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PGIM FIXED INCOME

A View from China on the U.S. Trade Competition

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In the context of game theory, the recently concluded Geneva reset indicates that the U.S. and China are gracefully moving away from a costly game of “chicken” to a “stag hunt” where the impulse is to compete for instant gratification, but longer-term self-interests are better served when key decisions revolve around the concept of cooperation.[1] The recent talks likely represent the start of a series of mini-deals and adjustments to the trading relationship that culminate in the decoupling of core strategic sectors and the bifurcation of supply chains in non-strategic sectors.

Our impressions from recent meetings with private and public sector participants in Beijing, Shanghai, and Shenzhen is that China sees this outcome as a sustainable solution - as long as it can preserve its own long-term, geostrategic interests. The negotiations will be complicated, with both sides maintaining strategic pressure points to keep the talks on track. We expect the 90-day pause between the U.S. and China to culminate in an upgraded, revived “Phase 1” deal that preserves the Geneva tariff settings of 50% with the potential for further reductions conditioned on the time-bound delivery of concrete outcomes. However, the average tariff level levied by the U.S. on China could jump to 80% if - at the end of the 90-days - China’s offering falls short. The following frames our view of the U.S./China relationship as it enters this new, critical phase.

A Contest of Leverage

China’s significant trade surplus with the U.S. - particularly the composition of that surplus - and its outsized role in global manufacturing value chains has placed it at the center of the U.S.’ tariff initiatives.

As both sides look for a more permanent and equitable reset, we infer from our meetings in Beijing that China prefers a negotiated outcome to decoupling, as long as it is mutually beneficial and preserves China’s geostrategic ambitions. Additionally, Beijing’s interests are better served via a series of incremental deals. In order to achieve this, China wants to dispel the notion that the U.S. has escalation dominance, and as a result, does not want to be seen to be caving into the U.S.’ “might is right” policy. This is driven by Beijing’s prevailing sense that the U.S. needs China as much as the U.S. thinks China needs it. Furthermore, China senses an upper hand considering the potential damage to the U.S.’ global credibility and leadership.

