US TRADE POLICY – WHAT NOW?

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National Australia Bank

Start of a new era in US trade policy?

- Trade was one of the key themes of Mr Trump's campaign. As his inauguration as President nears, attention focuses on what trade policies the Trump administration will pursue. Mr Trump's call for radical reform in US trade policy to lift domestic employment and wages reflects his strong criticism of what past policies have delivered. He has advocated imposing higher tariffs on countries that trade unfairly (with particular criticism of China), re-writing or scrapping the North American free trade agreement (NAFTA), taking a more aggressive line in bringing cases to the World Trade Organisation (WTO) and avoiding big new multi-country trade deals like the Trans-Pacific Partnership.
- In part one we discuss Mr Trump's trade objectives, some of the constraints that could stop him getting what he wants, what he is likely to do, whether it will deliver the scale of boost to employment he has mentioned on the campaign trail and what it means for Australia. The difficulty that Mr Trump faces is that sweeping trade measures would best achieve his ambitious jobs agenda, but those are precisely the reforms most likely to lead to WTO cases and trade wars. A trade war could also appreciate the US dollar via a 'flight to safety' in financial markets, working against the improved trade balance that the protectionist policy was intended to achieve. In summary, we see a significant move towards protectionism that still proves unable to generate enough jobs to re-build the US industrial sector and which is generally not positive for Australia.
- In part two we outline the various trade and tax measures that the Trump administration could adopt. Mr Trump specifically mentioned many of these as policy options on the campaign trail and the experts he has nominated for senior trade positions in his administration are across the detail. The economic impact of using potential measures already on the US statute book ranges from fairly minor to presenting quite a shock to established economic patterns. We assess how likely these individual trade and tax measures are to be pursued by a Trump administration, but stress the situation remains fluid.

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PART 1 WHAT HAPPENS NOW?

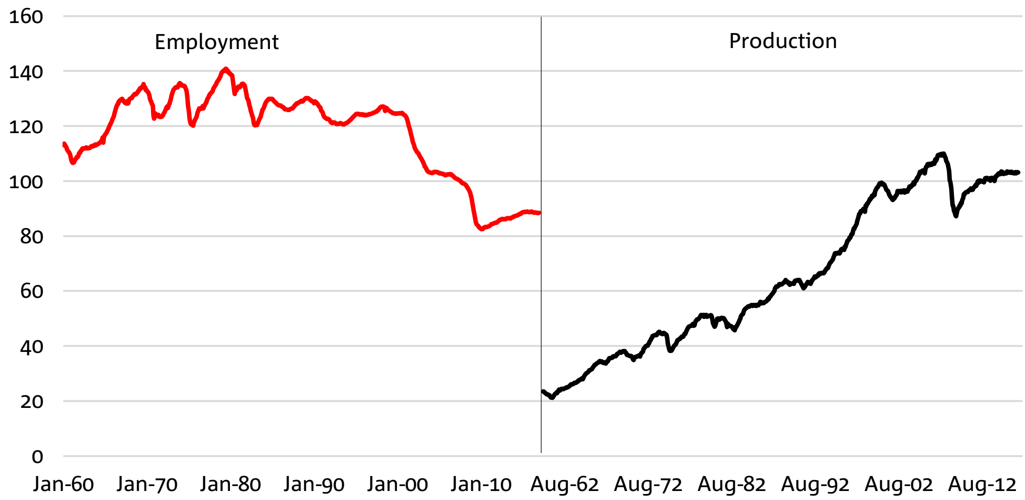
Photo: Jamelle Bouie

OBJECTIVES OF THE TRUMP ADMINISTRATION'S TRADE POLICY

"It's time to declare our economic independence once again" – Mr Trump 29 June 2016

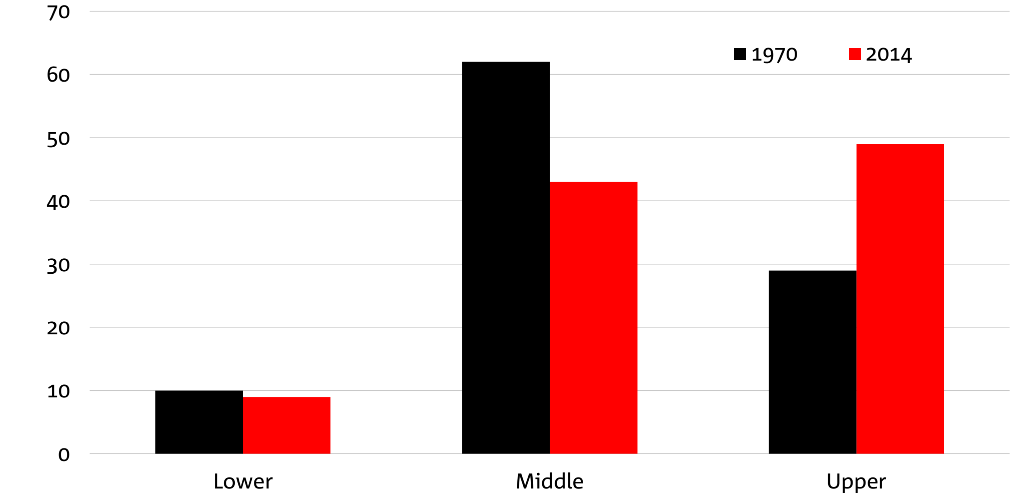
AIM – LIFT US PRODUCTION BY REBUILDING ITS MANUFACTURING

Manufacturing employment and production (2007 = 100)



THE SHRINKING MIDDLE CLASS SHARE OF THE PIE

Distribution of US household income by class (%)



