BEATING OF THE TRADE WAR DRUMS: THE TARIFFS ARE COMING (BACK)!

By Brian Fabbri
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The 2018 trade wars have begun

After much backing and filling President Trump has finally initiated a set of tariffs on steel and aluminum, and on several items imported from China. Every nation that was affected by these tariffs responded by setting tariffs on goods that are exported to them from the US. The president is now considering additional trade levies as a follow up to their responses. Do these actions and counter actions sound like a trade war? It clearly no longer resembles a negotiating tactic, as there is no sincere negotiation presently taking place.

Thus far, the initial list of tariffed items by the US’ trade counterparties does not appear to affect a significant portion of US economic output. However, this round of tariffs may not be finished, and – unlike the newfound friendship between the US President and DPRK Supreme Leader – there may no longer be any affection left between the warring parties to prevent second, or multiple additional rounds of tariffs, or trade impediments. Moreover, estimating the direct economic impact from the price increases emanating from the initial set of tariffs is woefully inadequate. Simple crude measures cannot estimate the indirect impacts and unintended consequences that these harsh, scary and worrisome trade-destroying acts can precipitate.

Financial market’s enthusiasm arrested

Tough trade talk has already suspended the initial enthusiasm of global stock markets. The constant back and forth on trade tariffs and eventual imposition arrested the early year price surge: The S&P appreciated 6.6% in January, keeping pace with improving economic forecasts and soaring corporate profitability. Since the President’s initial comments on tariff setting, the boom in the stock market ended. The S&P has lost 3.6%
in the sessions following his threats, and global markets have closely followed suit with less economic potential to support them than in the US.

Once financial participants become convinced that global leaders are determined to pursue growth-stymieing trade-barrier policies, the present stall in financial markets will intensify into a devastating asset price retreat.

**Trade wars are lose-lose games**

It is unnecessary to recount the inglorious details of the last trade war disaster during the 1930’s, when tit-for-tat diplomacy created a global economic meltdown. The latest salvoes emanating from the US coming quickly after the first round of tariff increases imply a total incredulity of global trades’ benefits and a complete disregard for the dire lessons of the past. Moreover, their imposition by willful Presidential decree disregards the rules laid down by the General Agreement on Tariffs and Trade (GATT) and renders it mute. GATT was created decades ago, ironically by the US, to avoid such debilitating unilateral economic decisions.

Of course there are many trade imbalances between the US and the EU, and between all of China’s trade counterparties and China. China’s aggressive transfer of technology as well as commercial production details that it demands for access to their domestic markets needs to be addressed and resolved fairly, and in favor of its trading counterparties. GATT was originally created to be that arbitration mechanism, but it has failed to live up to its promise. Bolder actions are necessary than petitioning GATT through its lengthy settlement procedures: such as, bilateral negotiations. Alas, they did not succeed either. Therefore, the aggrieved world has chosen to indulge in unilateral trade sanctions, which if carried out to their fullest will climax in a global recession.

Ironically, tariffs alone cannot solve the US trade imbalance, even if they are imposed without retaliatory tariff increases. The US trade deficit is mainly the result of a national investment savings shortfall. Quite disturbingly, a deep enough recession could eliminate that savings investment imbalance and close the US trade deficit.

**Which economies are the US’s biggest trading partners?**

The biggest goods trading partners of the US are by far its neighbors: Canada and Mexico. Last year the US imported US$600 billion of goods and services from Canada and Mexico. They are also partners in the NAFTA trade treaty, which is presently undergoing intense renegotiation with the Trump administration. Their importance to the US economy is evident from the total trade data. US total trade with these two other NAFTA member’s accounts for 29% of total US international trade. Meanwhile, the proportion of the US net trade deficit...
with Canada and Mexico is significant, 11%, but much smaller than the proportion of their total trade.

**Net Trade by Economy**

How important is international trade to US’ biggest trading partners

From a net trade point of view international trade is an important component to all of the major economies of the world. This is especially true for the EU and China, as net international trade represents around 4% of their respective GDP’s. However, when global trade is viewed from the perspective of exports of goods, then the significance of international trade soars substantially.

**Net Trade as % of GDP by Economy**

As the chart below reveals, exports relative to GDP jumps in importance for all countries investigated. Consequently, as tariffs rise, exports will decrease. Fewer exports will diminish employment and, along with the rising prices of tariffed goods, raise the public’s ire at the governments that imposed tariff policies.

**Exports as % of GDP for select economies**

**Net trade at EU (ex UK) is nearly balanced**

The EU, with or without the UK, is the single largest economic block in the world apart from the US. Their net international trade position is relatively tiny compared with that of the US. It is basically in balance: a mere 0.7% of their GDP in 2016. When the UK is excluded from the EU data, the net position of the 26-member countries shrinks to just 0.2%. Moreover, the EU ex UK’s net trade position is frequently in annual surplus.

