



US China trade war fears – Q & A

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Key points

- > President Trump's actions on trade are mainly aimed at achieving better access for US exports to China and better treatment of US intellectual property by China. They are not primarily aimed at traditional US allies, reducing the risk of a global trade war.
- > So far there is only a "phoney trade war" between the US and China as major tariffs are only "proposed". Signs remain positive for a negotiated solution, but there is a way to go yet.

Introduction

Much has been written about the trade dispute between the US and China and the risk of a global trade war. Much of it has been hyperbole but financial markets have had to price in the risks of a full-blown trade war zapping global growth. This has been difficult given almost daily developments on the issue since early March. This note takes a simple Q & A approach to the key issues.

What is a trade war?

A trade war is a situation where countries raise barriers to trade with each other (such as tariffs or quotas on imports or subsidies to domestic industries) usually motivated by a desire to "protect" domestic jobs and workers sometimes overlaid with "national security" motivations. To be a "trade war" the barriers need to be significant in terms of their size and the proportion of imports covered. Tariffs on a few goods don't really count as a trade war because it's not significant.

The best known global trade war was that of 1930 where average 20% tariff hikes on most US imports under Smoot-Hawley legislation led to retaliation by other countries and contributed to a collapse in world trade.

What is wrong with protectionism?

A basic concept in economics is comparative advantage: that if Country A and B are both equally good at making Product X but Country B is best at making Product Y then they will be best off if A makes X and B makes Y. Put simply free trade leads to higher living standards and lower prices whereas restrictions on trade lead to lower living standards and higher prices. This is why economics should be compulsory in final years at high school!

The trade war of the early 1930s is one factor – along with wrong-footed monetary and fiscal policy – that contributed to the severity of The Great Depression.

A few years ago, at a presentation in Adelaide I tried to explain all this to a woman in the audience who was incensed by the recent closure of auto production in South Australia by Mitsubishi. After a while someone else in the audience asked for a show of hands as to who drives an Australian-made car – only about five hands went up including mine (the Holden!) but most people's hands stayed down, including the lady's and she said she liked the safety of a Volvo. Fair enough. But it seems that while some want to protect local industry they don't buy it themselves. The experience of heavily protecting Australian industry in the post WW2 period was that it was just leading to higher costs and prices and lower quality products and Australians' were voting with their wallets to buy better value foreign made goods. We might have protected lots of manufacturing jobs if we stayed at the levels of protection of 45 years ago, but we would have become a museum piece as would the US.

Fortunately, despite the loss of jobs in manufacturing (from 25% of the workforce in 1960 to around 8% now) other jobs have come along in the services sector where Australia's and America's relatively highly-skilled but highly-paid workforce have a comparative advantage compared to workers in less developed countries.

In short, if you want to support your country's products buy them, but trade barriers don't work.

Why is President Trump raising tariffs then?

It's simple. He is fulfilling a 2016 presidential campaign commitment to "protect" American workers from what he regards as unfair trading practices. He has long held this view – see his 1986 interview with Oprah where his focus was Japan. Last year his focus was on deregulation and tax reform, which helped share markets. This year the November mid-term elections are approaching & polling not helped by his poor popularity has been pointing to the Republicans losing control of the House, so he is back in campaign mode returning to his campaign commitments on trade, knowing tariffs are popular with his supporters.

What does President Trump want?

President Trump wants better access for US exports to China. While it's been feared at times that Trump was willing to get into trade wars with any country that the US has a trade deficit with, including long time US allies – with criticism of Europe and Germany on the trade front and regular threats to tear up the South Korea/US free trade deal (KORUS) and NAFTA, and US aluminium and

steel tariffs originally thought to apply to all countries, it's clear the main focus is China:

- Europe has been exempted for now from US tariffs on aluminium and steel (along with most US allies).
- KORUS has been renegotiated with only minor concessions to the US (on steel and cars with a focus on reducing non-tariff trade barriers); and
- The NAFTA free trade deal with Mexico and Canada looks on track to be renegotiated.

So maybe Trump is not so blindly protectionist as feared. Basically, the US under Trump feels that China is not giving its exports fair access and alleges – after a review under section 301 of the US Trade Act – that it's not respecting the US's intellectual property.

Where are we now?

