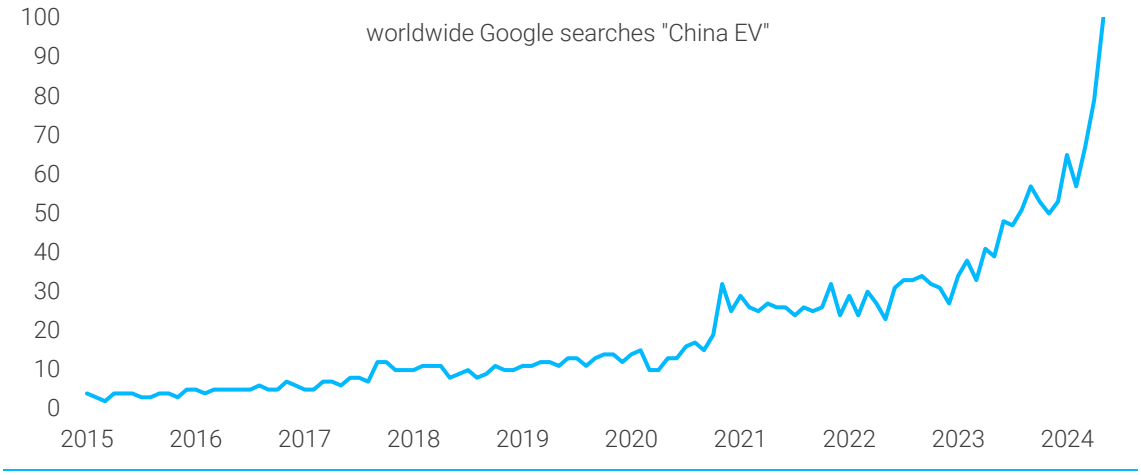
Macro Picture

# CHINA SHOCK 2.0 – HOW SIGNIFICANT?

**Dario Perkins**

Exports provide a way out of China's structural economic slump, and the authorities have already positioned the economy to dominate strategically important sectors (including EVs). This means a second deflationary shock, as Chinese producers dump their excess capacity on global markets. But this time there will be a lot more resistance from the rest of the world.

**Chart 1: From nowhere, China is suddenly dominating global auto exports**




Source: Google, TS Lombard

## IT IS HAPPENING AGAIN

Mainstream macro underestimated the impact of the original "China shock" in the 2000s, when the country's sudden manufacturing dominance generated a powerful deflationary impulse. And now we are on the brink of a second China shock. Exports are a way for the country to escape its structural slump, particularly in the sectors where the authorities have built a strategic edge.

## CAR WARS

The car industry is highly symbolic of China's new strategy, with Chinese producers suddenly seeing spectacular export gains. Owing to their massive cost advantage, China has room to cut prices significantly, dumping its domestic overcapacity on global markets. This is a threat to manufacturing in other major economies, particularly in Europe, where exposures are higher.

## TRADE WARS REVENGE

Compared with the first China shock, there is much greater resistance from policymakers in other parts of the world. The US and Europe have already increased their tariffs, and further protectionist policies are inevitable. While this new China shock will be more muted than the first episode, Chinese exports will still provide a deflationary draught for the (hotter) global economy.

# CHINA SHOCK 2.0 – HOW SIGNIFICANT?

Everyone is talking about a "China shock 2.0", with that country again looking to dump its manufacturing overcapacity on the rest of the world, just as it did when the country joined the WTO in the early 2000s. The rationale for this move is clear: China's domestic economy is experiencing a structural slump, and policymakers are no longer willing to prop up activity via a credit-fuelled property binge. Exports are their way out, especially as the authorities have been positioning the economy to make this transition, using large-scale industrial policy to reallocate resources to those sectors that will provide a strategic and competitive advantage in the 2020s (clean energy, semiconductors, EVs, etc.). As China pushes this overcapacity onto the global economy, it will drive down traded goods prices and unleash a fresh wave of de-industrialization on the developed world. We should not forget that mainstream macro underestimated the impact of the original China shock. Much of the analysis focused on the gains from trade, ignoring the severity (and persistence) of the pain it caused in many regions. By the time the consensus among economists had shifted, in the mid-2010s, the political fallout was already obvious.

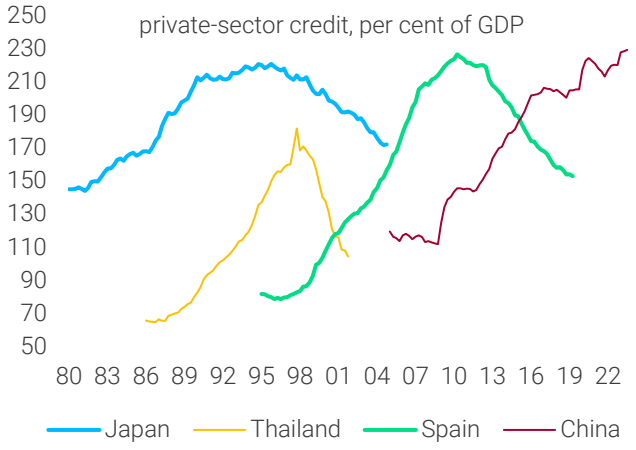
How will the China shock 2.0 compare? Deflationary pressures are set to emerge across various sectors, but one will dominate the public debate – the car industry. China's export penetration of the global auto industry has been spectacular over the past couple of years, with the country displacing Germany and Japan to become the world's largest exporter. Our analysis suggests this story is only just getting started. Chinese producers have a large cost advantage over their competitors. While, so far, they have been using this cost advantage to secure higher margins rather than drive down global prices, it is likely that their pricing strategies will shift, given China's overcapacity and domestic price wars set to spread to international markets. At the same time, Chinese brand awareness among global consumers is increasing, albeit from a low base. The Euro 2024 football tournament could be an important catalyst, especially in Europe, where BYD has replaced VW as one of the competition's marque sponsors (for, ironically, a competition held in Germany). And press reports suggest there is already an armada carrying Chinese vehicles headed towards European shores. As regards macro implications, it will be hard to match the impact of the first China shock, but the effects could still be significant. The auto industry is responsible for 5 per cent of consumer expenditure and 1 per cent of employment. With auto imports worth 1-2 per cent of GDP, plunging vehicle prices will be a material deflationary force.

Compared with the first China shock, the big difference this time will be the policy response. The US ("Washington consensus"), which originally encouraged the world to embrace unfettered free trade, is now pushing in the opposite direction, leading a policy of decoupling from China. Since a Trump election victory would accelerate that trend, there is obviously a lot of focus in financial markets about the potential impact of a new trade war (often using 2017-19 as the template). The reality, however, is that trade tensions between the US and China will intensify irrespective of who runs the White House. And now there is growing pressure on Europe to match America's protectionist response. Although the EU has been divided on this issue (with a notable Franco-German split), Europe's outsized exposure to the auto industry means the Union is now pushing ahead with the introduction of trade barriers and other protectionist/industrial interventions. Our assumption is that the China shock 2.0 will play out as follows: China's will attempt to dump its excess capacity on the world through lower prices and RMB depreciation, while other countries will respond via protectionism and their own strategic industrial policies. The net effect will not be as potent as the original China shock, but it will still provide a deflationary draught for the global economy. Given the secular price pressures emerging elsewhere, that might be a good thing.

# 1. IT'S HAPPENING AGAIN

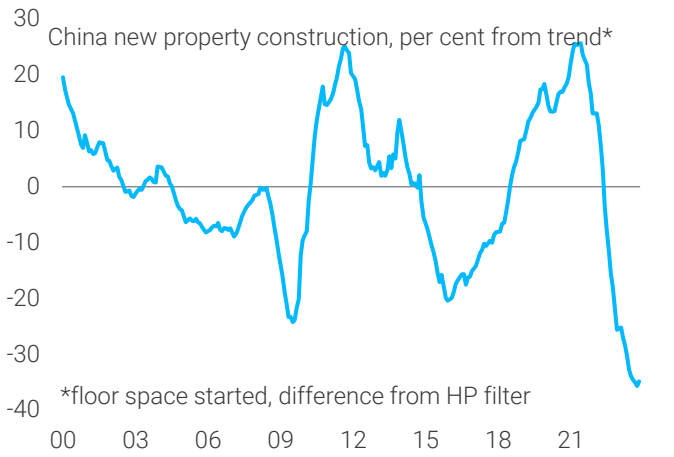
China's integration into the global economy was one of the most important macro developments of the past half century. Yet most economists failed to appreciate its significance in real time, particularly in terms of the negative impact it would have on certain segments of Western society. By the time those effects were understood, they were already having a tangible impact on international politics, unleashing a wave of populism and a strong anti-globalization backlash, which has permanently shifted mainstream political attitudes towards China. Now, however, there is talk of a second China shock (China shock 2.0). With China's domestic economy suffering a structural slump, policymakers clearly see exports as an escape route, particularly in areas where they have built overcapacity and a deliberate geostrategic advantage. (It is no exaggeration to say the authorities have been planning this policy pivot for at least a decade.) But how material is this second China shock going to be? Can it justify the current hype, particularly in sectors like electric vehicles (EVs). What will Chinese deflation in these sectors mean for the rest of the world? And given the very different political attitudes compared with the early 2000s, can US and European policymakers avoid a repeat of what happened during the first China shock?