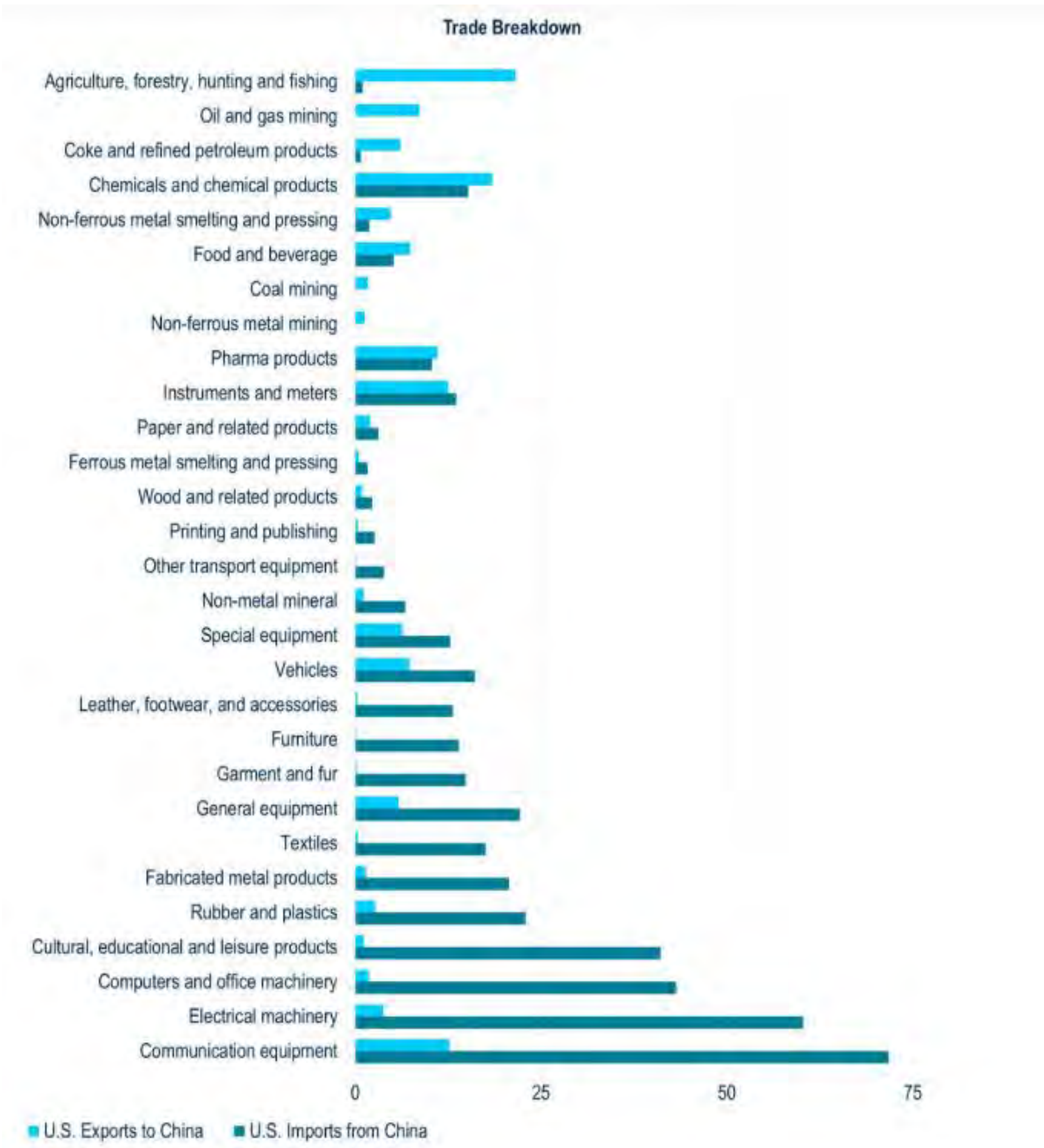
China’s Trade Advantage

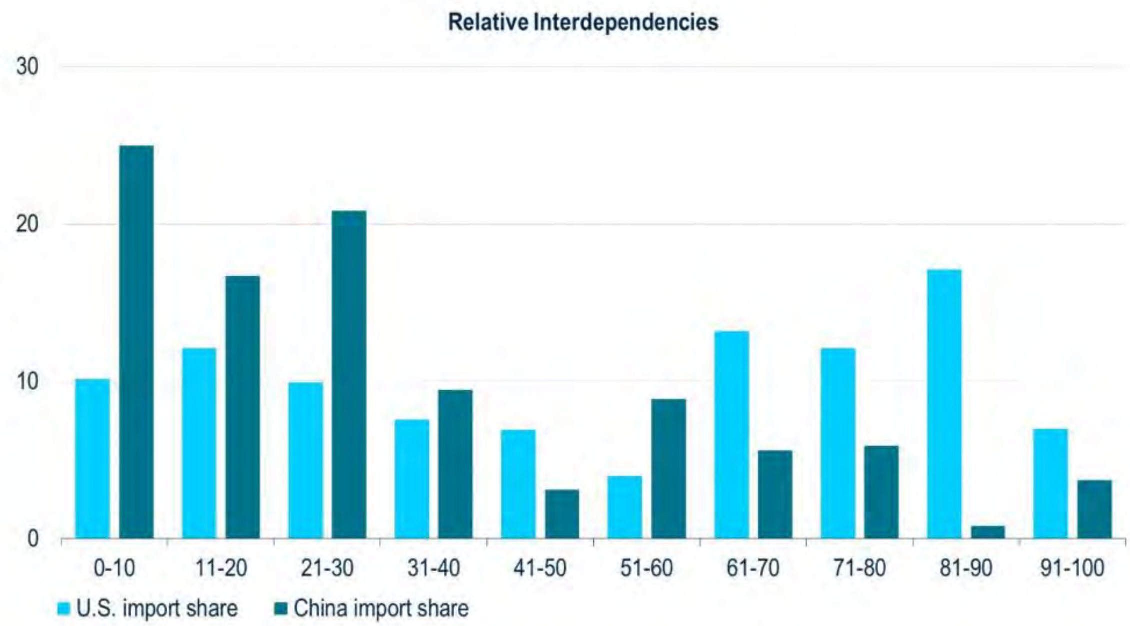
While an outright trade decoupling engineered via embargo-level tariffs would have conceivably resulted in the U.S. achieving one of its stated goals of reducing its trade balance with China, it would have been a highly disruptive and unsustainable outcome.