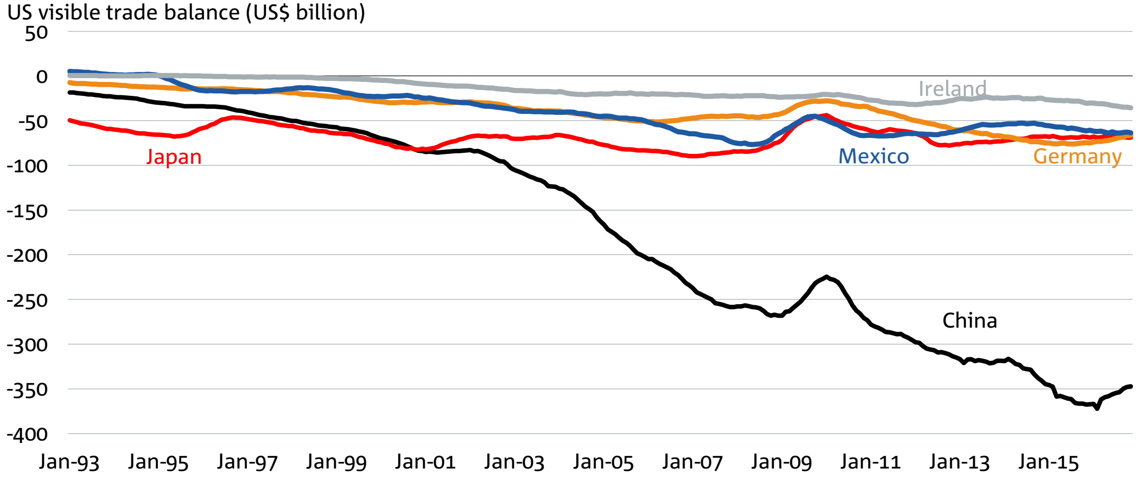
- Re-building the US industrial base, aiming to "massively increase jobs, wages, incomes and opportunities for the people of our country" is the principal economic objective of the Trump Presidency. Mr Trump has said that the US used to follow a production-oriented approach to running its economy. This, he says, spread the wealth and income widely, ensuring that there was a big US middle class and he wants to return to those days.
- His election campaign focused on the problems of that squeezed and shrinking US middle class. Pew analysis shows how the share of middle income earners in the US population and household income has fallen. Until 2000 this erosion in share more reflected people shifting into upper income groups than moving down the income ladder. However, the situation has changed since 2000 with 13 times more US households moving down from the middle to lower income group than climbing out of the middle income category and into the upper income segment.
- Opinion polling shows voters feel the pressure. Which presidential candidate had the best plans to create and maintain US jobs was the top determinant in voter choice while employment and joblessness are seen as the biggest national problem. Now that Mr Trump has won the election, 46% of those polled see creating and preserving jobs as the number one issue that he needs to address. The polls also confirm the lack of growth in median household incomes that was, until recently, such a hallmark of the US labour market. Many respondents say that they expected their children to experience lower living standards than they had. These were the sentiments that propelled Mr Trump into the White House and underpinned Mr Sanders' strong campaign for the Democratic party nomination.
- Mr Trump says that trade policy is crucial to lifting US employment and incomes. Mr Trump has called his trade policy "the centre of everything" and, in the specific case of China, added that "at the centre of my plan is trade enforcement with China. This alone could return millions of jobs into our country" (Mr Trump, 8 August 2016).
- Mr Trump has repeatedly emphasised that he is not anti-trade, his concern is with the "bad" trade deals that previous US administrations have signed (e.g. NAFTA). He wants to renegotiate these to get better deals – "Trade has big benefits and I am in favour of trade. But I want great trade deals for our country that create more jobs and higher wages".

 Sources: Federal Reserve, Pew Research, BLS, NAB Economics

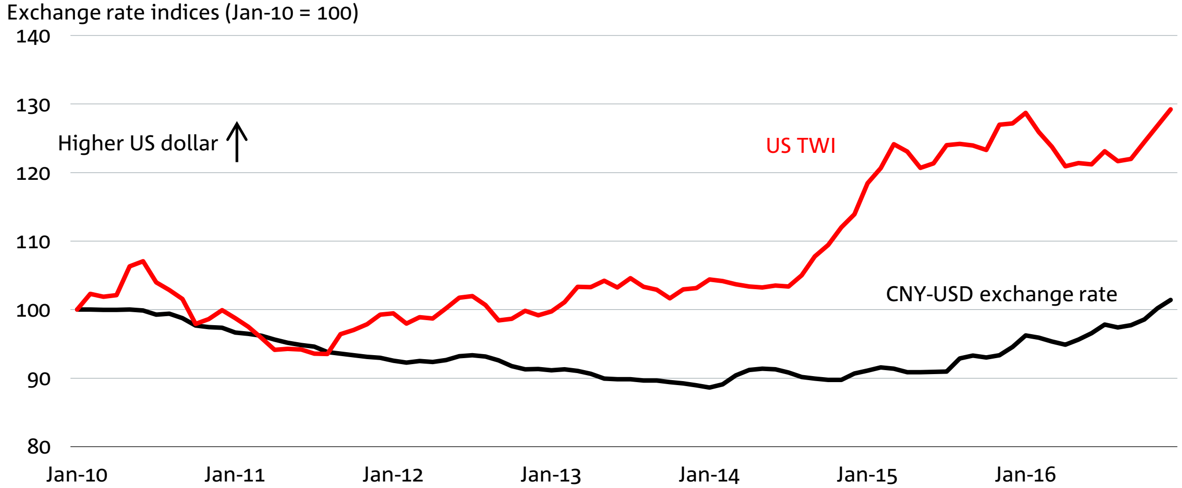
CHINA A MAJOR FOCUS FOR US TRADE POLICY

"They break the rules in every way imaginable" – Mr Trump 9 August 2016

TRADE DEFICIT WITH CHINA BALLOONED IN THE LAST TWENTY YEARS



RMB DEPRECIATION AGAINST USD REFLECTS USD'S BROADER RISE



- Mr Trump has repeatedly accused China of "unfair" trade practices that tilt the competitive playing field away from US firms. China's allegedly undervalued exchange rate, breaching of global trade rules on intellectual property and the continued use of subsidies in contravention of WTO rules (in areas like agriculture) have been listed by Mr Trump.
- Mr Trump's nominee for US Trade Representative, Robert Lighthizer, has been especially critical of the US-Chinese trading relationship, pointing out that it has not developed as predicted when China joined the WTO, highlighting the widening US trade deficit and job losses, calling for a tougher US trade stance on Chinese "unfair trade" and "currency manipulation" and wondering whether the Chinese system is even capable of complying with the obligations of WTO membership.
- Opinion polls show most US people think that trade liberalisation has cost rather than created US jobs and that globalisation has cost rather than benefitted the country. More US people polled think free trade has harmed rather than helped the US. There is a willingness to consider more protectionism and suspicion of trade agreements.
- The US now has a massive good trade deficit with China – amounting to $US319 billion in the first 11 months of 2016, almost half the total US deficit of $US677 billion. Mr Trump links that widening trade imbalance to the closure of tens of thousands of US factories and the loss of millions of manufacturing jobs.
- This decline in manufacturing employment does not just reflect trade with China, technological change has also lifted labour productivity ensuring that fewer staff are needed. Recent analyses, however, highlight the extent to which the accelerating loss of US manufacturing jobs between 2001 and 2007 coincided with the US granting better access to Chinese imports in 2000. One study found that increased imports from China led to the loss of around 2.4 million jobs in the US between 1999 and 2011.
- US regions exposed to greater import competition from China experienced more downward pressure on wages as well as higher job losses in manufacturing and larger shares of the population that were either unemployed or forced outside the labour force. There was little migration out of these regions, instead many retrenched workers stayed put. This helped Mr Trump win key industrial states that the Democrats were counting on to win the election.

