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ECONOTE No. 73: "Trade wars" with a focus on China and Asia. 24/6/2018

Summary	Investment Conclusions
Country A, imposing tariffs on imports from country B, is supposed to reduce exports from that country but this could also reduce the GDP growth of B. This could then reduce imports by country B thus affecting the exports of all its trading partners including those from country A. The impact is multiplied if country B retaliates and also imposes tariffs. **This, in sum, is the expected cost of trade wars**. Needless to say when quantified to specific cases, here Trump versus China, NAFTA and steel and aluminum exporters, the whole case reduces to modest quantified damages on a macro level, although individual exporting companies will be hurt. Hence our relaxed stance on this trade war nonsense. Disruptive but not fatal.	The panic in the stock markets caused by tariffs is justified on the basis of the impact on individual companies, but not on the impact on the GDP growth of individual countries. The sum total trade involved in Trump's tariffs represents a very small percent of global trade and, in any case, are focused on 3 countries, China, Mexico and Canada. The steel and aluminum tariffs affect companies exporting these goods, not countries. Car tariffs, however, may involve in the big four of the EU. Most Asians, including China and India, have little to worry in terms of GDP growth as do most Latams, bar Mexico, and, incidentally, also the US ! (See FactBox)

Oh God, does he really HAVE to ?

Unfortunately yes.Trump promised in his election campaign to impose tariffs on China and renegotiate NAFTA as well as "even out the playing field" in other areas such as car imports to the US.The response of the US business sector was almost universally negative, as was the collective opinion of economists. Their responses were based on the expectations that the tariffs would lead to overall decreases in labour employment in the US and higher prices for consumers.This was considered a high price to pay in order to reduce USA's USD 350 bl trade deficit with China.The fact that Trump's administration will simply not take into account their own counsel and their own supporters in the business community, never mind the fallout from the retaliation of the trading parners of the US, is simply a reconfirmation that, occassionally in life, it is worth doing something to spite everyone else and to follow gutty feelings rather than quantitative evidence.A classical example here is the death penalty which has had next to zero support as a deterent to crime, but gives the community a good feeling of revenge satisfaction.So the tariffs will punish those "bad people" who have been cheating the good, simple Americans out of their jobs.Sounds good despite being wrong and useless. Now to business, who gets taxed ? China's USD 50 bl worth of exports gets hit by 25% tariffs followed by another USD 200 bl of exports to be taxed if the Chinese retaliate, as they will.Note that the China exports hit by tariffs are about 10% of total Chinese exports in 2017, a small sum indeed.

Canada and Mexico get hit by "NAFTA related tariffs" as well by 25% duties on steel and 10% on aluminum which is applicable to everyone else. Next in line will be tariffs on cars aimed at imports from NAFTA, the EU and Japan.The markets' reactions to all this, bar equities, was measured. As Fig 1 shows the strength of the USD did lead to weakness in some Asian currencies, but except India, most the weakness in the forex rates of major Asian exporters was modest.

Fig.1: USD forex index (red), USD forex to CNY (yel), INR (Gr), KRW (blu), SGD (Mauve) TWD (br), 2017=100

Source: Bloomberg

Is the devil in the details? You bet it is !