**Chart 2: China risks a balance-sheet recession**




Source: BIS, TS Lombard

**Chart 3: Plunge in housing demand**

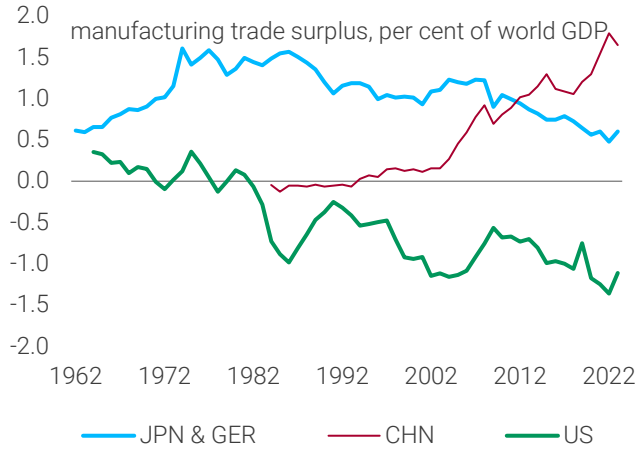



Source: CEIC, TS Lombard

## China's escape route

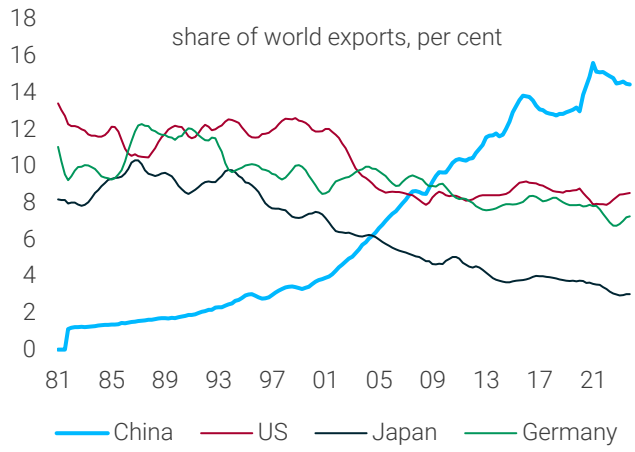
China's economy has struggled in recent years. The underlying problem is simple: after a massive credit splurge that lasted more than a decade, the authorities are no longer willing to prop up GDP growth by stimulating their domestic property sector. Such an adjustment was always inevitable. China's post-GFC credit boom was already one of the largest in history, and it has seen the country devote an uncomfortably large share of resources to property-related activities. The authorities have realized that this was unsustainable, from the point of view of both financial stability – where nobody wants to repeat Japan's financial crash of the early 1990s – and the wider social objectives, where a speculative, Ponzi-financed property market is not exactly consistent with traditional Communist values. China needs a way out, a means of reviving its economy without compounding the macro-financial imbalances that have built up since 2008. So that it can focus on "high quality growth" rather than high levels of growth. And growing China's exports – the country's original development strategy – is once again the policymakers' solution.

**Chart 4: The first China shock never really ended**




Source: UN Comtrade, Brad Setser (via X), TS Lombard

**Chart 5: China has dominated global exports**




Source: IMF, TS Lombard

In a way, China is pivoting back to the growth model it had before 2008. But this time, rather than rely on the exportation of cheap industrial products and low-value consumer goods, the authorities are looking to pivot into new sectors – areas where China has consciously built a strategic competitive advantage. The decision to get into EV production, for example, was taken back in 2008. And for a decade, the state has used strategic industrial policies – big subsidies, tax deductions, public procurement, land provision, cheap energy and low-interest loans – to divert resources into the sectors that can provide the basis for long-term growth (like semiconductors and clean energy). Although it has caught Western pundits by surprise, China has been planning this transition for a long time. The travails of the past few years have been just an accelerant, forcing China to radically step up the support it provides for these sectors. It is clear that Xi Jinping would much rather support the economy by boosting supply rather than rely on the sort of "decadent" demand stimulus that has been fashionable in other parts of the world. But a policy that emphasizes supply over demand is inherently deflationary.

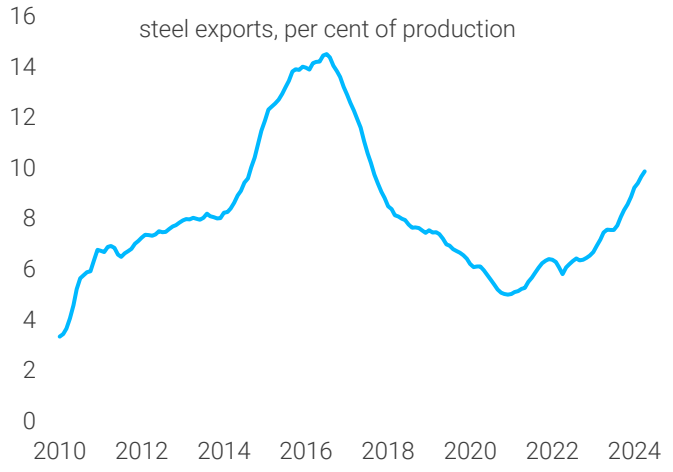
## Chinese overcapacity

"Overcapacity" is not exactly a new theme for China's economy. But the country's domestic slump is obviously making it worse. According to the Rhodium Group, supply-demand imbalances have widened materially since 2021, with the overall capacity utilization (at <75%) falling to its lowest level since 2016. And the authorities' determination to focus their stimulus on a relatively narrow subset of industries is clearly not helping. According to Brad Setser, who tends to steer clear of clickbait or hyperbole, China has no choice now but to push this overcapacity into global markets. Setser highlights three sectors where the overcapacity problem is becoming particularly acute:

1. **Steel production:** China accounts for 50-60 per cent of global steel production; and although its exports are modest compared with its domestic use (Chart 6), they are now growing rapidly. Owing to China's scale, even a relatively small pivot to exports would have serious repercussions for the price on international markets. As Setser points out, China currently exports around 100 million metric tonnes of steel, which is more than America's annual production. China's domestic property slump is only making this situation worse. While housing starts have already plunged, the authorities have been forcing developers to complete their existing projects, which is why steel demand has held up relatively well. Once

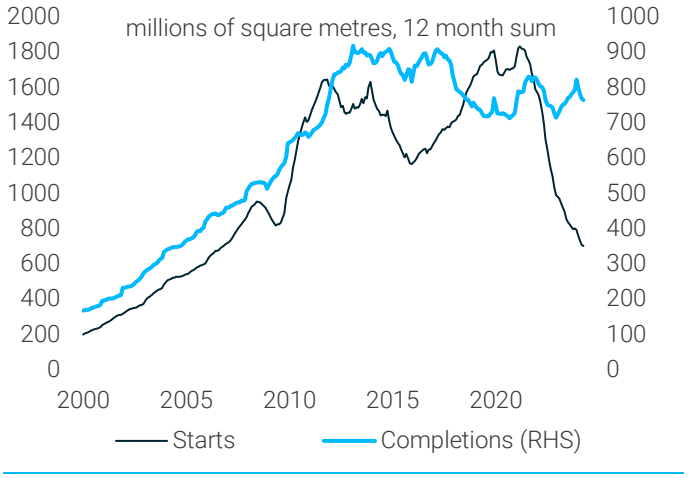
this adjustment is complete and housing completions "catch down" to starts, demand could fall significantly further.