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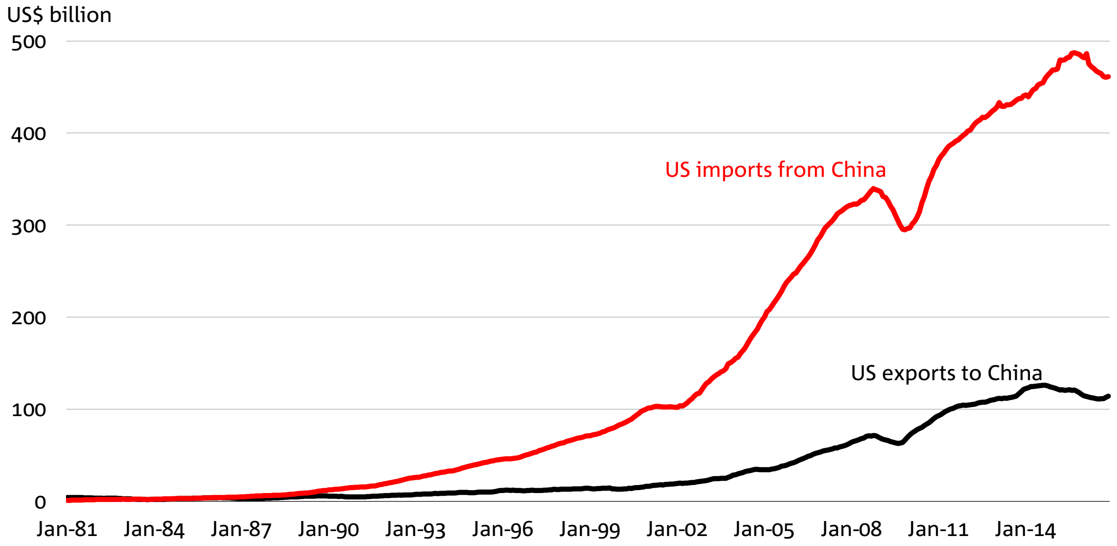
Sources: Datastream, NAB Economics

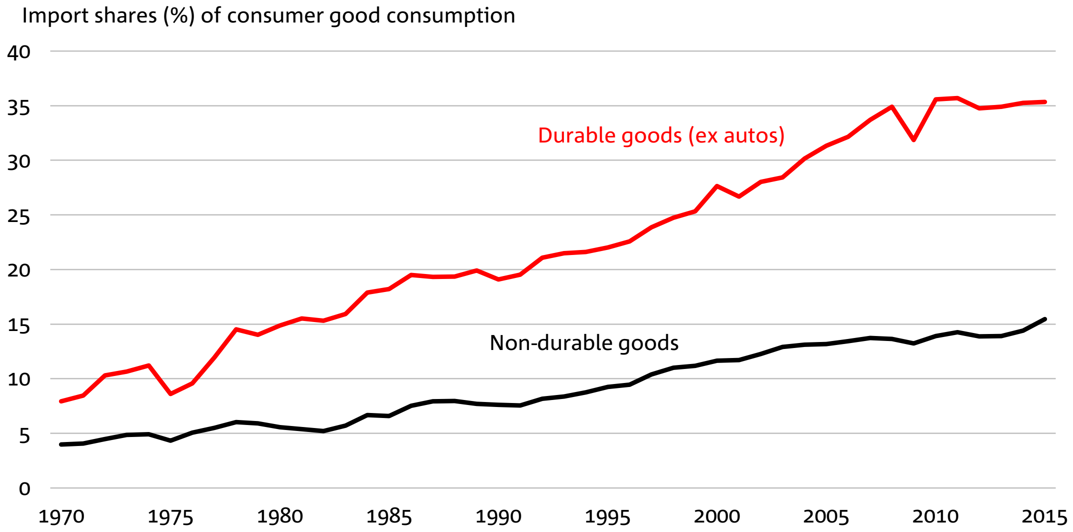
CONSTRAINTS ON THE TRUMP ADMINISTRATION'S TRADE POLICY

US business and consumer lobby pressure probably counts the most

TRADE IMBALANCE MEANS CHINESE MORE TO LOSE IN TRADE WAR



RISING IMPORT SHARE MEANS TARIFF HIKES LIFT US PRICES BY MORE



Sources: Datastream, BEA, NAB Economics

- While the Republicans have won the Presidency and both houses of Congress, possibly freeing Mr Trump of the legislative constraints that overshadowed so much of President Obama's period of office, his administration still has to take account of the adverse consequences of higher tariffs.

1. The likelihood of retaliation from China if the US lifts tariffs on Chinese goods – experience suggests that the Chinese government will not take higher trade barriers on its exports lying down. When the Obama administration temporarily lifted tariffs on imports of tyres from China in 2009, the Chinese imposed anti-dumping duties on imports of US chicken products soon afterwards. US jobs are at stake in any trade war. Over 8 million US jobs depend on key export markets, over 600000 rely on trade with China and a trade war with China could result in sizeable job losses in key US manufacturing states. Despite this, US trade hawks doubt if China could win a trade war as its trade surplus gives it more to lose.
2. The near certainty of new US trade barriers being taken to the WTO for dispute resolution – the Chinese, who already have taken the US to the WTO over its refusal to grant them market economy status, will use the WTO to try to strike down new US barriers. New trade barriers erected under section 301 or tariffs put on Chinese exports because of an alleged "under-valuation" of the RMB could lead to WTO cases. Other WTO countries could take cases over corporate specific tariffs aimed at "outsourcing" US multinationals or the use of border tax adjustments to rebate direct taxes for exporters and lift import costs. The US could well lose all these cases but it could take years and, judging by 2010 comments by US Trade Representative Lighthizer, the US might just ignore an adverse WTO verdict and accept trade retaliation for breaching another country's trade rights.
3. US business lobbies are worried by the impact of 5% or 10% across the board hikes in tariffs, leaving NAFTA, anti-outsourcing taxes aimed at particular corporations and the whole idea of putting a new border tax on all imports. Absent any offsetting US dollar appreciation, imported goods will rise in price, eroding profits in sectors like retail and adding to costs for integrated supply chains in industries like autos. Such business pressure could help soften protectionist moves in the new administration.
4. The higher import prices that flow from increased tariffs and border tax adjustments on imports will lift US consumer prices – and imports loom increasingly large in US consumption. Given that improving the living standards of the squeezed US middle class was so prominent in the election campaign, raising prices could be politically difficult.

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WHAT IS PRESIDENT TRUMP LIKELY TO DO?

