



# Investment Note



2 March 2018

## Latest US tariffs do not augur a trade war

On 1 March 2018, US President Trump announced that his administration will impose 25% tariffs on steel imports and 10% tariffs on aluminum imports. The decision is expected to inflame relations with key trade partners, as the European Union and Canada have already raised objections to the proposed action. Geoff Lewis, Senior Asia Strategist, believes that in the short term the tariffs will not have a big negative economic impact. But over the medium term, a more active US trade policy may conflict with macroeconomic goals to stimulate the US economy. Investors should watch the reaction of affected countries to understand whether increased trade friction is on the horizon.

### US policy shift to trade issues may increase volatility

Yesterday, President Trump announced the intention to impose tariffs on steel and aluminum imports. Trump cited Section 232 of the 1968 Trade Expansion Act in making the decision, which can be unilaterally implemented by the president via executive order. It is important to note that a final decision has not been announced; a formal announcement of the Section 232 investigation is expected by mid-April.

It has been expected for some time that with tax reform completed, President Trump would next turn his attention to foreign trade and the promise to his support base to pursue “fair trade”, in the process reducing the large US trade deficit and bringing jobs back to America. The US Trade Representative undertook last August to examine trade with China in a number of key areas, including intellectual property. His reports were completed recently, leading to the introduction on 23 January of tariffs on solar panels and washing machines under Section 201 of the US Trade Act, primarily aimed at China and South Korea.

Yesterday’s announcement is confirmation that President Trump means business, with trade relations now his policy priority for 2018. The move apparently caught markets by surprise. The Dow Jones Industrial Average fell roughly 1.7% on the day, while the Standard and Poor’s 500 moved lower by 1.3%. Asian markets displayed widespread weakness. The Nikkei 225 was lower by 2.5% at market close today, while Hong Kong’s Hang Seng Index was off by 1.5%. China’s market reaction was more muted: The Shanghai Composite fell by 0.6%.<sup>1</sup>

Whatever the economic impact, trade issues are likely to provide an additional source of volatility for markets in coming months that investors will have to contend with. While yesterday’s announcement may have seemed to come out of the blue, the imposition of tariffs on steel and aluminium on national security grounds has in fact been widely canvassed and debated in recent months. With China the

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<sup>1</sup> Bloomberg, 2 March 2018.

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world's largest steel producer, the move is consistent with President Trump's determination to address the China/US trade relationship squarely and directly.

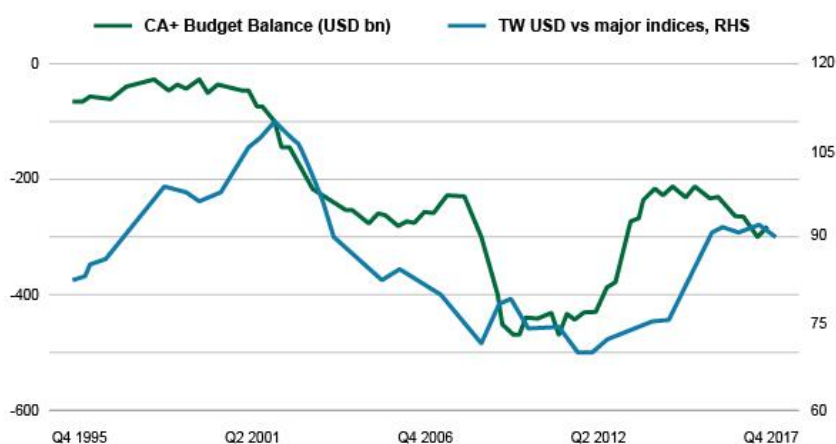
With the global economy in the midst of a synchronised upturn, world trade is currently growing strongly, with export volumes up 4.5% last year.<sup>2</sup> The imposition of US import tariffs on a few key products is unlikely to have a big negative impact in 2018. In the medium term, much will depend on the response of China and other nations. They will of course protest vocally and seek to challenge the legality of the US national security argument at the WTO trade dispute tribunal. This is a time consuming process and ahead of a WTO determination that is not in other countries' interests to start a trade war.

### US trade goals in conflict with macroeconomic goals

Macro-economic conditions today, with the US economy close to full employment and the Federal budget deficit in 2018 set to widen to 4.2% of GDP,<sup>3</sup> are even less conducive to any rapid improvement in the US trade balance. The irony is that President Trump's stimulative fiscal policies guarantee that the US current account deficit will continue to widen. With the US personal savings rate close to historical lows and government borrowing bound to increase, the US external balance looks set to deteriorate via an even larger deficit on international trade in goods and services<sup>4</sup>.

Selective tariffs on US trade on steel and a few other products of the kind announced by President Trump cannot possibly alter this prospect. Raising the rhetoric on trade protection could be seen as a means to lower the US dollar and limit future expansion of the trade deficit by maintaining a more competitive currency. Governments that attempt to talk down a currency with poor fundamentals run the risk of a loss of control and substantial overshoot.

**Chart 1: US twin deficits and the dollar<sup>5</sup>**



CA: Current Account;  
TW USD: Trade-weighted US dollar

<sup>2</sup> Capital Economics, 23 February 2018.  
<sup>3</sup> Federal Reserve, February 2018. <https://www.whitehouse.gov/>  
<sup>4</sup> See "How to Lose a Trade War" by Stephen Roach - Project Syndicate, Jan 26, 2018  
<sup>5</sup> Source: Capital Economics, February 2018

But perhaps the biggest risk from a more aggressive resort to tariffs and other trade restrictions by the Trump Administration is that it could fail to recognise that its macro-economic and trade policies are in potential conflict, with goals that are mutually incompatible. Under such a scenario, initial trade restrictions fail to have much impact, since macro trends would continue to favour a wider US trade deficit. Growing frustration on the part of US policymakers could see the resort to harsher measures, perhaps even a general tariff on imports, causing foreign trade partners to react with their own countermeasures.

The world is still far from embarking on such a dangerous path, however. Investors should not extrapolate the significance of the tariffs on steel and aluminium imposed by the US yesterday, measures that many trade experts had in fact expected. What matters now is whether the US and China can sit down at the negotiating table and sort out their differences. The fact that President Xi Jinping's top economic adviser, Liu He, is currently in Washington for just that purpose holds out hope that a trade conflict can be avoided.

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