**Chart 6: China's export pivot in the steel industry**




Source: Datastream, TS Lombard

**Chart 7: Pent-up deflation from housing collapse**

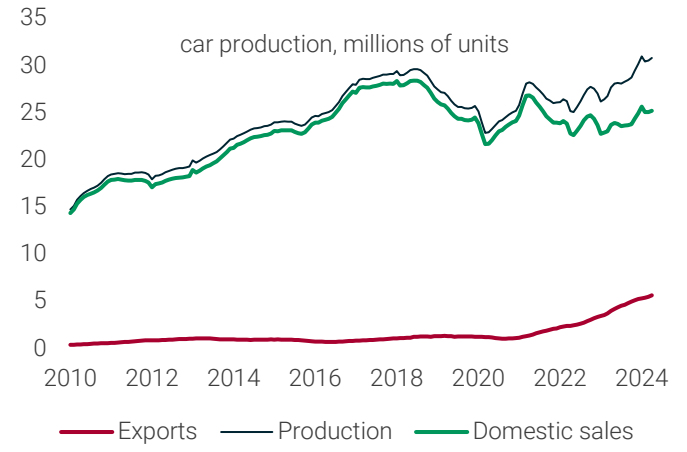



Source: CEIC, TS Lombard

2 **Auto production, especially EVs: China's auto** production – both traditional "ICE" vehicles and, more recently, EVs – has risen dramatically over the past decade,. Until the last couple of years, most of this output was channelled to meet demand from Chinese consumers. Now, however, the domestic market is looking saturated, with supply rapidly outstripping demand and most producers engaged in aggressive price wars since the autumn of 2022. BYD, which is the country's largest EV producer, has recently slashed the prices of all its vehicle models, with rival companies such as Xpeng, Zeekr and SAIC-GM-Wuling all following suit. Yet supply continues to increase, in part owing to state subsidies, production targets and bailouts. According to the National Development and Reform Commission, there will be 150 new models on Chinese roads in 2024 (of which 110 are EVs). As in the case of steel production, even a relatively modest pivot to exports will have serious repercussions for international markets given the scale of Chinese production. Three years ago, nobody took Chinese auto companies seriously. Now China is the biggest exporter.

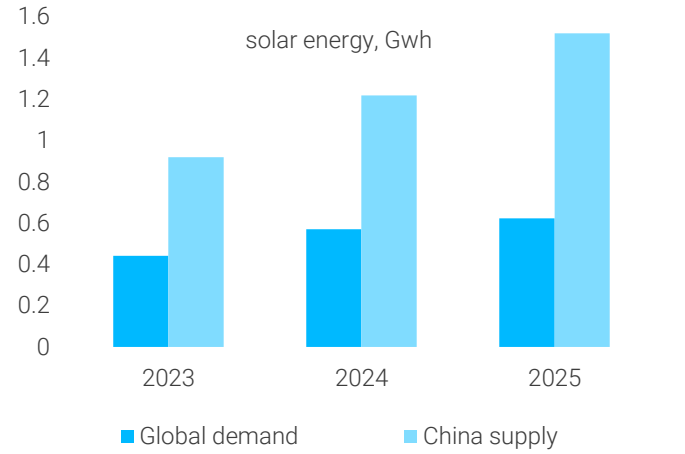
3 **Other clean energy resources, including solar capacity:** China dominates a range of products that will be necessary for the green transition, including semiconductors, solar cells, solar panels, lithium-ion batteries, natural graphite, permanent magnets and other critical minerals. Whereas some estimates suggest China's EV supply capacity is twice as large as demand from Chinese consumers, in areas like batteries (and all their major components) supply is four times greater than demand. Setsor also highlights a study from Bloomberg showing that China's current solar capacity is expected to exceed even the most optimistic forecasts for global demand in the coming years. The underlying issue is that with China's policies prioritizing supply over demand, industry is responding to output incentives rather than price signals. This can only store up problems for producers in other parts of the world.

### Chart 8: Export pivot in China's auto output




Source: Datastream, TS Lombard

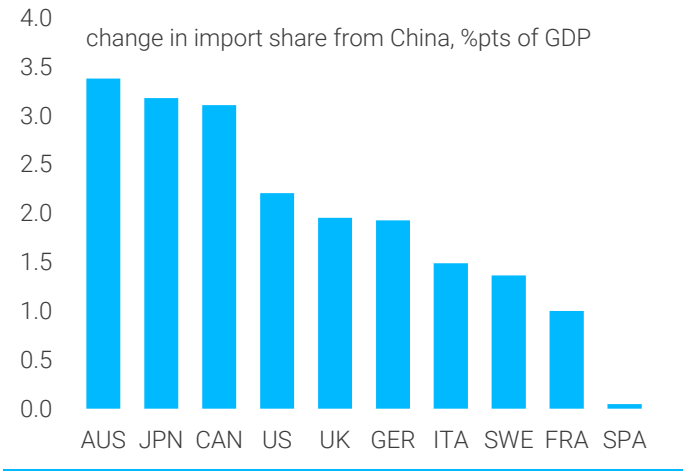
### Chart 9: China's excess capacity in solar energy




Source: Bloomberg, TS Lombard

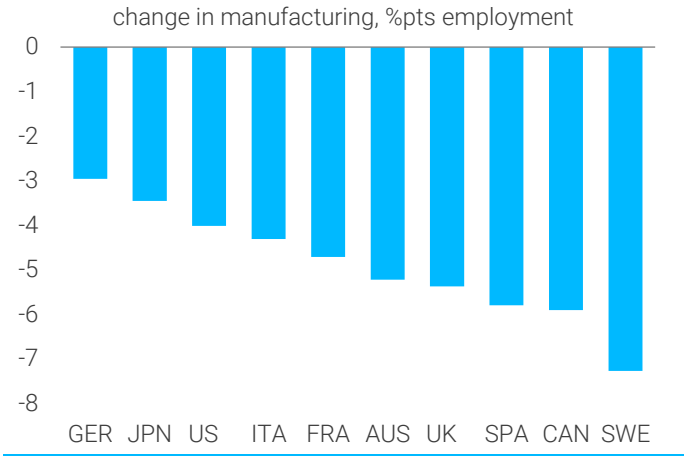
What is the impact of all this likely to be? From a consumer perspective, "a flood of cheap Chinese goods" (as the Wall Street Journal put it) does not sound like a particularly bad thing, especially when the world is suffering from an acute cost-of-living crisis. China has long been the "world's factory"; and with the country's technological hubs and economies of scale, everyone stands to benefit from rapidly improving Chinese efficiency. The fact that these gains will be tilted towards the products we need for the green revolution – an explicit priority of many Western governments – can make the current situation only even more advantageous. Clean energy is getting cheaper (Chinese solar panels are now so cheap, some people in Europe have started using them as fence panels), but it is important to remember what happened during the previous China shock, in the early 2000s. Back then, there was an overwhelming consensus among economists that free trade with China was a good thing. That view was somewhat mistaken.

### Chart 10: Impact of China shock 1.0




Source: IMF, TS Lombard estimates

### Chart 11: De-industrialization after 2001




Source: OECD, TS Lombard

## The original China shock

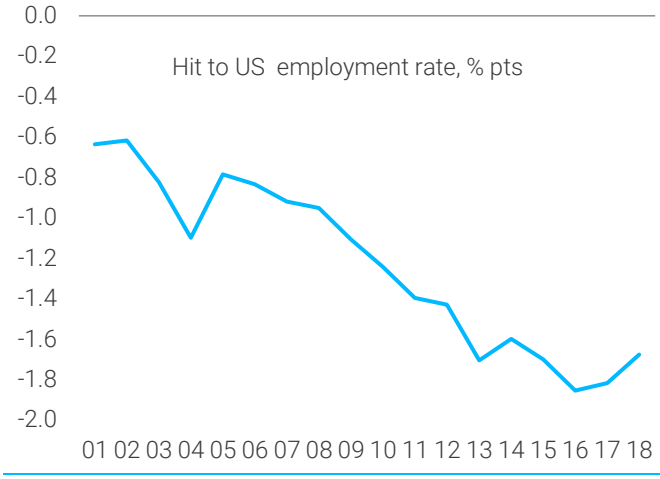
While the exact timing of the original China shocks is fuzzy, most of the research dates it to the early 1990s, with Deng Xiaoping's liberalization efforts. It clearly accelerated in 2001, when the US shepherded China into the WTO, encouraging the rest of the world to reduce their trade

restrictions. This was the "Washington consensus", based on the US belief that free trade was the best way to deliver global peace and prosperity. ("Free trade stops wars!" proclaimed Toby Zeigler in an episode of the influential TV drama *The West Wing*, back in time when it was plausible to imagine a US President who had a Nobel prize in economics.) At the same time, provincial leaders in China did their best to encourage FDI, especially from manufacturing companies, so they could raise growth, hit ambitious GDP targets and get promoted. As Noah Smith put it, "this involved building a ton of infrastructure, offering tax incentives and support services, kicking peasants off their land, allowing pollution to get dumped in the water and air, and so on". And, of course, China's central bank helped the transition, deliberately holding down the value of RMB to keep exports competitive. The policy was a success, comfortably beating all expectations.