"Replace the present policy of globalism… with a new policy of Americanism" – Mr Trump 15 September 2016

A TRUMP-LITE TRADE POLICY

- Renegotiate or end NAFTA
- Review cost/benefits to the US of other free trade agreements
- Label China a currency manipulator
- Introduce anti-subsidy duties based on currency under-valuation
- More aggressive pursuit of unfair trade cases at WTO
- More aggressive use of anti-dumping and trade safeguards
- Pressure US multinationals to stop out-sourcing but no new tariffs
- Oppose China being classed as a market economy in WTO
- Use US trade law to punish breaches of US intellectual property
- Launch targeted section 301 cases for selected products
- Do not proceed with the TPP trade agreement
- Bring cases using section 232 to block imports (national security)

THE BIG SHIFT

- Withdraw from NAFTA
- Label China a currency manipulator
- Impose anti-subsidy duties based on currency under-valuation
- Across the board tariff hike (Section 122, payments imbalance)
- Aggressive use of law against intellectual property breaches
- Use 301 and 232 laws to curb imports in big industries (steel)
- More aggressive use of anti-dumping and trade safeguards
- Appeal, then ignore, adverse WTO rulings on US trade measures
- 35% tariff imposed on out-sourcing US multi-nationals
- Demand renegotiation or exit from other trade deals e.g. US/Korea
- Respond to trade retaliation with further US import barriers
- Border tax adjustment imposes charges on imports, rebates exports

- Now Mr Trump has to put his ideas on trade into practice and It remains unclear just what he will do. We provide two trade policy scenarios opposite, list possible trade and tax measures in the second part of this note and guess which the new US administration will adopt. Although Mr Trump has promised major initiatives on his first day of office, the new trade policy will take time to emerge - much depends on how the voters and Congress view the measures and how far other countries retaliate. Our initial guess is that we will get more than the 'Trump-lite" scenario but not as much as "The Big Shift" scenario.

- President Trump could well mean exactly what he says on trade and we are about to see major changes in US trade policy rather than just window-dressing moves that do not amount to much:

1. The team he has nominated for the key trade jobs are "true believers" that the US needs a more aggressive and nationalist trade policy – nominating trade hawks like Robert Lighthizer as US Trade Representative, Peter Navarro as Head of the White House National Trade Council and Wilbur Ross as Commerce Secretary is hardly a signal that Mr Trump intends to water down his trade agenda.
2. Neither Mr Trump's trade agenda nor his rhetoric during the campaign presented trade policy as a politically "small target" – plenty of lofty goals were set, big numbers were quoted and hard words spoken. Big trade measures will be needed to produce big economic changes. With all this on the record, it becomes much harder to just tinker with the system and either meet the goals set or keep faith with the voters.
3. Opinion polls show many Americans are unhappy with past US trade policy, which probably influenced many votes. US states facing the greatest challenge from Chinese competition used to vote Democrat as that party was traditionally seen as less in favour of free trade. Mr Trump overturned that usual voting pattern at the November election by winning key industrial states, probably because of his trade agenda. If he now fails to deliver big trade reform, there could well be a lot of unhappy voters who switch back to the Democratic party.

- There seems a good chance that these domestic political imperatives will override concerns over consistency with WTO rules or the threat of retaliation and result in a meaningful shift in US trade policy toward protectionism.

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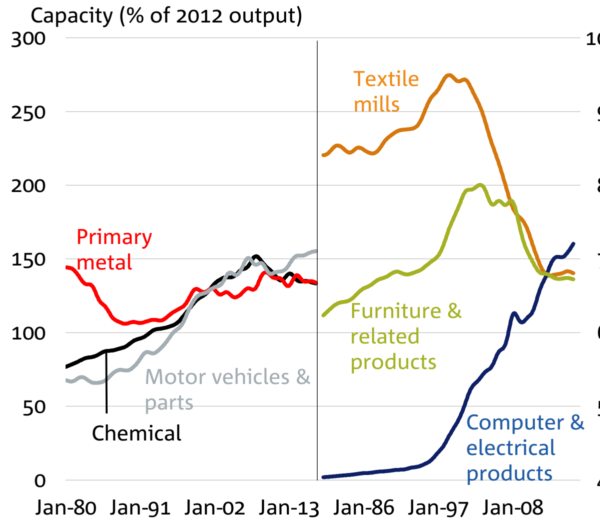
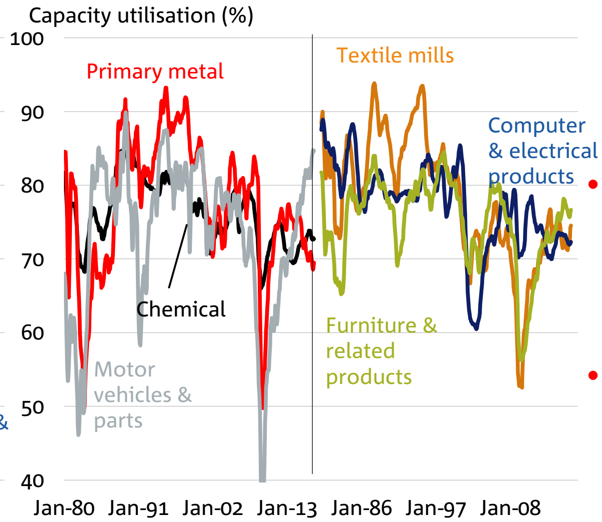
WILL THE NEW US TRADE POLICY DELIVER THE JOBS?

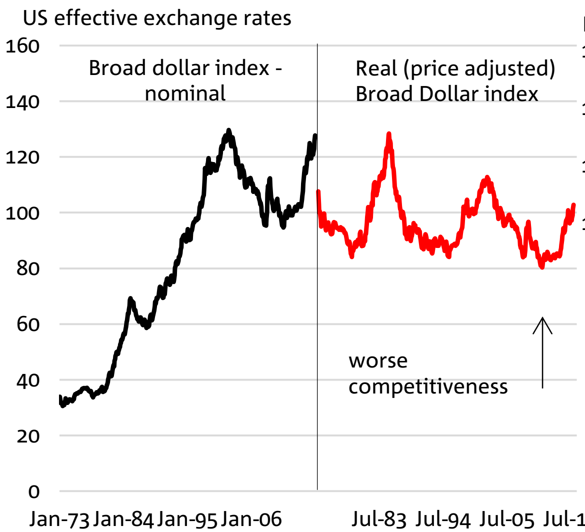
"I will be the greatest jobs producer that God ever created. And I mean that" – Mr Trump 11 January 2017