In nominal terms, China’s annual exports to the U.S. (~$440 billion) are more than three times greater than its imports from the U.S. (~$145bn). This imbalance is also apparent across industries (top panel of Figure 1) and import value (bottom panel of Figure 1).

These charts indicate the extent to which the U.S. relies on China across complex supply chains, particularly in tech-related goods, such as communications equipment and computing devices. Conversely, China predominantly imports easily substitutable primary inputs from the U.S. Therefore, China's reliance on the U.S. is either built on simpler supply chains or has been receding in the case of more complex goods, such as avionics, advanced transportation systems, high purity chemicals, and advanced semiconductor manufacturing equipment.

FIGURE 1: Complex U.S. supply chains, e.g. in computers, remain reliant on imports from China. China's supply chain reliance on the U.S. is in highly-commoditized, lower-value goods. (Top Chart: USD billions; Bottom Chart: market share %)

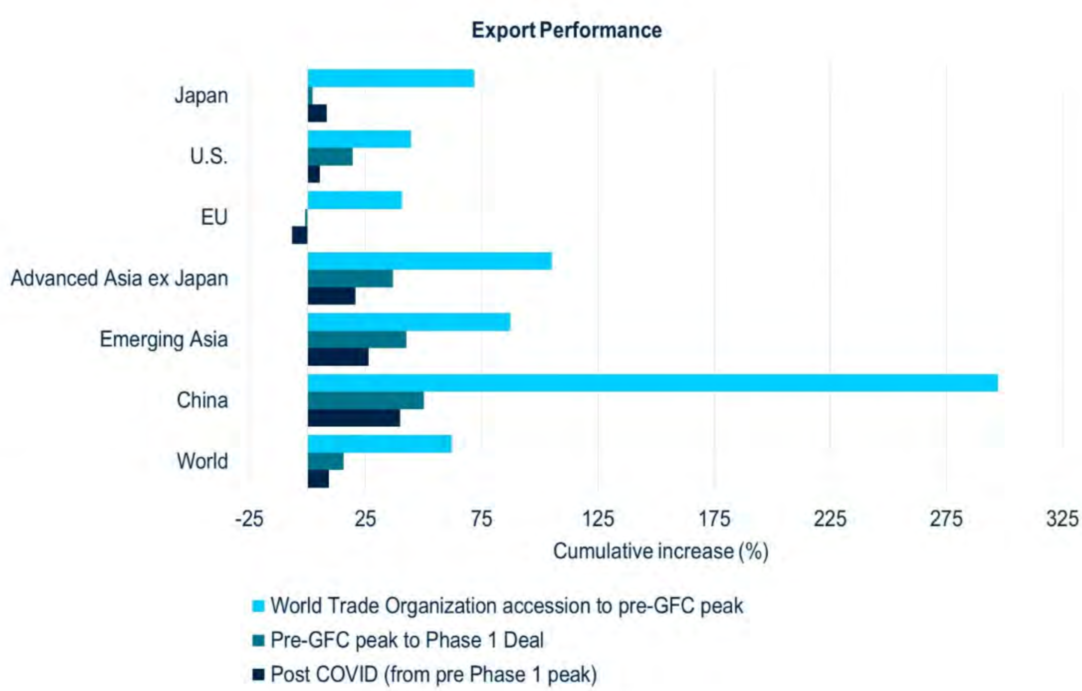




Source: Trademap, UNCOMTRADE.

Even with the supply chain derisking following the Phase 1 trade deal under Trump 1.0, the bulk of the growth in world export volumes has come from China and China-linked supply chains (top panel of Figure 2), which has notable ramifications as we explain below. In the case of the U.S., direct imports from China have been declining since 2019, but when adjusting for trans-shipments via ASEAN, India, and Mexico, the U.S. reliance on Chinese supply has barely budged (bottom panel of Figure 2).