**Chart 12: Permanent decline in US wages**


Source: David Autor et al (2021)

**Chart 13: Permanent scarring of US wages**




Source: David Autor et al (2021)

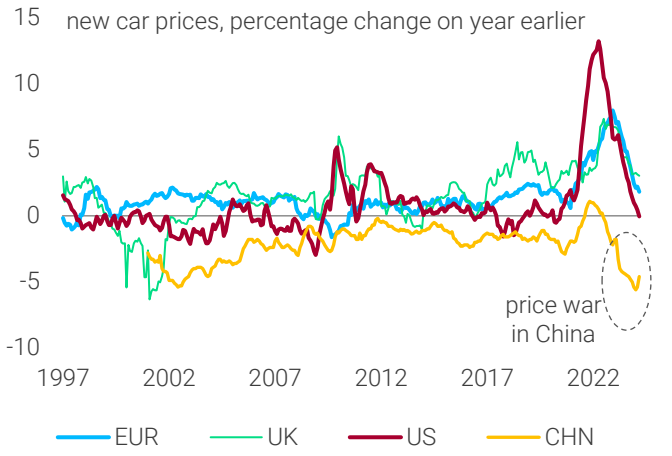
China's share of global trade increased rapidly, with Chinese exporters capturing more than 10% of global exports by 2010 (up from less than 4% in 2001). Traded goods prices declined, particularly for low-value consumer goods such as textiles and cheap furniture (in the US, this was called "the Walmart effect", although the same trends happened everywhere). Between 1992 and 2010, most developed economies had to absorb around 2-4% of GDP in additional Chinese imports (Chart 10), which accelerated their long-running de-industrialization, as domestic manufacturers could not compete with Chinese prices. On some estimates, the US lost more than 1 million manufacturing jobs after 2001, with similar declines elsewhere. Western industrial capacity either relocated to China or disappeared completely. Naturally, the China shock produced winners and losers. Consumers benefitted from lower prices, while exporters of high-value items now had a new, rapidly growing market in China. If German exporters of luxury cars or precision machinery did quite well. But an Italian company exporting ceramics and textiles, or a Portuguese firm exporting plastic toys did not. They had no natural market within China and were outcompeted both at home and abroad.

## Persistence and scale

Most studies found that on balance, the original China shock was beneficial for Western economic welfare. What people overlooked, however, was the scale, speed and persistence of the negative side effects. Economic theory assumed our economies would adjust, as people in the sectors and regions that were most exposed to foreign trade relocated to new jobs in new areas, supported by a boost to economy-wide living standards. But by the mid-2010s it was clear that

this was not happening. The consensus on these issues changed decisively after the publication of David Autor's paper "The China Shock: Learning from Labor Market Adjustment to Large Changes in Trade". To quote Noah Smith again, this study was "like a meteor crashing into the econ profession – prior to Autor et al. (2016), 'free trade is good' was the most unshakable consensus in the profession; after the paper came out, that consensus was shattered." Autor showed that the negative effects of the China shock were not wearing off. Instead, they were very persistent, causing a permanent reduction in employment and living standards in some parts of the US. In fact, in a follow-up paper in 2021, Autor and his colleagues showed that those scars are still apparent today. Why? The researchers identified several factors: the sheer speed/magnitude of the China shock, the specialization of some US geographic regions in a particularly industry and the fact that the workers who were worst affected were poorly equipped to find job opportunities elsewhere, because they did not have the right skills for the modern economy. Are we likely to see similar dynamics with this latest instalment of the China shock?

**Chart 14: Auto deflation yet to hit the RoW**

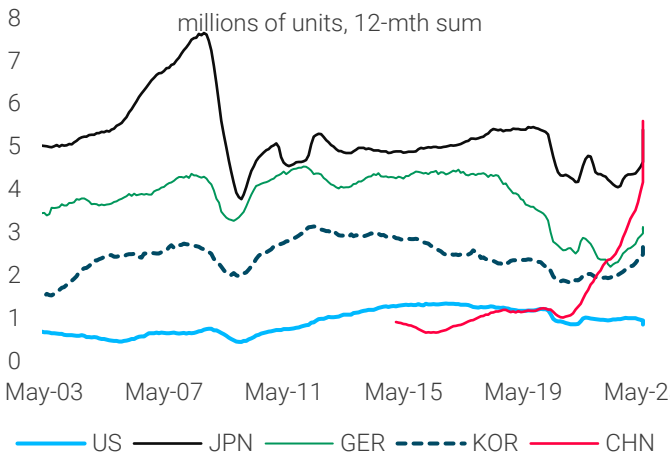



Source: national sources, Datastream, TS Lombard

**Chart 15: No significant deflationary impulse, yet**

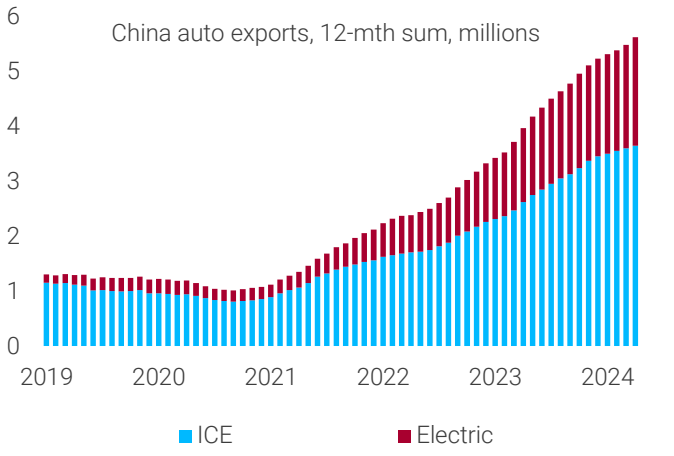

Source: Datastream, TS Lombard

**Chart 16: New competitor, out of nowhere**




Source: CEIC, TS Lombard

**Chart 17: Not just a story about Chinese EVs**

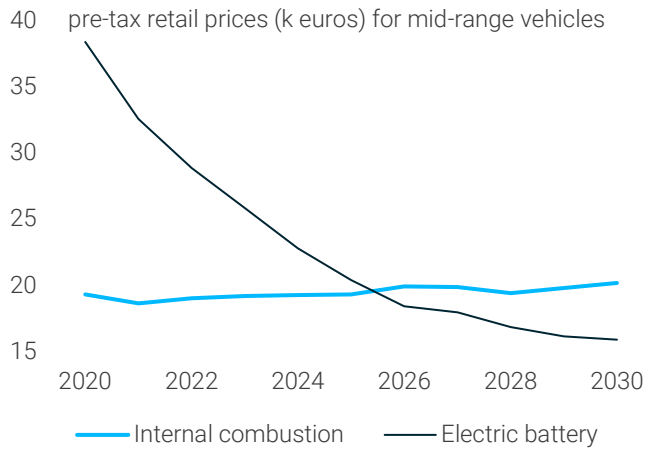



Source: CEIC, TS Lombard

# 2. CAR WARS

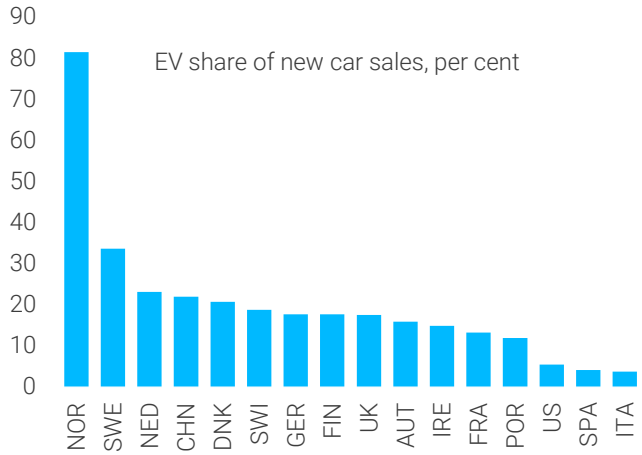
The second China shock is set to play out across various sectors, but there is clearly one industry that is already dominating the public discussion – car production. The US and Europe have long prided themselves on their auto industries, which have always been a symbol of technical competence, status and even consumer freedom. While this is not the first time their car industries have been challenged by a new entrant – similar pressures emerged in the 1970s, with the sudden influx of more affordable, reliable and fuel-efficient vehicles from Japan – the speed of China's entrance into the global marketplace has been truly spectacular. Our analysis suggests this new China shock is only just getting started, and that we could see significant deflation in this sector over the next few years. From a macro perspective, although auto lobbyists tend to exaggerate their importance to the modern economy, there is still significant exposure in terms of GDP and employment – particularly in Europe, which is much more exposed than the US.