KEY SECTORS LOSE CAPACITY BUT STILL LOTS OF SCOPE TO LIFT OUTPUT

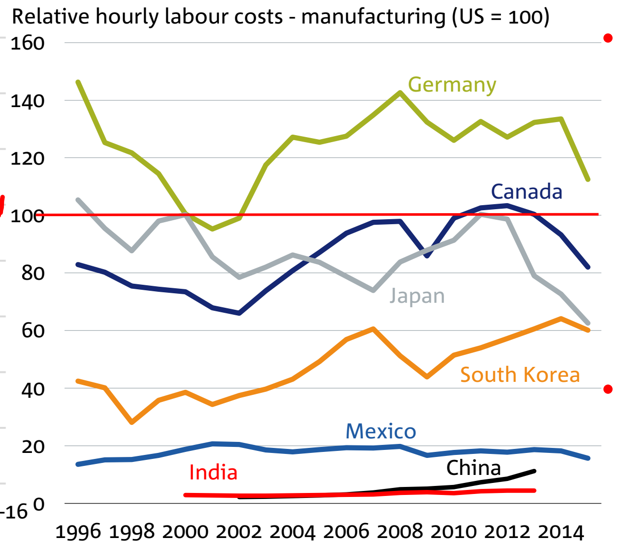




US$ LIFT HITS COMPETITIVENESS



US WAGES 10 TIMES THOSE OF CHINA



Sources: Federal Reserve, The Conference Board, NAB Economics

- Mr Trump's vision for US jobs and wages is ambitious and achieving it will require a big expansion in US manufacturing. Rebuilding the US industrial sector is a massive challenge – 50000 firms have gone since China joined the WTO in 2001, 6½ million jobs have been lost since 1980, the productive capacity of sectors like textiles, clothing and footwear has shrunk and recently output has been stagnating rather than increasing, so it is no longer the case of efficiency improvements driving down employment.
- There is still scope for increased manufacturing output with around 25% of installed capacity lying idle across several key sectors. Consequently, a fair amount of supply capacity appears to be available to meet many of the shifts in demand from imports to local output that would be triggered by higher US trade barriers.
- Re-building industrial capacity looks a far greater challenge. Mr Trump has expressed his concern at a rundown in the US pharmaceutical industry's capacity and sectors like that could be expanded. However, bringing back the lost plants and jobs in labour intensive industries like textiles, footwear or furniture looks much more difficult. US wages are far higher than those in China and the application of modern technology and management systems in Chinese export manufacturing has done a lot to close the productivity gap between it and the US. Very big tariffs would be needed to close the cost gap between China and the US in sectors like clothing.
- Using US trade policy to lift US employment by millions is going to require some serious changes – tinkering at the edges will not generate enough jobs and nor will pressuring a handful of multinational corporations to stop outsourcing operations. Really far reaching changes in policy – like across the board tariff increases, border tax adjustments and drastic cuts in imports from China on the back of anti-currency manipulation and intellectual property breaches would probably be required. Such measures would trigger WTO challenges, trade retaliation and lobbying by US importers – but they could well be the sort of measures needed to bring back enough jobs and we doubt if all these will occur.
- This job creation task is also not helped by the appreciation in the US$, which has eroded the competitiveness of its industry. A 10% loss in US competitiveness lifts imports by 2½% and cuts exports by 4%, running against the trade plans of the new US administration. Overall, we are doubtful that Mr Trump can rebuild industrial sector employment by several million.

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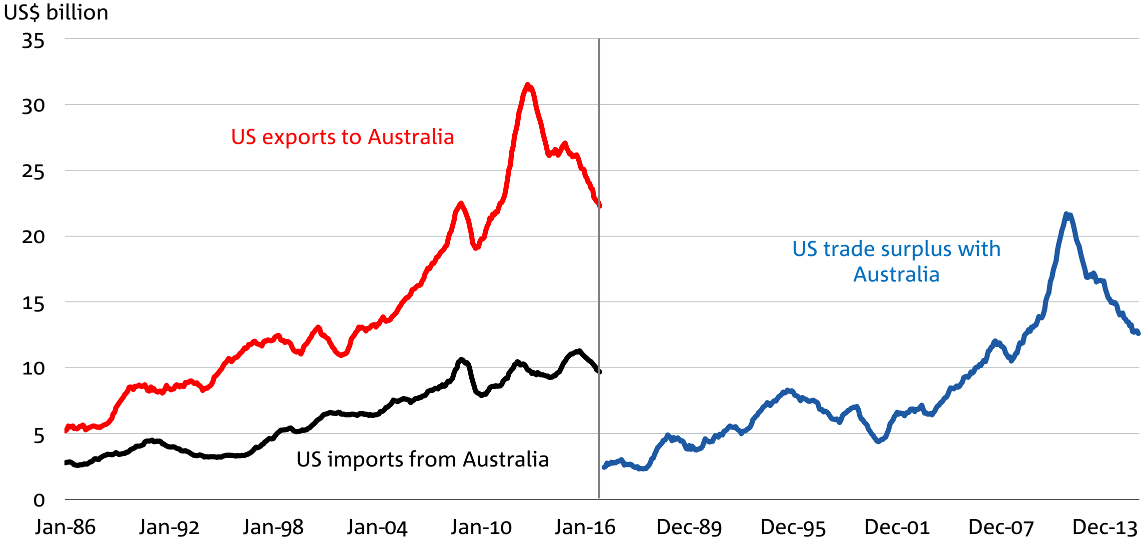
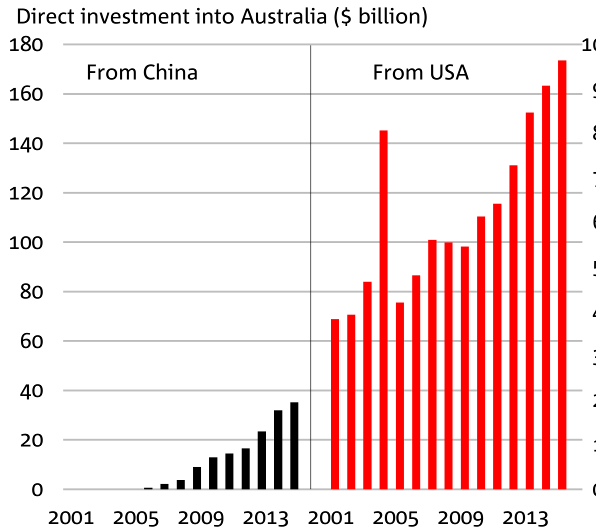
WHAT DOES IT MEAN FOR AUSTRALIA?