The importance of international trade for the EU is also better understood when viewed from the perspective of exports. Then the role of exports relative to total GDP increases to 10.6% in 2016. Nevertheless, the percentage of exports for the EU is slightly smaller than it is for the
US, where exports are 12% of GDP. Understandably, most of EU trade is internal, from member countries to other member countries. This was one of the fundamental purposes behind the creation of this multi-country economic union.

Contrary to casual expectation, the EU has a large trade deficit in automobiles. This deficit is supported by a large surplus in capital goods trade. EU’s exports of industrial goods and capital equipment account for more than half of all EU exports. These well-crafted products enjoy high global demand. Tariffs on these price-inelastic goods would be quickly passed through into final goods prices in all importing economies.

The trade deficit in automobiles has shrunk dramatically, by almost 70% from its peak in 2011 to its 2017 level. Moreover the EU has reversed a small trade deficit in consumer goods to a widening surplus in the past several years. Unusually slow recovery from the global recession has reduced Europe’s demand for consumer products. Thus higher tariffs on imported consumer goods into the EU would probably have a relatively smaller impact on final prices in the EU.

EU Merchandise Imports(blue) and Exports(red) by type in 2017 (% of Total)

EU exports go mainly to US

The EU ex UK exports go mainly to the US, as the following chart demonstrates. Over 19% of their exports are destined for the US. In 2017 the US imported approximately $450 billion worth of goods from the EU, third in dollar amount after NAFTA and China. Exports to China are a distant second destination. Consequently, a protracted and aggravated trade war with the US would be very costly for the EU economy, especially now since the natural rate of economic growth in the EU is estimated at less than 1%. The EU economy could easily be thrust back into recession.
**The US is everyone’s biggest export market**

The EU is not alone in its trade dependence upon the US. As the next chart demonstrates, the EU is joined by Japan and China all of whom export around 20% of their products to the US. The two exceptions studied are Canada and Russia. Canada and Mexico, members of NAFTA, export approximately two thirds of their products to the US and their economies will be radically affected by a trade war with the US. In contrast, Russia exports only 4% of its products to the US and therefore can ignore the effects from a trade war. Of course, restrictions placed on Russia for political purposes have had, and will have, a much more serious negative effect on their economy.

**Conclusion: No one wins a trade war**

Once tariffs are imposed and retaliation occurs against the initiating country, the trade war begins. Quite naturally the prices for all of the goods that are targeted for tariffs will increase. Second, some previously decided upon orders for those tariffed products are no longer competitive and therefore will be canceled. Third, corporate investment decisions will be delayed, or scrapped until more information about international trade practices are discovered. Fourth, essential supply chains are broken leaving manufacturers, who are dependent upon a carefully constructed international set of sources for the ingredients that are necessary to complete their production are slowed, as new sources are sought, or halted. In either case costs will rise and finished prices will be substantially higher. Lower inflation everywhere was one of the keynote benefits from the creation of global supply chains.

The net result for all countries involved will be higher inflation and less international
trade. Higher inflation not only means higher prices of goods for global consumers to pay, but also higher interest rates. Central banks will be forced to react to the sudden acceleration in inflation. Consequently, the era of easy money and accommodative monetary policy is now history.

Less international trade will almost certainly be translated into fewer jobs everywhere. The declines in employment herald decreasing income and slower economic growth. Economies, where economic growth was listless, such as in the EU and some emerging market economies are particularly vulnerable to higher tariff-led declines in demand.

Last year public and private economists were busy raising their forecasts for present and future global GDP growth. This year they will likely be preoccupied paring their economic growth predictions.

With GDP growth decelerating and central banks beginning to tighten monetary policy to flush out the boost in inflation, a global recession may not be far away. More likely, the world will be forced to soon endure another era of stagflation.

For more information, please contact camri@nus.edu.sg

Research Assistance provided by Ms Wu Shujie of CAMRI
## KEY INDICATORS TABLE (AS OF 31 MAY 2018)

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Source: Bloomberg

### APPENDIX

#### GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US$ where applicable)

**S&P500**: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)

**FTSE**: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)

**NIKKEI**: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)

**HANG SENG**: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)

**STI**: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)

**EUR**: USD/EUR exchange rate: 1 EUR = xx USD (EUR)

**YEN**: YEN/USD exchange rate: 1 USD = xx YEN (JPY)

**CMCI**: Constant Maturity Commodity Index (CMCIP)

**Oil**: West Texas Intermediate prices, $ per barrel (CLK1)

**3MO LIBOR**: interbank lending rate for 3-month US dollar loans (US0003M)

**10YR UST**: 10-year US Treasury yield (IYC8 – Sovereigns)

**10YR BUND**: 10-year German government bond yield (IYC8 – Sovereigns)

**10YR SPG**: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)

**10YR SGS**: 10-year Singapore government bond yield (IYC8 – Sovereigns)

**US ISM**: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)

**EU PMI**: Purchasing Managers’ index for the 17 country EU region (PMITMEZ)

**JP TANKAN**: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)

**CHINA IP**: China’s Industrial Production index, with 1-month lag (CHVAIOY)

**LC**: Local Currency

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