**Chart 18: EV prices are suddenly competitive**




Source: Bloomberg, TS Lombard

**Chart 19: EV penetration varies widely**

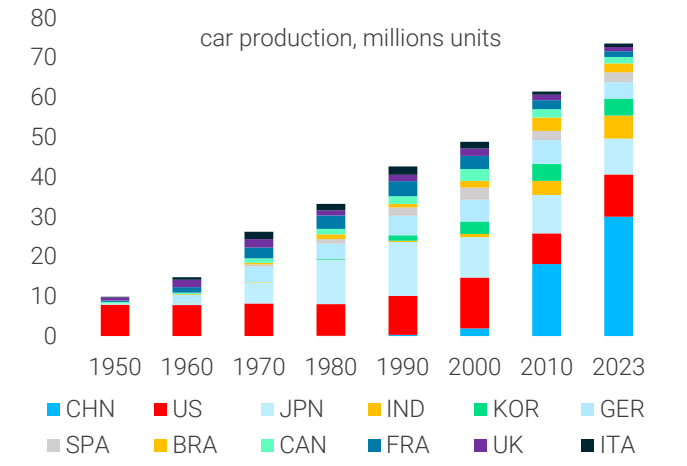



Source: Statista, TS Lombard

## New entrant

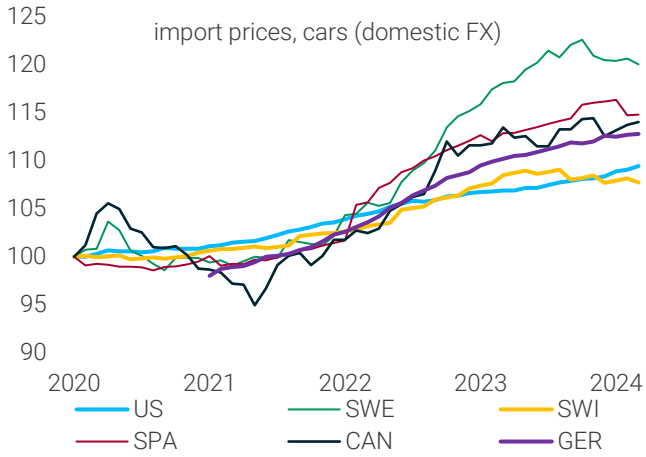
There is no doubt that a lot more Chinese-made cars have suddenly appeared on our roads. Around two-thirds of them are conventional vehicles powered by fossil fuels. If you live in the UK, for example, you may have spotted the strange reappearance of the MG car, which was originally a British company (MG stands for Morris Garages.) China acquired MG in the early 2000s – after the British firm went bankrupt – and has only recently reintroduced it to the UK, selling cars that are primarily built in China. While China's ICE exports have exploded since COVID-19, there is no question, particularly given government NetZero targets that most of the potential for future growth lies in EVs. In most developed markets, EVs are still priced above conventional engines. But that is beginning to change. According to recent Bloomberg analysis, EV prices are falling rapidly and will be cheaper than ICEs within the next couple of years. China's overcapacity can only speed up that transition, especially as Chinese-produced cars are already cheaper to build, deploy cutting-edge technologies and come with impressive speeds and ranges. (BYD has just launched a vehicle with a range of 2,000 km). Elon Musk once poked fun at BYD, but last year it surpassed VW as the largest selling brand in China. Now BYD is planning to take over the world.

**Chart 20: China's emergence in auto markets**




Source: Wikipedia, TS Lombard

**Chart 21: Deflationary impulse has barely started**




Source: national sources, TS Lombard

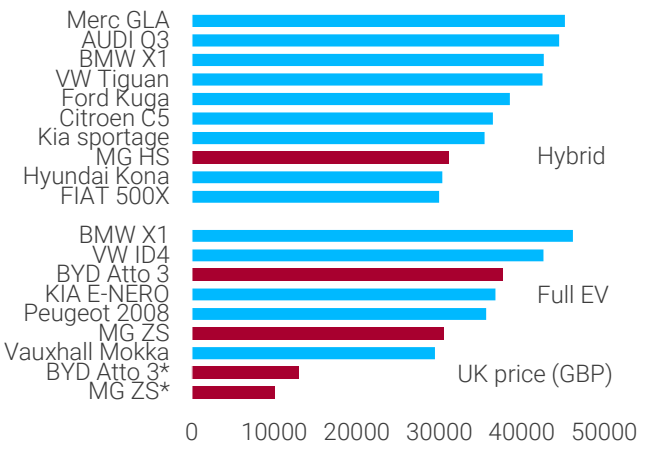
## The start of something big?

Despite the sudden appearance of Chinese cars on European roads, there is no evidence (so far) that China's auto industry has become a major deflationary force. This can be seen from the price of new vehicles, as recorded in DM consumer-price indices. While inflation in car prices has fallen sharply over the past 18 months, the decline is largely an overhang from COVID-19. Prices surged during the pandemic (rising 10-15% in most jurisdictions) and have stabilized as supply tensions have eased and demand conditions normalized. But there is no evidence of Chinese "dumping". While it is harder to get data on the price of imported automobiles, there are a handful of DM countries that provide such statistics. These show a similar pattern to the overall CPI (Chart 21). Import prices have stabilized since COVID-19, but we are yet to see significant deflation. Official Chinese data confirm this story. Although Chinese export prices are falling slowly, what is happening currently is not out of line with the trend of the past decade (and in terms of levels, the prices of Chinese exported autos remain well above pre-pandemic readings).

## Pricing to market

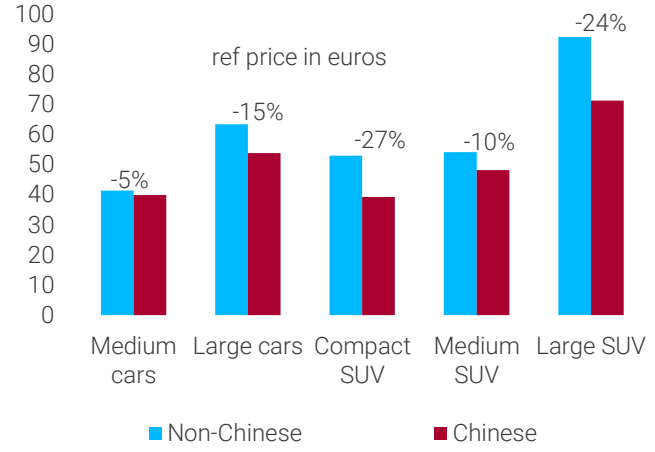
Given the lack of evidence of genuine Chinese deflation, it is tempting to think the whole China shock 2.0 thesis is overblown. In fact, it seems that Chinese producers have priced their vehicles in line with the conditions in foreign markets rather than trying to undercut their competitors. We have confirmed this dynamic by comparing Chinese car prices (both for ICE and EV models) to that of equivalent vehicles in the British market (using Carwow, the UK comparison website). Take the MG HS compact SUV: while the petrol version of this vehicle (at £18,000 for the basic model) is significantly cheaper than the Peugeot 2008 (at £24,000) or the Kia Sportage (at £29,000), the hybrid and EV versions of this model are priced in a similar range to their competitors. According to Carwow, the fully electric version of the MG HS retails at £30,000. BYD's Atto3 is priced at £37,000. These prices are not that different from the prices of the fully electric Peugeot 2008 or a VW ID4 (Chart 22). And our findings are consistent with what other researchers have found. Analysis from T&E confirms that China's price discounting, to date, has been modest vs the cost advantage Chinese producers have over their European rivals.

**Chart 22: China's EVs priced to market**




Source: TS Lombard via Carwow, *price in China (ex transport & VAT)

**Chart 23: Price comparison by model/size**




Source: T&E analysis

## Deflation is coming

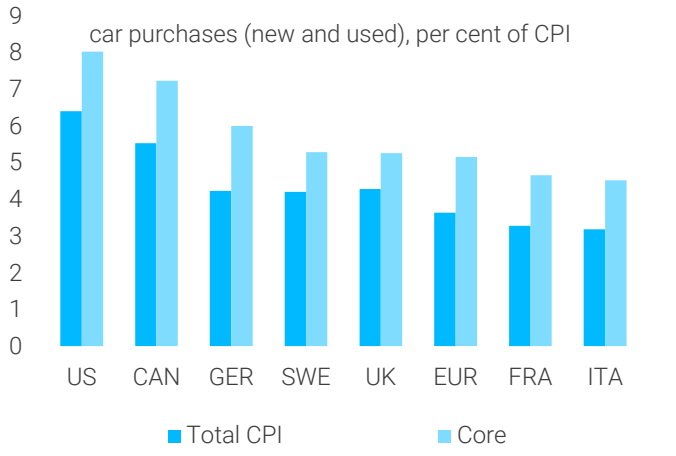
So the China shock 2.0 remains more of a *forecast* than a concrete reality, at least when it comes to the auto industry. But there are two reasons to think it will become more prominent over the next two years, gaining strength as a deflationary force. First, China's auto producers are making massive markups on these cars. Although BYD's Atto 3 retails at £37,000 in the UK, it sells at just over £13,000 in China. Taxes and transportation costs explain only a fraction of this price differential, with the rest going to producers' margins. Given the stagnant market in China, it seems inevitable that China's domestic price wars will eventually spread to international markets. Second, we know that Chinese manufacturers are already planning a dramatic expansion in their global footprint. Press reports say Chinese automakers such as SAIC Motor, Chery Automobile and BYD have recently rerouted global shipping to China to create an "armada" of ships carrying Chinese vehicles that is ready to head to foreign shores. (BYD, which exported more than 200,000 cars in 2023, is planning to double that number in 2023.) And the FT reports that Europe, in particular, is having trouble absorbing this extra supply. According to a story published by the newspaper in April 2024, there is now a glut of these vehicles at European ports. Port operators are irritated by this dynamic, pointing out that they have become a "carpark" for Chinese vehicles, which is interfering with their regular activities.