Many ways we can be affected, impact generally negative

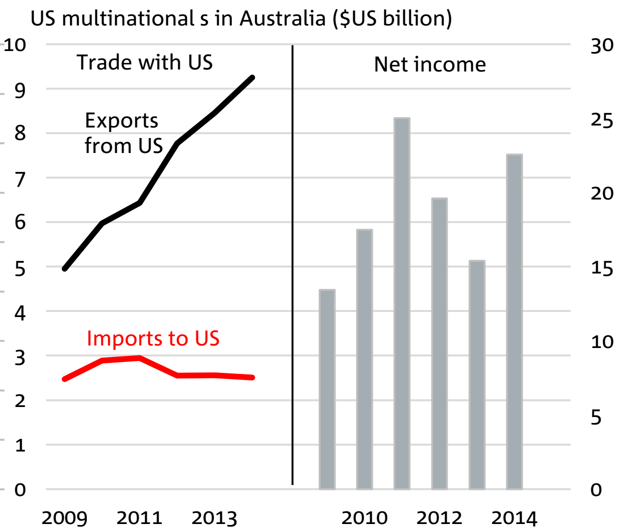
BIG BUT SHRINKING US GOODS TRADE SURPLUS WITH AUSTRALIA



US INVESTMENT OUTSTRIPS CHINA



STRONG US CORPORATE PRESENCE



- Australia's economic prospects could be affected by a US trade agenda along the lines of that outlined by Mr Trump in a number of ways:

1. China is our biggest export market (27.5% of 2015/16 exports) and the US ranks third (7% of 2015/16 exports). Despite the rapid growth in Chinese direct investment in Australia, the US stock is much bigger. Australia would face an unenviable situation in the event of a trade war between two such important partners, especially as it supplies so many raw materials to Chinese industries that could face increased barriers entering the US market.
2. A free trade agreement between Australia and the US entered into force in 2005 and Mr Trump has made it clear that he regards some of the previous US trade deals as poor outcomes. Our free trade agreement with the US has the usual clause saying either party can terminate it after 6 months notice. The Australia/US agreement has not, however been mentioned (unlike others like the Korean/US deal) and the US has a big trade surplus with Australia.
3. US multinational firms have a strong presence in Australia with sales here of $US227 billion and staff of 380000 in 2014. Most of these firms are majority owned affiliates and there is significant two way trade within US multinationals. The Australian operations of US majority owned affiliates exported $US2.5 billion to customers located in the US in 2014 but they imported far more from US-based firms ($US9.3 billion in 2014). Most of this trade occurred within the same group – Australian operations buying almost $US8 billion from their US parents and selling them $US2.2 billion. This suggests that the corporate out-sourcing, which is a focus on Mr Trump's concerns in places like Mexico, is far less of an issue here.
4. Mr Trump's tax policy would tax the worldwide earnings of US corporates promptly rather than allow them to defer paying taxes by holding their profits abroad. He proposes to allow these "trapped" foreign funds to be allowed back into the US at a concessional tax rate. Sizeable sums could be involved here as the Australian affiliates of US multinational firms had net income of almost $US25 billion in 2014 and changes in US tax rules could be expected to affect their Treasury operations.
5. Australia has always been a strong supporter of the WTO and the multilateral rules-based world trading system. Both Mr Trump and his trade nominees have pointed to weaknesses in the WTO's processes and emphasise the scope for using unilateral US power in trade issues. Australia, as a small trade dependent economy, benefits from global support for the WTO rules-based system.

Sources: ABS, NAB Economics

PART 2
TRUMP'S MENU OF TRADE OPTIONS

'If China does not stop its illegal activities, including its theft of American trade secrets, I will use every lawful presidential power to remedy trade disputes...'
Donald Trump 29 June 2016

Photo: Max Goldberg

CHINESE CURRENCY "MANIPULATION"

"Certainly they are manipulators" – Mr Trump 14 January 2017

Trump on the record over Chinese currency policy

- "At the centre of my plan is trade enforcement with China. This alone could return millions of jobs into our economy" (8 August 2016).
- "I will instruct my Treasury Secretary to label China a currency manipulator" (June 29 2016) on the first day in office (October 22 2016).
- "They break the rules in every way imaginable…illegal export subsidies, prohibited currency manipulation and rampant theft of intellectual property" (8 August 2016).
- "I am going to instruct my Treasury Secretary to label China a currency manipulator and to apply tariffs to any country that devalues its currency to gain an unfair advantage over the United States" (15 September 2016).
- "Instead of saying "we're devaluating our currency", they say "oh our currency is dropping". Its not dropping. They're doing it on purpose" (13 January 2017).
- "Certainly they are manipulators but I'm not looking to do that" (13 January 2017) – i.e. name China a currency manipulator on day one in office as previously planned – "I would talk to them first".

What can be done?

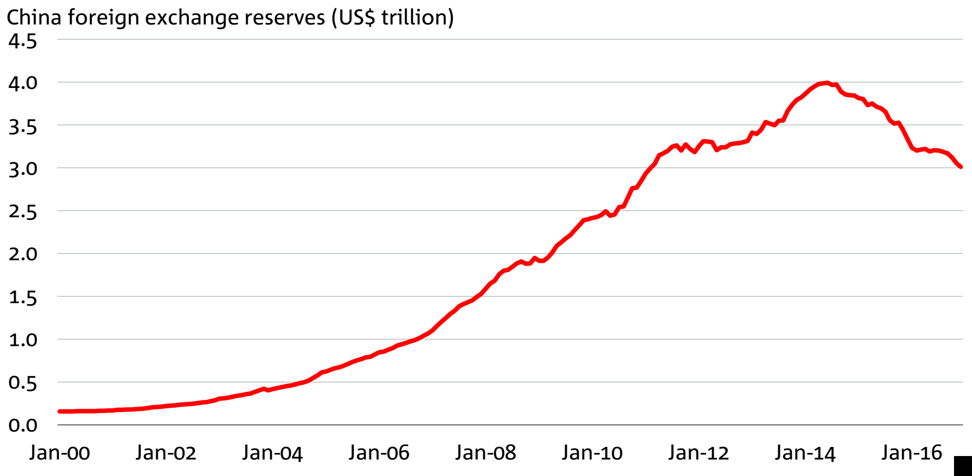
- There have been repeated Congressional efforts to enact laws combatting "unfair trade" fuelled by alleged Chinese currency undervaluation which resulted in the (milder) 2015 Trade Facilitation and Trade Enforcement Act.
- The US Treasury issue six-monthly reviews of the currency policies of countries that have big trade surpluses with the US, "material" current account surpluses and use persistent one-sided intervention in the foreign exchange market (selling their home currency to depreciate it?).
- Treasury' numerical guidelines say a country should have a $20 billion surplus with the US, a current account surplus greater than 3% of GDP and net purchases of foreign currency exceeding 2% of GDP over 12 months to be considered a currency manipulator.
- Until now, a country has to meet all 3 criteria to be called a "currency manipulator", allowing action to be taken against it. That could change.
- After trying to persuade the offender to change its policies and waiting a year, the US President can impose measures against the manipulator – but they are not very punitive – stop the Overseas Private Financing Corp from putting in new money, stop US public purchases from the offender, bring in the IMF and reconsider signing a trade deal with the manipulator.