FIGURE 2: China continues to drive global export growth, meaning its overall share of imports to the U.S. generally remains unchanged. (Top Chart: cumulative increase %; Bottom Chart: %)

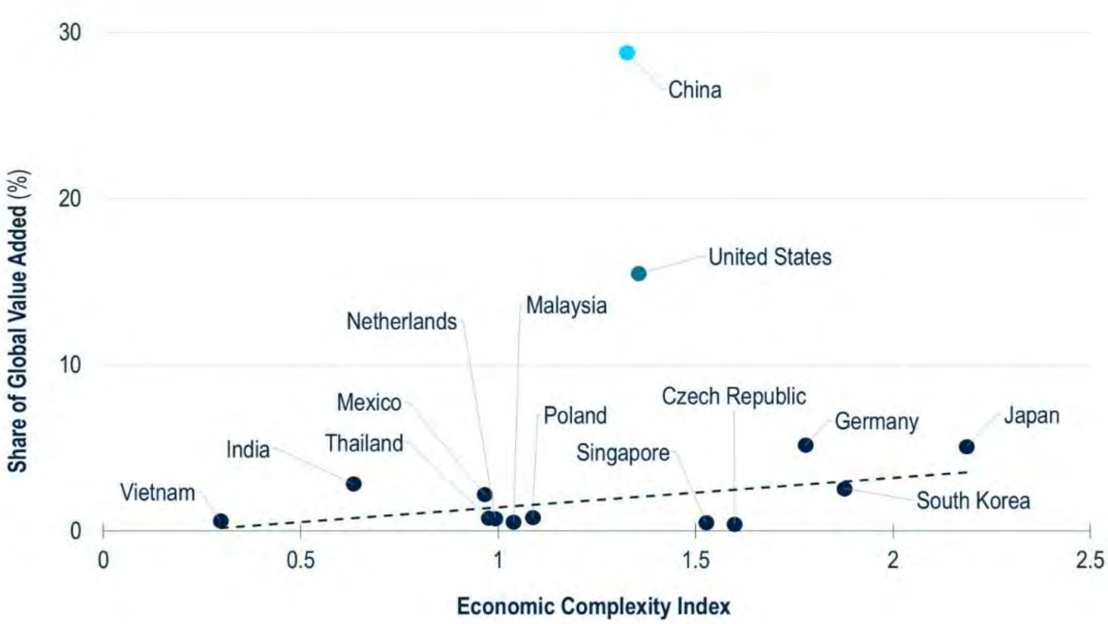


Source: Netherlands Bureau for Economic Analysis (CPB), U.S. Census Bureau.

The Power Competition Becomes More Competitive for the U.S.

Frustrated with the outcome of the Phase 1 deal, the U.S. initially assumed a maximalist approach intended to ensure a credible decoupling threat that prompts changes from China. Viewed through a wider lens, this competition is also about addressing long-term spheres of influence in trade, technological hardware, AI and soft power. The ability of the U.S. to exert any long-term leverage over China via trade depends on the success of substituting away from Chinese goods and components - not just in the U.S., but globally (Figure 3). Therein lies the difficulty given China stands alone in the manufacturing value that it adds across the global trading spectrum.

FIGURE 3: The difficulty in substituting China out of global value chains



Source: Observatory of Economic Complexity (OEC) and World Bank as of 2024.

"If your enemy is secure at all points, be prepared for him. If he is in superior strength, evade him. If your opponent is temperamental, seek to irritate him."[2]

China is increasingly regarding U.S. policy as not just an act of containment, but one that also aims to curtail its global influence. As China seeks to safeguard its geostrategic development goals, the quote above describes its tactical efforts to adapt, diversify, and retaliate. Indeed, China wants to dispel the notion that the U.S. has escalation dominance and to counter Trump's "certain uncertainty" with "policy certainty" at the domestic and global levels.