## The impact on the CPI

With price discounting in the auto sector set to gather pace, the question is what this means for the macro economy. To get a sense of direct exposures, we look at car imports as a share of GDP (Chart 25). For most developed economies, this comes out at 1-2 per cent of GDP, which is roughly half of the rise in import penetration during the first China shock. But it is not just the price of imported vehicles that will be squeezed. Domestic manufacturers, too, will be under pressure to reduce their prices, and we should expect significant spillovers to used car prices. It is important to remember that auto manufacturers have used various credit schemes to support demand over the past decade, including PCP and hire purchase agreements. Usually, at the end of these agreements, car owners have the option to either pay for the car outright (a fixed "balloon payment") or give the car back to the manufacturer. In an environment where prices are falling owing to Chinese competition, borrowers can be expected to choose the latter option, which

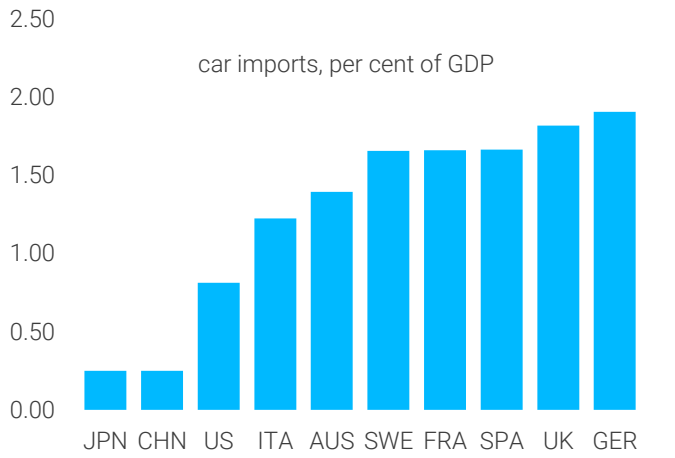
would generate a glut in the used-car markets. Since new and used car vehicles are worth a combined 5-8% of the typical CPI, we could be looking at a sizeable disinflationary force.

**Chart 24: Cars could be significant deflation force**




Source: national sources, TS Lombard

**Chart 25: Scope for a China shock 2.0**

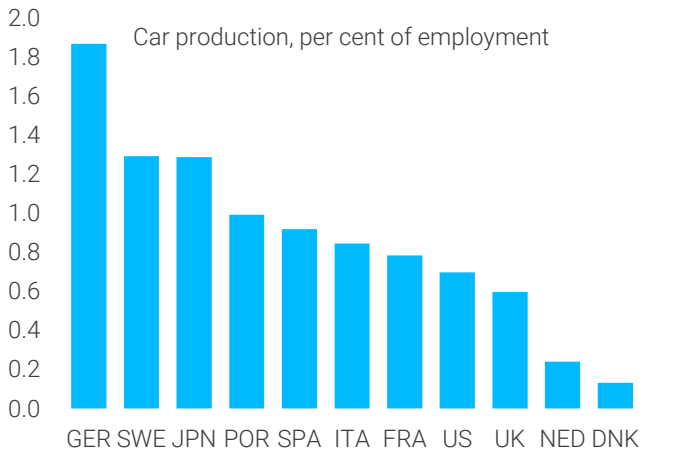



Source: national sources, TS Lombard

## The impact on jobs and growth

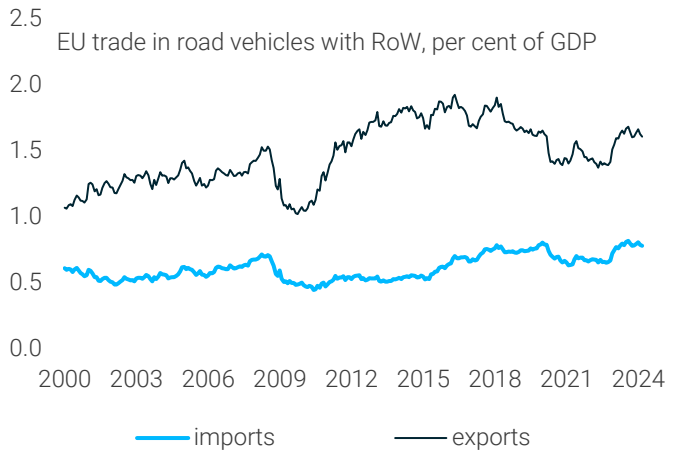
Every 10 per cent decline in auto prices should reduce the CPI by around of 0.5 percentage points. But that is only one part of the deflationary impulse. Chinese imports would also undermine auto production in other parts of the world, which means lost output and jobs. And if the auto lobbyists are right, this would be a material hit to those economies that have oriented themselves around the car industry. In a 16-page open letter, Renault's boss, Luca de Meo, warns that Europe is facing a catastrophe, since its car industry "directly and indirectly" accounts for 13.8 million jobs (more than 6 per cent of the EU's workforce) and 7 per cent of the regional bloc's economic output. Naturally the Renault CEO is talking his own book. "Indirect exposure" is a popular phrase in the auto industry, but it seems to include jobs that have nothing to do with actual car production, such as sales and people who work as mechanics. Many of these jobs would remain viable even if Europe had to forfeit its entire industry to Chinese imports.

**Chart 26: Not a massive threat to jobs?**




Source: national sources, OECD, TS Lombard

**Chart 27: Car war would erode EU surplus**



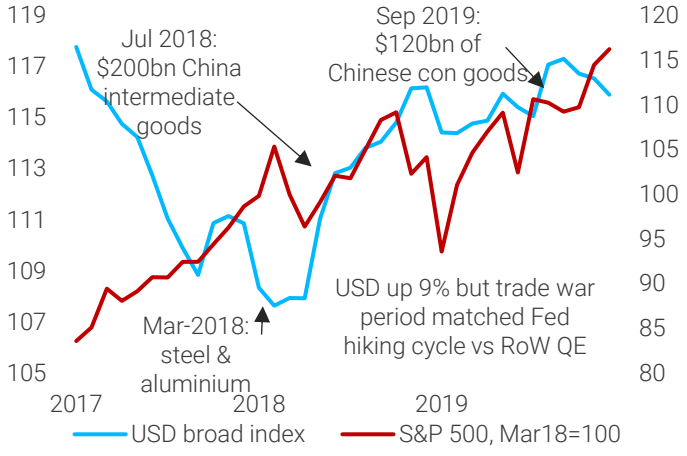

Source: Eurostat, TS Lombard

In terms of direct exposure, the numbers are much less impressive. For most developed economies, car production accounts for no more than 1 per cent of total employment, although that figure rises to almost 2 per cent for Germany, which has outsized exposure. Even if we include *some* indirect exposures – to auto supply chains, for example – we are still talking about the sort of destruction that typically occurs in a regular recession. While the lesson of the first China shock is that we should not downplay these effects – because they are likely to be highly persistent and will hit some regions particularly hard – it is also important not to exaggerate the risks. Talk of the "deindustrialization of Germany", for example, seems wildly overdone. Our main takeaway, contrary to all the hype, is that we are looking at a sequel to the China shock that will not come close to matching the impact of its predecessor. And that is before taking account of the policy response, which is going to be radically different from what happened in the 2000s.