The Bottom line

- The sanctions directly resulting from calling China a currency manipulator seem unlikely to cause sleepless nights for the Beijing leadership – they are unlikely to do much damage to an economy like China.
- The US Treasury's latest report failed to identify the Chinese as a currency manipulator, it was 1 of 6 countries on the Treasury watch list alongside Japan, Germany, Korea, Taiwan and Switzerland.
- Although the RMB has been falling, the IMF assessment is that China's currency is "broadly in line with fundamentals" - i.e. not undervalued. Other analysts agree. While the RMB could have been undervalued in the past, that is a much harder case to make now.
- China's current account surplus has been trending down and that is expected to continue, recent regulations have been making it harder to take money out of the country (rather than the easing in capital exports which would hold down the RMB), China's reserve assets have been falling which suggests the authorities are propping up the currency rather than helping it fall and offshore markets are signalling that the currency has further to fall.
- While Mr Trump can instruct his Treasury Secretary to label the Chinese as "currency manipulators" the impact is limited and the case looks weak.

OUR GUESS – LIKELY DESPITE A WEAK CASE

CHINESE FX RESERVE ASSETS NOW FALLING, RMB BEING PROPPED UP



Sources: CEIC, NAB Economics

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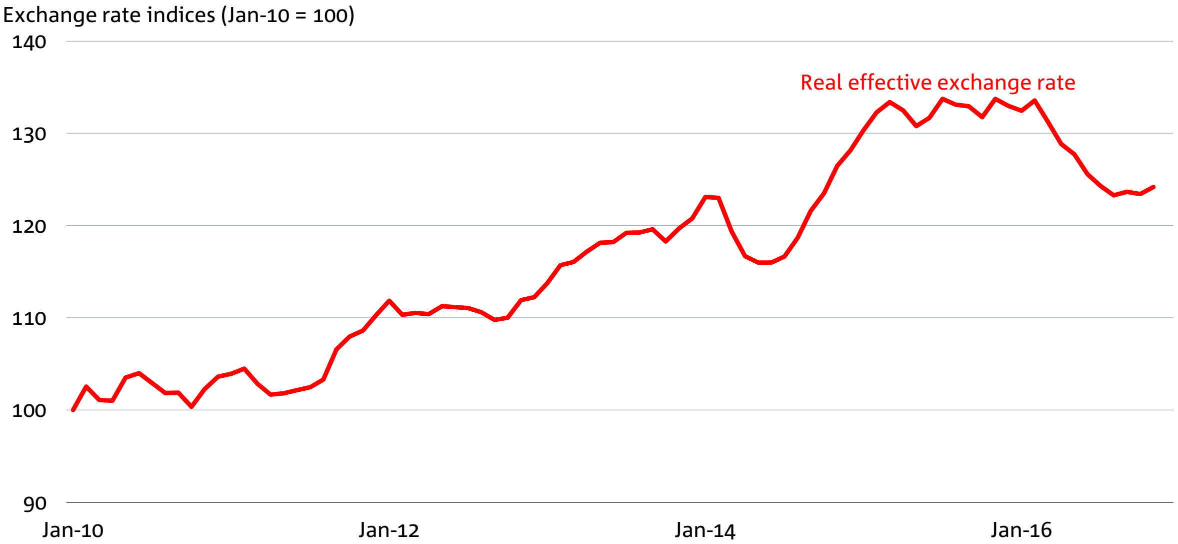
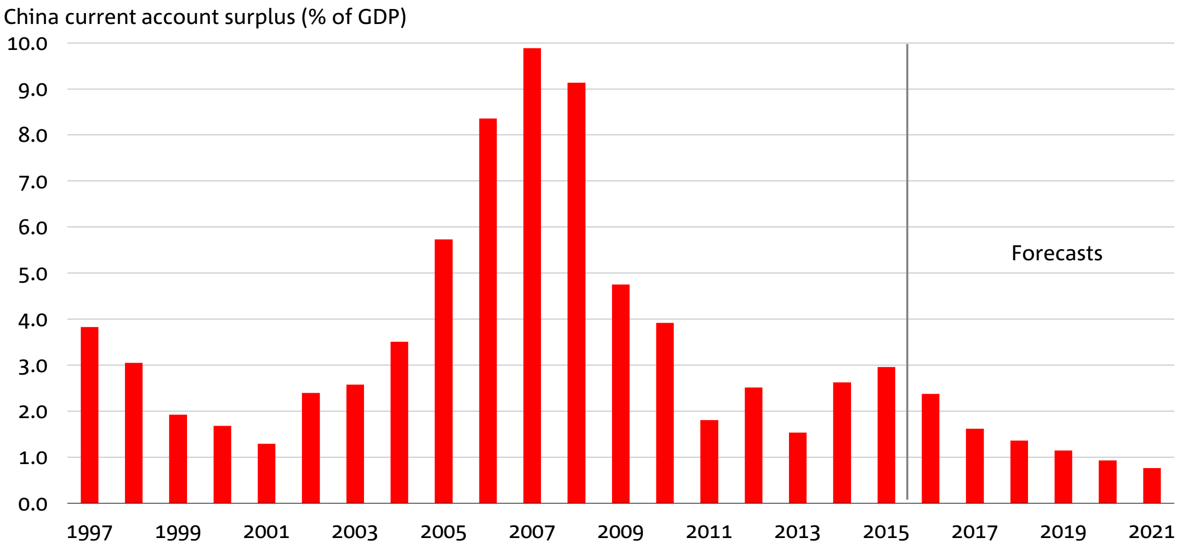
PUT EXTRA TARIFFS ON "UNDERVALUED" CHINESE GOODS

Chinese entry to the WTO enabled "the greatest jobs theft in history" – Mr Trump 28 June 2016

WORSENING TREND IN CHINA'S COMPETITIVENESS



BIG DECLINE IN CHINA'S CURRENT ACCOUNT SURPLUS



Sources: CEIC, NAB Economics

- Mr Trump could bring out bigger guns against alleged Chinese currency under-valuation and impose countervailing tariffs against Chinese exports that have been allegedly subsidised by this currency policy. Mr Trump has spoken of a 45% tariff on imports from China.
- Mr Trump has said that after China has been labelled as a currency manipulator "this will begin a process that imposes appropriate countervailing duties on artificially cheap Chinese products". Many protectionist efforts by US Congressmen have been aimed at getting duties imposed on Chinese goods brought "unfairly" into the US at undervalued USD/CNY exchange rates. Past efforts to write into US law that a "fundamentally undervalued" Chinese exchange rate amounts to an export subsidy to Chinese shippers have failed. If that could be written into US law, it would make it easier to impose countervailing duties on imported goods.
- The US Commerce Dept has not treated currency manipulation as tantamount to export subsidies in the past but there are plenty of previous bills for the Trump administration to pick up if it wants to toughen up the regime facing Chinese exporters to the US.
- There are, however, good reasons for the US Commerce Dept's position

1. The Chinese currency is probably not under-valued right now – China's current account surplus as a share of GDP has fallen from 10% in 2007 to just over 2% in 2016. The IMF expects that surplus to fall under 2% this year (below the US Treasury's current threshold level for identifying currency manipulators), trending down to ¾% of GDP by 2021.
2. Currency undervaluation may well not represent subsidies to exporters in terms of the WTO rules. If the US takes China to the WTO and loses its case, it will deliver a publicity victory to the Chinese. If the US unilaterally imposes countervailing duties on allegedly subsidised imports from China, the Chinese will probably take a case to the WTO and could also retaliate against US exports. However such a case could take a long time to conclude and in the meantime Chinese exporters will face higher tariffs in the US. The US government could also refuse to accept an unfavourable WTO decision and keep applying the duties on Chinese exporters, living with Chinese trade retaliation.