Fears of a global trade war were kicked off in early March with Trump's announcement of a 10% tariff on aluminium imports and a 25% tariff on steel imports. US allies were subsequently exempted but China was not, and it announced similar tariffs on roughly \$US4bn of imports from the US matching the US tariffs. So tit for tat. But tariffs on \$US4bn of imports are trivial – less than 0.1% of US imports for example.

The focus then shifted to China. On March 22 in response to the Section 301 intellectual property review, Trump announced 25% tariffs on \$US50bn of US imports from China with the details announced two weeks later but to be subject to a period of comment before "proposed" implementation in late May/early June. At the same time the US lodged a case against China with the World Trade Organisation, providing confidence Trump is not trying to undermine the global trading system.

China then announced "plans" for 25% tariffs on \$US50bn of imports from the US with a focus on agricultural products. So more tit for tat – but in this case only in relation to proposals or plans. And still only small at around 1.5% of US imports, implying an average tariff increase across all US imports of just 0.4%.

To appear to stand up for American farmers, President Trump announced that the US would consider tariffs on another \$US100bn of imports from China. China indicated it would again announce a proportional response should the US do so. So fears started to rise of an escalation. But again, it's all proposals.

On March 22 Trump asked the US Treasury to consider restrictions on Chinese investment in the US by May 21.

What is the most likely outcome?

So far what we have really seen is not a trade war but a phoney trade war between the US and China. The tit for tat tariffs triggered in relation to US steel and aluminium imports are trivial in size. All the other tariffs are just proposals, contingent on the US and China being unsuccessful in reaching a negotiated solution. Our view is that a negotiated solution will head off their implementation, indefinitely delay them contingent on trade success or result in very watered-down tariffs:

- President Xi Jinping's speech at the Boao Forum committing to lower import tariffs for various products, increased market access for foreign investors and strengthened protection of intellectual property rights echoes comments by Premier Li and indicates that China is aware of the issues and willing to negotiate.

PBOC Governor Yi has added more detail in relation to making it easier for foreign participation in the Chinese financial system and indicated the China will not manipulate a Renminbi depreciation in the trade conflict. So it's a good first step.

- Similarly, while President Trump wants to be seen to "stand tough for American workers" a full blown escalation into a real trade war with China come the November mid-term elections is not in his interest as it would mean higher prices at Walmart and hits to US agricultural exports both of which will hurt his base and a much lower US share market which he has regarded as a barometer of his success.

Reaching a deal with China will be harder than "fixing" KORUS and NAFTA and there is a long way to go with setbacks inevitable, but ultimately a deal is likely.

Will all this really fix the US trade deficit?

No. The real issue is that America as a nation spends more than it earns which results in it importing more than it exports. The only way to solve this is for it to save more but the now rising US budget deficit due to tax cuts and spending hikes will mean it will save less. So while a deal with China may reduce the US trade deficit with China the trade deficit will simply shift to other countries.

What to watch?

Key to watch for is negotiation between the US and China on trade. Meanwhile, the US Trade Representative will hold hearings on its proposed US tariffs on \$US50bn of imports from China on April 23, these tariffs "if any" are due to be finalised by May 21 and the US Treasury is due to propose restrictions on Chinese investment in the US by May 21 – but both could be delayed if negotiations are ongoing. May 1 will also see exemptions to the US's steel and aluminium tariffs expire if they are not renewed.

What would be the impact of a full-on trade war?

The negative economic impact from a full-blown trade war would come from reduced trade and the disruption to supply chains that this would cause. This is always a bit hard to model reliably. Modelling by Citigroup of a 10% tariff hike by the US, China and Europe showed a 2% hit to global GDP after one year with Australia seeing a 0.5% hit to GDP reflecting its lower trade exposure compared to many other countries, particularly in Asia which will face supply chain disruption. But of course we are currently nowhere near a 10% average tariff hike. And the current situation really just involves the US and China so arguably Chinese and US goods flowing to each other could - to the extent that there are substitutes - just be swapped for goods coming from countries not subject to tariffs thereby reducing the impact.

Why have share markets fallen?

A full-blown trade war would depress global growth so share markets have moved to make some allowance for the probability of this. If a trade war is averted, even though we may not have trade peace, share markets will be able to unwind this, albeit volatility will still remain high given other issues such as Fed tightening and ongoing risks around President Trump.

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