# 3. TRADE WARS REVENGE

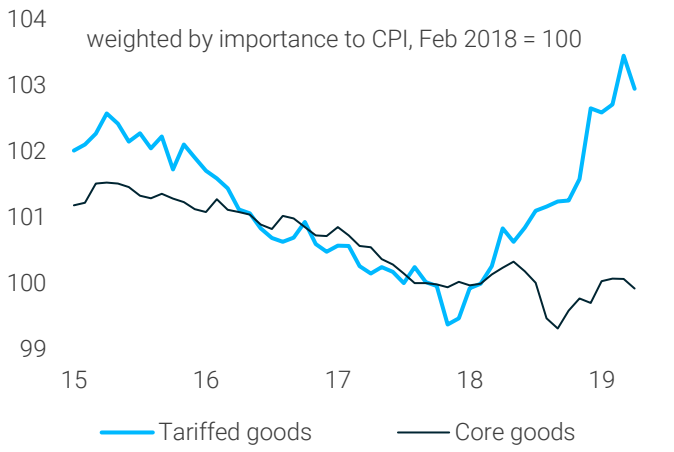
Compared with the first China shock, the big difference this time will be the policy response. The US ("Washington consensus"), which originally encouraged the world to embrace unfettered free trade with China, is now pushing in the opposite direction, leading a policy of decoupling from China. The Biden administration has already imposed hefty tariffs on "strategically" important imports, including EVs; and, regardless of who wins the US election, we are likely to see a further ratcheting up in trade tensions over the next couple of years. The question is not whether trade wars will continue but how far Europe (and various EMs, which are also seeing an influx of cheap Chinese vehicles) will go in adopting US-style protectionism and industrial policies. Our assessment is that US and European protectionism will dampen the impact of this new China shock but not prevent China from providing a mild deflationary impulse. For a global economy that is otherwise facing structural inflation pressures, this is not necessarily a bad thing – particularly if you are a Western central banker charged with trying to hit a 2% inflation target.

**Chart 28: Last trade war brought market volatility**




Source: Datastream, TS Lombard

**Chart 29: Tariffs raised US prices during Trump era**



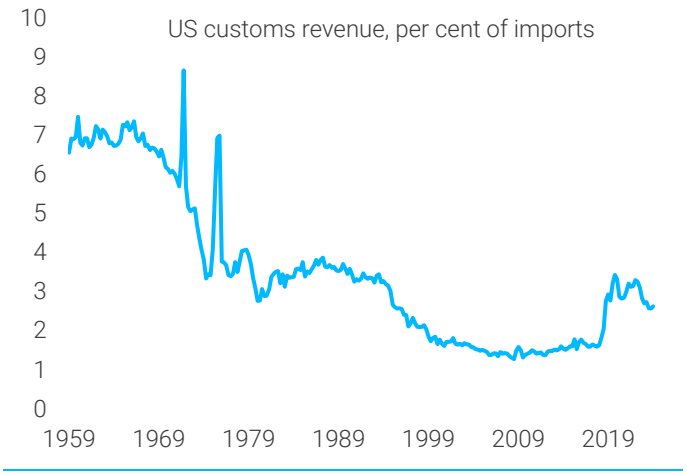

Source: Fed analysis

## US response to China shock 2.0

Unlike in Europe, China's penetration of the US auto market has so far been marginal. But that has not prevented a forceful policy response, one that is designed to keep China out. The Biden administration's recent tariff hikes on a range of Chinese products have fuelled talk in markets of

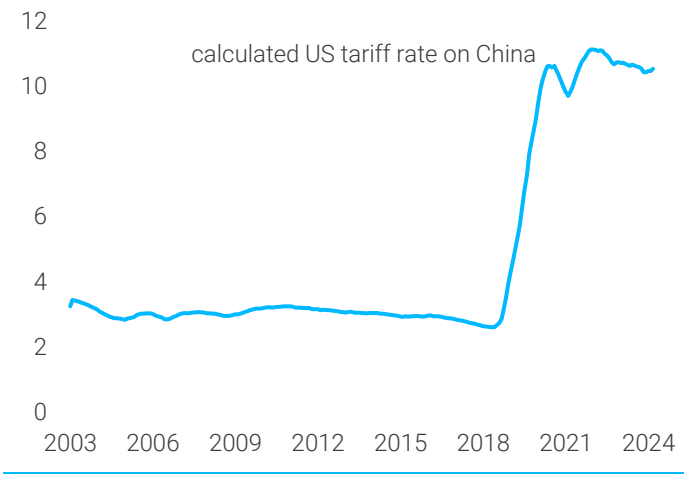
a new trade war. The reality, however, is that there was never really a de-escalation in the US-China trade war. We can see this in US customs receipts, which increased dramatically during the Trump era and has remained elevated under Joe Biden. (The average tariff on Chinese goods increased from 2.5 per cent to 11.2 per cent under Trump and remains above 10% with under Biden). And we know what impact this has had. US consumers have paid higher prices on these products (see this Fed study) and a significant amount of US demand has been diverted to trade with other countries, including Mexico and Vietnam. Bilateral trade between the US and China has plunged, in part (but only in part) because Chinese exports were rerouted to dodge the tariffs.

**Chart 30: Trump tariffs delivered new trade regime**




Source: US customs data, TS Lombard estimates

**Chart 31: US tariffs on China remain high**




Source: US customs data, TS Lombard estimates

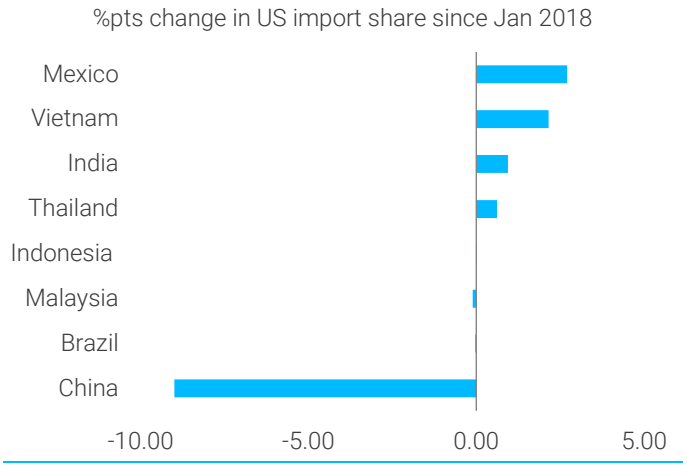
Looking ahead, it seems inevitable that there will be a further escalation in trade tensions between the US and China. Donald Trump has already threatened to impose larger tariffs, and strategists are trying to figure out what this means for financial markets. On the basis of what happened in the period 2017-2019, the big story is likely to be one of uncomfortable uncertainty. Risk assets were volatile during the previous trade war, with every escalation in tariffs (typically announced from Trump's Twitter account) causing short-term market selloffs. And the US dollar appreciated – although, because the Fed was raising interest rates during that period, it is hard to isolate the true impact of US protectionism. Theoretically, it makes sense for US tariffs to cause the exchange rate to rise – for two reasons. First, tariffs make the US more competitive without shifting investment or saving; so the currency rises to restore balance. Second, the dollar is a barometer of global risk sentiment and always appreciates in times of stress.

## Europe's response

Given Europe's outsized exposure to the car industry, it is no surprise that the EU has decided to follow the US and impose its own hefty tariffs on China. Last week, the European Commission provisionally imposed tariffs of up to 48 per cent on China EV imports, concluding an investigation on Chinese trade practices that it had launched last autumn. Yet Europe's politicians remain divided on this issue, with a notable Franco-German split that comes down to who benefits from the status quo. Germany, where auto production is tilted towards high-end luxury brands, has enjoyed strong export demand from China over the past decade. German producers are anxious not to lose this market, which is what will happen when China retaliates with its own tariffs (or a complete boycott of European vehicles). At the same time, Germany has accumulated large sums of FDI in China, with BMW, Audi and VW all establishing production plants that sell to

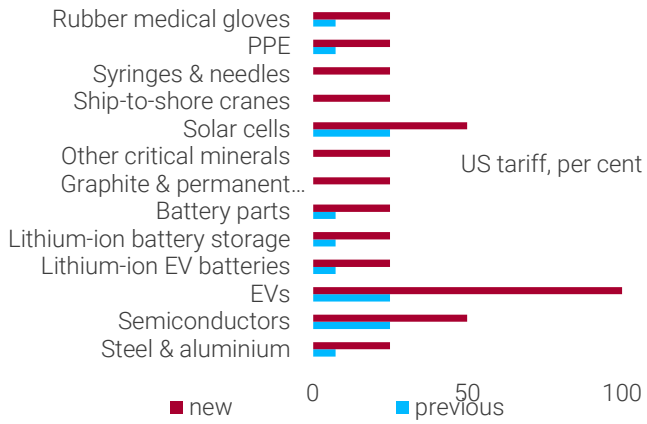
Chinese consumers as well as exporting to other parts of the world (including back to Europe). While BYD is now China's largest producer, Germany's VW comes a close second and Germany still holds a 20 per cent share of China's market overall – the largest auto market in the world. It is easy to understand why the German government is desperate to avoid a trade war and is already trying to dilute the EU's new tariff plan: Germany is in a different position from France, which faces stiff competition from China and does not have a Chinese market.