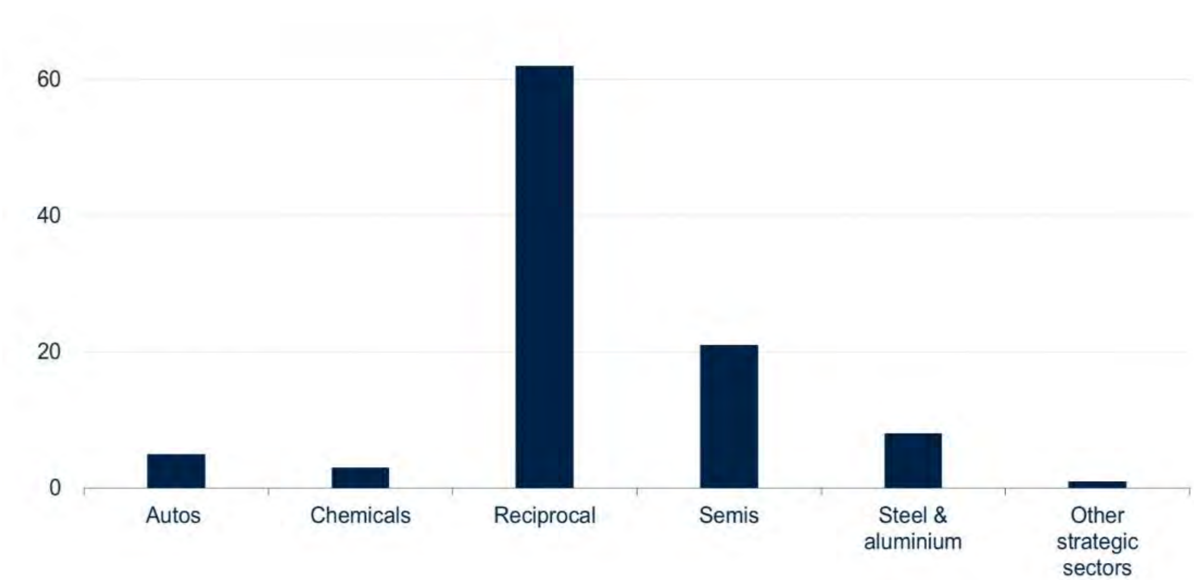
At a domestic level, this comes from showing resilience, strengthening domestic consumption, and safeguarding its competitive advantage in strategic sectors. At a global level, this certainty comes from projecting a reliable alternative to the U.S. order while strengthening ties and supply networks with the Global South as well as other trading partners.

Tariff Calculus and Outlook

According to our calculations, the Geneva reset takes the average level of tariffs levied by the U.S. on China to 50% vs. 20% at the end of 2024.[3] Yet, room for movement exists as President Trump deemed an 80% tariff on China as reasonable in the lead up to the Geneva talks.

The average tariff on China could rise to 80% in a scenario where the U.S. maintains the 20% fentanyl and 10% universal tariffs, removes the exemptions on microchips, levies a 25% tariff on all sectors currently undergoing 232 investigations, and levies an additional 10% "reciprocal" tariff on all sectors not captured by 232 investigations (see Figure 4 for a tariff breakdown by sector).

FIGURE 4: China's Total Exports to the U.S. by Tariff Regime (%)



Source: BACI, CEPII, UNCOMTRADE.

The Effect on China's Outlook

A series of pre-emptive consumer stimulus measures, accelerated fiscal spending, property market stabilization, and an export boost prior to U.S. trade barrier implementation - helped China's growth exceed 5% in Q1' 25.

Anticipating the possibility of a baseline 60% tariff, the March National People's Congress set the 2025 growth target at "around" 5%, supported by a net fiscal impulse equivalent to 2% of GDP. More recently, in response to the tit-for-tat escalation, the PBoC announced further stimulative measures to the tune of 1.5% of GDP. Policy support will likely continue targeting housing, services consumption, sci-tech innovation, autos, and small-to-medium enterprises.

