a free economy — they look at it now and say, ‘The coronavirus is the tipping point that pushed it over the edge.’ Peter has been clear in his belief that China is an adversary and not to be trusted, and the coronavirus has shown he’s been right.” -- Sen. Rick Scott (R-Fla.)

To be sure, Sen. Rick Scott (R-FL) is a China hawk, but his quote above captures where a growing number of members of Congress now stand. In short, more and more policy makers see China as an enemy of the United States.

And public opinion has shifted dramatically during the last month or two as well. We may never know whether Covid-19 came from a wet market or the lab in Wuhan, but we do know the Chinese government misled health officials from international organizations and other nations. As a result, the Chinese government has gone from unpopular to a pariah among the American people. The polls on the next page show the backlash against China, already strong before the coronavirus, is accelerating.

Andy Laperriere, CFA

(202) 888-1151

alaperriere@cormacteam.com

Melissa Turner, CFA

(202) 888-1153

mtturner@cormacteam.com

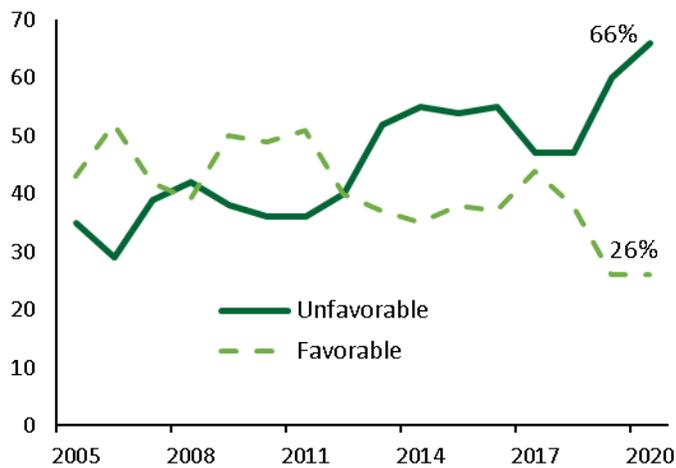
Don Schneider

(202) 888-1154

dschneider@cormacteam.com

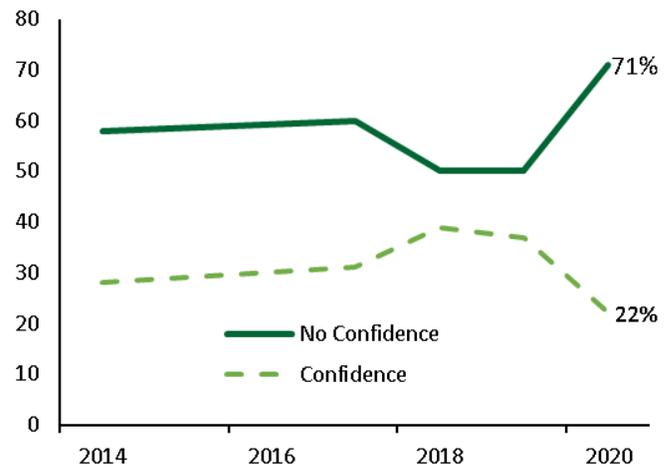
Copyright 2020 Cornerstone Macro. All rights reserved. This report is prepared exclusively for the use of Cornerstone Macro institutional clients and may not be redistributed, retransmitted or disclosed, in whole or part, or in any form or manner, without the express written consent of Cornerstone Macro.

### UNFAVORABLE VIEW OF CHINA HAS GROWN THE PAST TWO YEARS



Source: Pew. Survey of Americans conducted March 3-29, 2020.

### MOST AMERICANS DON'T HAVE CONFIDENCE IN CHINESE PRESIDENT XI JINPING TO DO THE RIGHT THING REGARDING WORLD AFFAIRS



Translating that anger at China into an effective policy response, however, is going to be challenging. For starters, there are a number of overlapping policy concerns and priorities. On one level, there is a desire to punish China for its bad behavior related to the coronavirus. Another major policy concern is that the US is too dependent on China for important medicines and personal protective equipment (PPE). But during the middle of a pandemic when these goods are more critical than ever (and the US is more dependent on China) probably isn't the best time for the US to throw its weight around.