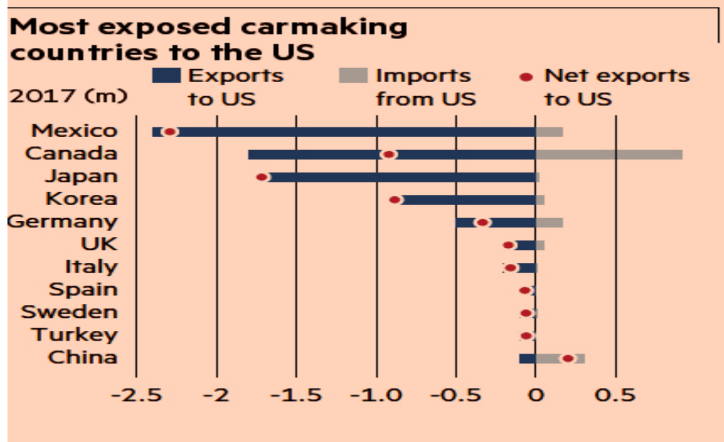
The following quotes from the Business SCMP 23/6/2018 summarise admirably the absurdity of these tariffs and their negative impact on the US : **“ (these tariffs) largely tax the exports of foreign enterprises operating in China, whether US-owned or parents domiciled in other advanced economies (all US allies)….46% of China’s exports in 2014 (the latest data available) were accounted by foreign invested enterprises. Of exports to the US , 60% came from these enterprises…..of the 1,333 products targetted on Trump’s orginal USD 50 bl tariff list..85% of them are intermediate inputs and capital equipment destined for technology-intensive products being exported not by Chinese companies, but by US- owned businesses and other foreign invested companies “.**

A similar nightmare awaits the planned tariffs on the imports of cars in the US, especially those from Mexico, the largest exporter of cars to the US. (Fig. 2) As all these cars are produced by foreign and US companies in Mexico, these tariffs would impact US companies. The situation becomes even more complex by the operation of foreign car companies, mostly EU and Japanese, in the US, where they partially rely on the importation of parts, which will now be subject to duty. There is also the consideration of the impact of retaliation, especially for US-BMW which exports most of its output. The best illustration of these unintended consequences was the impact on the solar panel industry in the US, 75% of which was dedicated to the installation and maintenance but not of production. The tariffs imposed earlier in this year made imported panels more expensive leading to less of them being installed and thus threatening employment in the sector.

Fact Box: Net exports and their impact on GDP

Tariffs are supposed to reduce exports and thus lower GDP growth. What drives GDP is NOT exports but the difference between exports and imports growth: growth of net exports. The measurement is not very accurate, but accurate enough to debunk the idea that China and the USA are “export driven economies”. They are not. In China during 1978 -2017 the maximum contribution of net exports to GDP growth was in 1994 at 4.0%, and the minimum in 1985 at - 6.7%. In 2016 the contribution was - 0.64% and in 2017 + 0.63%. In the US in 2017 net exports contributed -0.09% while for 1Q18 a tiny +0.08%. Net exports contribute not even one percent to GDP growth in both economies and, hence, fall in exports growth on its own due to tariffs may have a small impact on growth.

Fig.2: The US car export/import market



Source:FT

Concluding on Asia, and China in particular

The economy of China may lose, at worst, a few bps of growth if more than just USD 50bl of exports are impacted. After all the total exports of China to the US in 2017 was over USD 500bl ! S.Korea has avoided, by a quota arrangement, the price impact on its steel exports to the US, but not India, which exports about USD 1.2bl of steel.But just like China, India is not an exports-driven economy, so the impact will be sectoral and not macro.There is, of course, the far more complex impact of the “ripple” effect.If China imports printed circuits from Taiwan and China’s technology exports to the US fall significanlty, there will be a secondary impact on Taiwan despite the fact that exports from Taiwan to the US have not been included in the tariffs.Disruptions in the supply chains could also have unforeseen effects.Impact on individual firms could be severe.The ZTE (unrelated to tariffs) example of the Chinese telecoms firm which was excluded for compliance etc reasons from buying US chips and was effectively closed down almost instantly, only to reopen again as a part of tariffs bargaining, shows how sensitive production lines can be to the availability of imported inputs, and by extension, to their prices which can affect demand for the final product.

The, sad, bottom line of all this, is that the US tariffs have nothing to do with economics, competitiveness and US jobs, but with posturing politics and crude instruments of blackmail in achieving mostly marginal if not negative sectoral benefits.Mercifully Asia’s trade flows, bar China’s, are not yet affected except indirectly.The impact of GDP growth rates will likely be very modest.

Andrew Freris (writing completed 24 June 2018)