The Geneva reset removes the threat of embargo conditions and allows critical trade to resume, partially alleviating some of the pressure points on China. Yet, as our week of meetings revealed, whilst there is evidence of silver linings in China's recovery, it remains fragile and vulnerable to paybacks (we'll cover the contours of its recovery and the domestic policy support in an upcoming post). If tariffs ultimately exceed 60%, non-linearities and negative feedback loops are likely to kick in given that exports to the U.S. account for 3% of China's GDP and about 8% of the country's total manufacturing sector employment.

Beijing will likely tolerate some growth downside vs. its 5% target and will want to avoid a recession - which we think of as sub-3% growth. We believe the underlying growth rate in China is around 4.5% and the cumulative hit from tariffs is likely around 1%, possibly keeping growth above the recession threshold.

In this context - and in addition to partial cushioning from accelerated trans-shipment of Chinese goods via trading partners - we think Beijing could achieve a near-term fiscal multiplier of 0.5x that it can potentially strengthen with the right fiscal mix over the medium term to 0.8x.

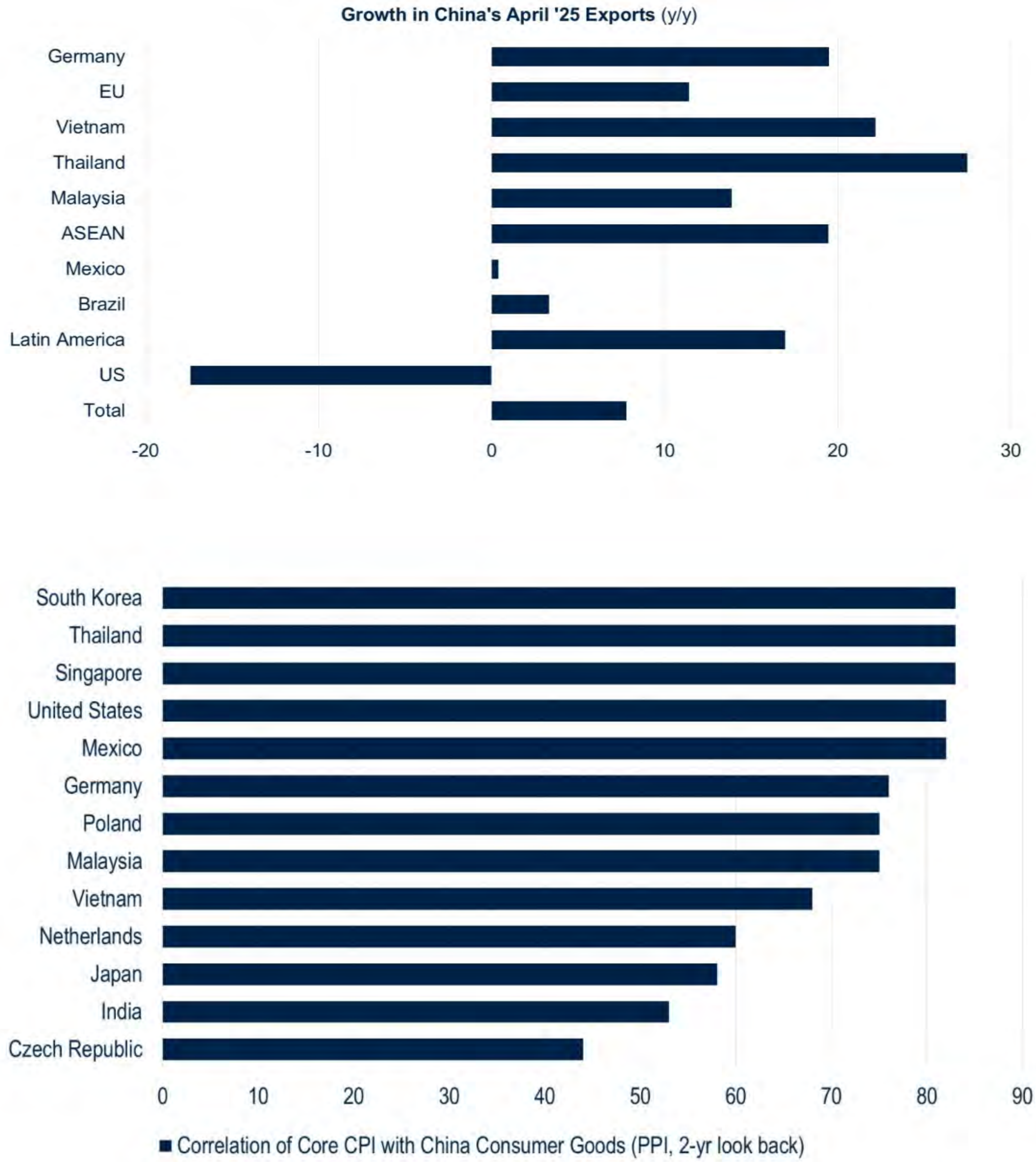
As a result, we are keeping our estimate for China's growth in 2025 at 4.2%, but see non-linear downside risks to this point forecast, going to 3% if we return to embargo-esque conditions and China is unable to engineer a powerful enough domestic demand offset.