A big reason for the shortages of chemical reagents, PPE, hospital beds, and many other goods is a function of our modern, efficient economy and has nothing to do with China or even foreign trade. To be sure, it is a government failure not to have sufficient stockpiles of certain items, but that isn't the main issue either. The US does not have a lot of spare hospital beds because excess capacity is expensive and hospitals are under financial pressures – as they should be – to operate efficiently. Just-in-time inventory and dispersed supply chains are also a function of the desire to produce goods at the lowest cost and are driven by competitive pressures – in normal times, a good thing. How does Congress force private companies, whether hospitals or makers of critical medicines or medical equipment, to build in (expensive) excess capacity?

Nonetheless, we led with the quote by Sen. Scott because there is an emerging consensus that China is an adversary. If viewed this way, it goes without saying that the US should not be dependent on an adversary for critical medical supplies. So we are in the midst of a fundamental reexamination of the US-Chinese trading relationship that now goes beyond unfair trade practices and stealing key technology.

But with that said, what can Congress do about it? There are no simple answers. And many people will define the problem differently. Is the problem imports from China or is the problem we produce so few medicines or other critical supplies in the US? Can we rely on friendly foreign countries or should the federal government insist that a certain share of critical items be produced in the US?

Of course, American companies, not Congress, decide where to make things and source them. Consider PPE. A lot of companies make it. Should Congress mandate that all of it be made in the US? What about the pulp imported from Canada that is a critical ingredient in surgical masks – should that be permitted? Should all imports from China of medical equipment – and every component part – be prohibited? What about machinery used in the production of medical equipment – can that come from China?

This is extremely complicated and is reminiscent of the debate over prohibiting outsourcing, which peaked sometime around 2004. Nothing came of it because it's almost impossible to prohibit outsourcing and trying to do so would create all kinds of unintended consequences. If you prohibit companies from outsourcing certain functions, they could just stop performing that task internally and purchase the service from a separate company. If you block US companies' access to the lowest cost inputs, US companies become uncompetitive and lose market share to foreign companies. Policies designed to stop outsourcing could easily result in US companies shipping production overseas, resulting in fewer jobs and less production in the US.

So what can be done? Defaulting on the US debt held by China, an idea mentioned in *The Washington Post* story yesterday, is not going to happen. Defaulting on your nation's debt is a sure-fire way to economic ruin. With the deficit this year now projected to be around 20% of GDP, defaulting on the debt China owns is even riskier. Larry Kudlow ruled out the idea yesterday and one is hard pressed to find a serious person in favor of defaulting on any US debt obligations.

Some in Congress have proposed removing China's sovereign immunity, thereby allowing Americans to sue China in US courts. This raises a host of issues and is unlikely to pass Congress this year, and maybe ever. Some are demanding more generically to "make China pay," though it is not clear how this would be accomplished. The administration may move to prohibit the Thrift Savings Plan (TSP), the retirement fund for federal workers, to invest in Chinese companies, which is a more symbolic than a substantive move. And of course, there are scores of bills aimed at China that have been introduced in Congress having nothing to do with the coronavirus that could gain momentum in the current environment.

It's no surprise Trump threatened to raise tariffs on China yesterday, arguing that China's actions surrounding the coronavirus is even more important than China's unfair trade practices. Tariffs are Trump's favorite tool, so it is natural he would default to them. If policy makers decide China is the heart of the issue, economically prohibitive tariffs on certain goods the White House or Congress does not want to see the US import from China could be one way to address the problem in the long run.

Our instinct is material legislation targeting China probably won't become law before the election, but that could change. There will certainly be a robust debate after the election on the overlapping issues we raised above. And on these questions, many Democrats and Republicans may have views that don't fall along traditional party lines.

In the near term, our guess is the White House rhetoric aimed at China gets more intense, but the actions are likely to be changes at the margin. We argued that Trump was right that the US had more leverage than China going into the tariff fight, and the evidence is overwhelming the trade war hurt China more than the US. But with the US so dependent on China for critical medical supplies, a major escalation right now by the US is risky, so Trump will probably avoid it.