

# Preview - US-China talks

## Decision on Friday tariff increase to be crucial

- **On Thursday, US and Chinese negotiators will be face to face for the first time since the trade talks hit a huge bump in the road on Sunday when President Trump announced he would impose tariffs on China on Friday.**
- **The talks on Thursday will be crucial for the next steps in the US-China trade conflict. It will be critical whether the two sides can resolve the challenges and avoid the tariff increase on Friday. If not, it is a sign that the two sides are ‘digging in’ and we could then be faced with a period of very high uncertainty and further declines in stock markets. We see it as 50-50 whether we get the tariff increase or not.**

### What we know:

- **Tariff increase:** On Monday US Trade Representative Robert Lighthizer and Treasury Secretary Stephen Mnuchin confirmed that the current plan is to raise tariffs on Friday at 12:01 am (06.01CEST Friday morning). They did not comment on the other part of Trump’s tweet that said tariffs of 25% on another Chinese imports of USD325bn would be implemented shortly.
- **What could change this?** According to Mnuchin the tariffs would go up unless the Chinese delegation brings a new proposal that would satisfy the US side.
- **Reason for the U-turn:** According to Lighthizer and Mnuchin, the reason for the turn of events was China retreating on previous offers. According to sources close to the US side, China had made ‘systemic edits’ to a nearly 150-page draft trade agreement that would blow up months of negotiations, see *Reuters* 8 May. Specifically, a change that would mean certain parts of the deal would not be written into Chinese Law would have triggered fury on the US side. According to the sources, China’s top negotiator Liu He told the US team last week that they needed to trust China to fulfil its pledges through administrative and regulatory changes. However, the US has very little faith that China will live up to the changes unless they are written into law.
- **Timing of trade talks:** The talks in Washington are scheduled for Thursday and Friday. China confirmed on Tuesday that Liu He would come to Washington on Thursday, one day delayed from the original plan.
- **China’s response to the tariff threat:** After being silent for a while, Chinese state media started to release a response to the tariff threat and the view was mostly defiant. The strongest words came from People’s Daily’s WeChat account Tuesday: “*Things we think are advantageous for us, we will do it even without anyone asking*” adding that “*Things that are unfavourable to us, no matter how you ask, we will not take any step back. Do not even think about it*”, see *SCMP* 7 May. Other articles highlighted the resilience of the Chinese economy and that China had measures to keep the economy stable. An article in the generally more nationalistic *Global Times* had the headline “China ready for any outcomes in trade talks with US”, *Global Times* 8 May. The article

Chief Analyst  
Allan von Mehren  
+45 4512 8055  
alvo@danskebank.dk

says “No matter what the US side wants to do in the negotiations, China has the confidence to handle it. The worst-case scenario is that the negotiations break down and Washington comprehensively raises tariffs. Even if this happens, the Chinese economy will be able to withstand it.” However, China has also stated it is open to continue talks for mutual benefit, hoping that the two sides can “meet each other half way”.

## What to expect?

So the key question is where this leaves us for the possibility of getting trade talks back on track. In a long tweet on Wednesday afternoon Trump among other things tweeted that “China has just informed us that they (Vice-Premier) are now coming to the U.S. to make a deal. We’ll see, but I am very happy with over \$100 Billion a year in Tariffs filling U.S coffers... great for U.S., not great for China”.

The talks on Thursday will be crucial. If the two sides can meet each other sufficiently for Trump to cancel, or at least postpone, the tariff increase, then it is probably a sign that a deal is still believed to be within reach by the two sides.

However, if Trump decides to move on with the tariff increase, then there is a very high risk we get a breakdown of the talks and the Chinese delegation pack their bags and go home on Friday without continuing the talks. It will be hard for a Chinese Vice Premier to continue negotiations in what could be seen as a humiliation domestically in China. It could leave a period without new scheduled talks and, worst case, that Trump quickly starts the process of imposing 25% tariffs on USD325bn as he has threatened to do.

## Who has the strongest hand – and how far apart are the two sides?

A couple of factors will be important for the outcome. First, how far apart are the two sides really from each other and is China willing to give Trump enough for him to be happy? Second, which of the sides believe they have the strongest hand? If Trump believes he holds the best cards, he will be inclined to use more tariffs to put more pressure on China. Using maximum leverage has always been his way of negotiating. However, it also depends on how good a chess player he is and whether he thinks two to three moves ahead. A tariff increase and further escalation risks sending stock markets down significantly, and he needs to be willing to take this pain for the leverage to work. Last year he apparently wasn’t willing to take this pain and he started negotiating with China before following through on his threat to put tariffs on all imports from China.

China also may believe that they can weather another escalation through stimulus and that Trump will be more in need of a deal soon due to the upcoming Presidential election. So China might have an interest in resuming the game of chicken and bet on Trump eventually having to turn in order to avoid the risk of a sharp slowdown and market declines.

Going into the talks, both sides have an interest in sounding as tough as possible to scare the other. Brinkmanship is an art where you cannot show weakness. But how far they are really willing to go is almost impossible to say.

## Risk off if tariffs go up

If Trump moves on with the tariff increase, it would likely trigger a more or less immediate retaliation from China which would likely include a similar increase in tariff rates to 25%. In addition, China can be expected to put a halt to purchases of agricultural goods as they did last year in response to the US tariffs (they started buying again early this year as part

of the ceasefire). This would be a clear escalation and likely to trigger a further sell-off in equity markets and push bond yields lower. Other risk assets and currencies vulnerable to risk would also be hurt.

On the other hand if Trump cancels or postpones the tariff increase it would probably lead to a short-term relief rally in stocks as markets would see it as a bluff and expect a trade deal to still be in reach.

Our baseline scenario is still that we have a trade deal by the end of Q2 as we doubt Trump is willing to take the pain from a strong escalation of the trade conflict. But as we wrote on Monday, uncertainty has increased significantly.

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