More on the U.S. - China Interdependencies

The Geneva reset alone is unlikely to lower overall U.S-China trade dependency. Yet, it can complicate supply chain relocation for Chinese firms if the U.S. succeeds in creating China shut-out clauses with trading partners. Should U.S. global tariffs level off at a uniform 10%, with lower standards, that level by itself is unlikely to impact global supply chains and will likely exacerbate re-routing via trade partners.

European and Asian exporters are increasingly linked to and in direct competition with Chinese goods on global markets. As the April '25 trade data in the top panel of Figure 5 show, their domestic markets are particularly exposed to being flooded by Chinese goods. Although difficult to control, China will likely show sensitivity to global perceptions on dumping given the perception of being seen as exporting disinflation (bottom panel of Figure 5).

FIGURE 5: As China's global exports continue to grow, the high correlation between core inflation and China consumer goods prompts disinflation concerns. (Top Chart: %)



Source: China General Administration Customs, National Statistics Agencies, PGIM Fixed Income.

Medium-Term Landing Zone and Conclusions

We see several results from the Geneva reset: it makes the tariff structure more sustainable; the choice of participants helps foster a more stable negotiating environment; and strategic sectoral exemptions on both sides alleviate near-term chokepoints on critical imports (while also potentially prolonging negotiations).[4, 5] In the near term, we expect China to offer a renewed Phase 1 deal that maintains the Geneva reset. Failure to reach such an agreement could result in the 80% tariff scenario.

Longer term, we see the U.S.-China reset as a multi-year process, making a quick one-shot, comprehensive solution unlikely. For its part, the U.S. has indicated a comprehensive solution could take two to three years to achieve. In the meantime, while trust-building mini deals may emerge, each side will likely maintain the threat of tariff snap-backs and strategic pressure points during the staged negotiations.

We expect the U.S. to push for strategic decoupling as well as a reduction in China's central role in global value chains. The U.S.' effectiveness in doing so will crucially depend on its bilateral trade deals with other major economies, and the U.S. has hinted at lower tariffs on partners that limit China's involvement in their economies. As is evident from the U.S.-UK trade deal, it is highly likely that the U.S. pushes for China "shut-out" clauses in its bilateral trade deals, which China would look to prevent, possibly leading to renewed macro volatility.

As a result, we see a medium- to long-term landing zone where the U.S. will push to decouple in core strategic areas. But in a global "stag hunt," the dependency of the U.S. and its trading partners on China means that they may have to tolerate bifurcated supply chains in non-strategic sectors into the foreseeable future.

1. The "stag hunt" derives from a story. It depicts a scenario where two or more entities can cooperate to hunt a rewarding stag. Alternatively, if one entity chooses not to cooperate, instead choosing to hunt easier-to-catch, but less-rewarding, hares, the stag hunt fails.

2. The Art of War, Sun Tzu

3. We take Peterson Institute weighted average tariff level as of end 2024 that accounts for all tariff developments under Trump 1.0 and Biden since 2018.

4. China has appointed Vice Premier He Lifeng as its trade negotiation lead, he will be accompanied by Li Chenggang, while Treasury Secretary Bessent and Trade Representative Greer will lead the U.S. efforts.

5. 95% of all iPhone production is China linked.

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