**Chart 32: Trade diversion since US tariffs**




Source: Datastream, TS Lombard

**Chart 33: Biden's latest round of tariffs**




Source: FT, TS Lombard

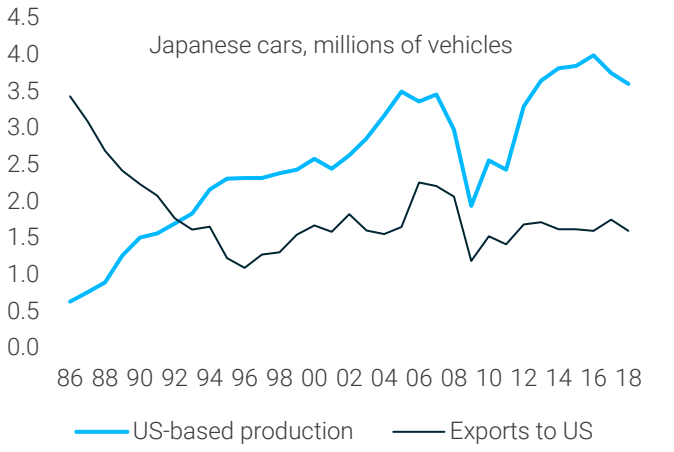
## A false solution

The European and US car industries have faced this sort of competition in the past, most notably when the Japanese auto sector emerged in the 1970s. By the early 1980s, in fact, Japanese producers had grabbed a 25 per cent market share in the US and a 10 per cent share in Europe. That dynamic triggered a trade war. Back then, the solution was for Japan to agree to voluntary export restrictions while establishing manufacturing plants in the US and Europe. Japanese companies could sell to those markets, without destroying large numbers of European or American jobs. There are some commentators who think a similar solution is available in the current trade war. Chinese EV producers have already established factories across Eastern Europe (most notably the BYD plant in Hungary in reward for Hungary's opposition to EU protectionism); and it is possible they could open new facilities in the core of Europe – and even in France and Germany. Economists at the Peterson Institute argue this is a workable endgame, because China and Europe are targeting different sectors of the market. But there are two big problems with PIIE analysis. First, whereas Japan and the US/Europe were political *allies* in the 1980s, that is not the case with China today. Indeed, China and the US are geostrategic rivals. Allowing another wave of deindustrialization could further weaken the Western economies and create disadvantages in any future military conflict. Second, modern vehicles are not just a mode of transport; they are also highly sophisticated computers on wheels. Are Western governments going to trust China when it comes to data collection, etc.? The US ban on TikTok suggests not.

Even if a trade war is not in Germany's short-term economic interest, it is no surprise to see the EU brush aside German opposition. China is already cutting its dependence on foreign auto brands and will continue to do this, regardless of whether other nations impose tariffs. A recent Fed study highlights the role of completely knocked down (CKD) production, which was popular in the 2010s and is now being phased out as part of the government's "Made in China" strategy.

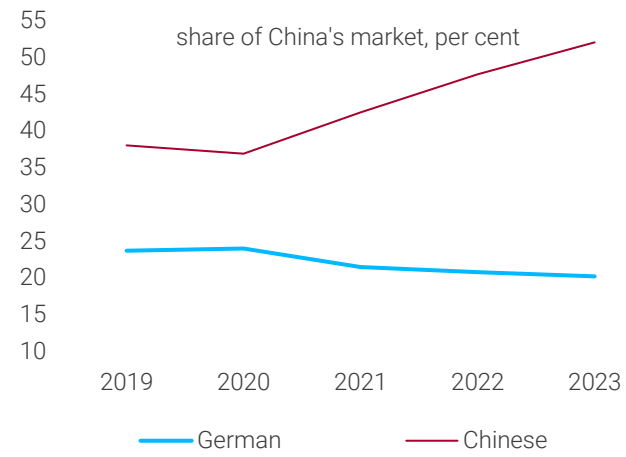
CKD vehicles are vehicles that are assembled in China but are made of imported parts and components, sometimes constructed using complete kits of auto parts that are ready for assembly. As Fed officials point out, this demonstrates that China is undergoing not just an increase in auto production but a shift in which auto production is now comprised of 100 per cent domestic-made vehicles. But the greater problem for Germany is that the transition to EVs is inevitably curbing its advantage in auto engineering; and that suggests its role in China is going to diminish, regardless of EU protectionism. Remember, 40 per cent of the value in EV comes from the battery, and this is where China now has a massive technology advantage. (BYD is doing well because it was a battery-maker that decided to make cars only recently.)

**Chart 34: The solution to the US-Japan trade war**




Source: JAMA.org, TS Lombard

**Chart 35: Germany doesn't want to lose China mkt**




Source: Reuters

## Net effects

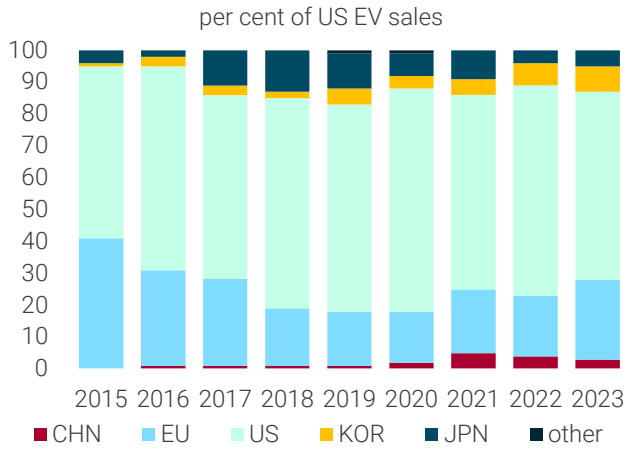
Ultimately, we think the US, Europe and a number of large EMs will continue to ratchet up their protectionism, by levying further tariffs on Chinese imports, erecting important non-tariff barriers (such as the latest French scheme, which provides subsidies for low-carbon EV production, to the exclusion of most Chinese brands) and introducing various forms of state aid and fiscal support programmes for domestic producers. We noted elsewhere that attitudes towards strategic industrial policy have shifted dramatically in recent years. While industrial policy was once a tabu topic (because governments should never "pick winners" or prop up failing industries), today the consensus is moving against the neoliberalism that has dominated the last 40 years. These policies are sure to dampen the deflationary consequences of the China shock 2.0. Arguably, the very reason why Chinese producers have set their prices so far above their production costs is that they expect tariffs to rise and want to be able to absorb those increases in their margins. But it is a stretch to think Western protectionism will halt Chinese deflation completely. China's domestic weakness is structural, and exports are the only way out. If tariffs are effective, the authorities will have to find other ways to boost their international trade, including via sustained RMB devaluation. We think it is reasonable to expect a mild but sustained deflationary impulse.

## Bottom line

Everyone is talking about a "China shock 2.0", with China looking to dump its vast domestic manufacturing overcapacity on the rest of the world, just as it did when the country joined the WTO in the early 2000s. The reasons are clear: China's domestic economy is suffering a structural downturn and the authorities have been reallocating resources to sectors that can give

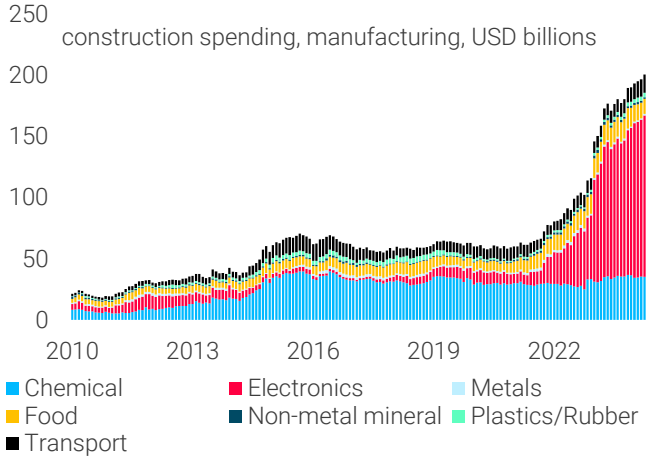
Chinese exporters a competitive and geostrategic advantage (EVs, semiconductors, anything related to the green transition). Back in the early 2000s, mainstream economics totally underestimated the consequences of the original China shock. The scale and speed of China's industrial dominance shocked the world; and by the mid-2010s, it had caused permanent scars on parts of Western society (with obvious political repercussions). Our analysis suggests the China shock 2.0 is only just getting started. Auto prices are set to fall, perhaps significantly, which will be a major problem for producers in developed economies – with Europe particularly exposed. Still, it is hard to imagine a deflationary shock as powerful as that in the early 2000s, especially as the policy response from other nations is going to be radically different. Whereas the US encouraged the world to embrace free trade with China in the early 2000s, there is now a very different "Washington consensus". Both the US and Europe have already announced substantial tariffs on China, and further protectionist/strategic industrial policies seem inevitable. Ultimately, these measures will significantly dampen – but not halt entirely – the deflationary impulse that China will provide to the global economy in the 2020s.

**Chart 36: China hasn't penetrated US market**




Source: FT, TS Lombard

**Chart 37: US is building domestic capacity**




Source: BEA, TS Lombard

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