OUR GUESS – LIKELY DESPITE A WEAK CASE

IMPOSE GENERAL TARIFFS UP TO 15%

Trump advisers discussed across the board hikes in tariffs

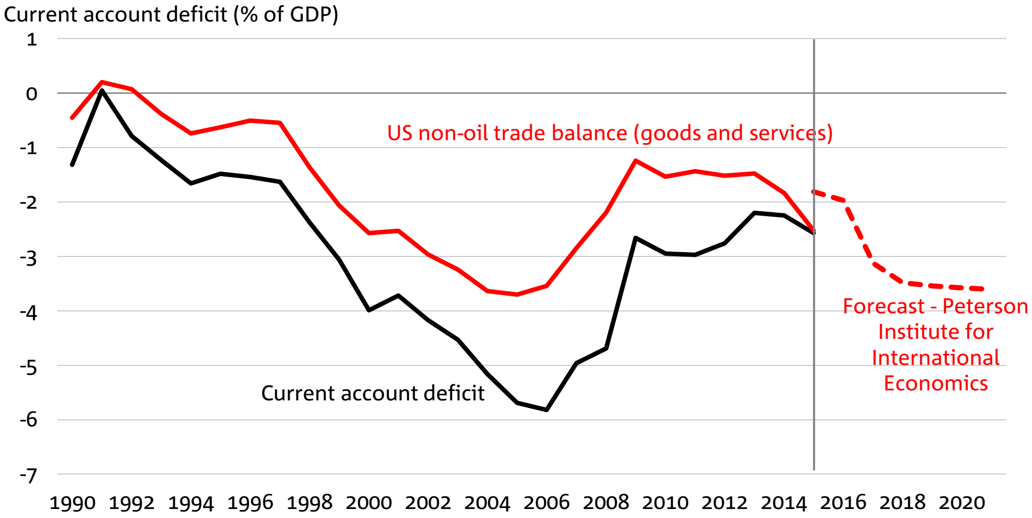
What the law allows

- Section 122 of the 1974 Trade Act allows the US President to impose a temporary import surcharge of up to 15% and/or import quotas for up to 150 days if the US faces "fundamental" problems with its balance of payments. Congress can extend measures beyond this 150 day period.
- These trade measures are imposed to deal with "large and serious US balance of payments deficits" or to prevent "an imminent and significant depreciation" of the US$.
- These tariff hikes and quotas should ordinarily be imposed across all US trading partners ("non-discriminatory treatment") but, if the President thinks it best to target just one or more countries "having large or persistent balance of payments surpluses", that can be done.
- Although the US now has a floating currency in which old style balance of payments crises should no longer arise, US administration lawyers would probably argue that a big or widening US current account deficit should be the new yardstick for application of the law. Some estimates predict that the US current account deficit is set to widen through the next 5 years.
- Trump advisers have reportedly considered across-the-board 5 to 10 percentage point hikes in tariffs and this provision could offer them legal cover.

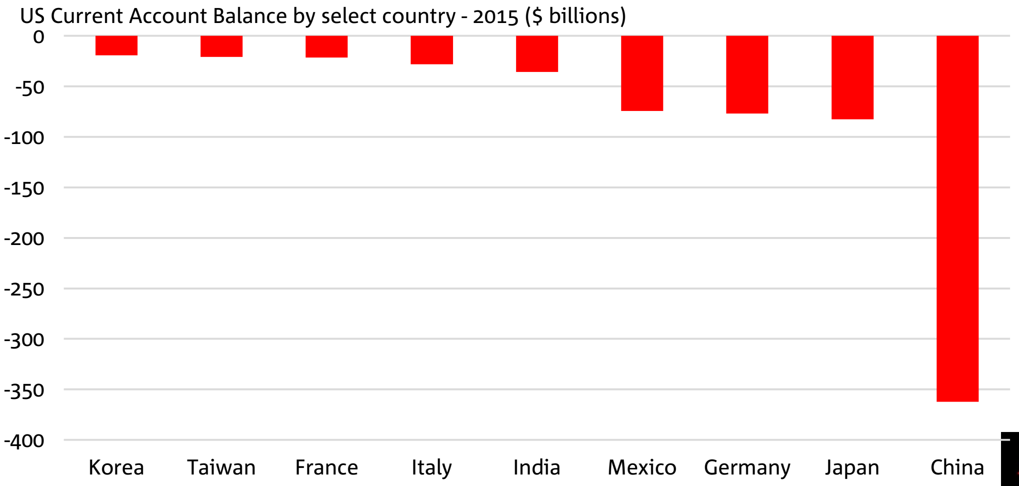
The precedent - Nixon's 1971 10% Import Surcharge

- President Nixon imposed a 10% surcharge on imports to pressure trading partners like Japan and Germany to lift their currencies, boost the competitiveness of US industry and improve the US balance of payments.
- This move followed a spate of protectionist bills in the US Congress and a US Treasury assessment that the US$ was 10 to 15% overvalued.
- The US Treasury wanted a $15 billion improvement in the US balance of payments and the preferred way to secure this was a big appreciation in the currencies of its major trading partners. The import surcharge was intended to put pressure on them to appreciate their currencies and eventually it worked to result in an 8% depreciation of the US$.
- The IMF felt that the US move was reasonable. Although the GATT did not like the approach, it did nothing to stop it and domestic legal challenges through the US courts failed to strike down the surcharge.
- Overall, the Nixon surcharge offers an interesting precedent for Mr Trump's team as it showed just how much power the US president could exert in the area of foreign trade and remain within national and global law.

US CURRENT ACCOUNT DEFICIT SET TO WIDEN



CURRENT ACCOUNT DEFICIT WITH CHINA IN A LEAGUE OF ITS OWN



 Sources: Datastream, PIIE, US Census Bureau, BEA, NAB Economics

OUR GUESS - POSSIBLE

National Australia Bank

TARGETED TARIFFS ON IMPORTS DUE TO UNREASONABLE/UNJUSTIFIABLE POLICY

"We allowed foreign countries to…cheat in every way imaginable" – Mr Trump 28 June 2016

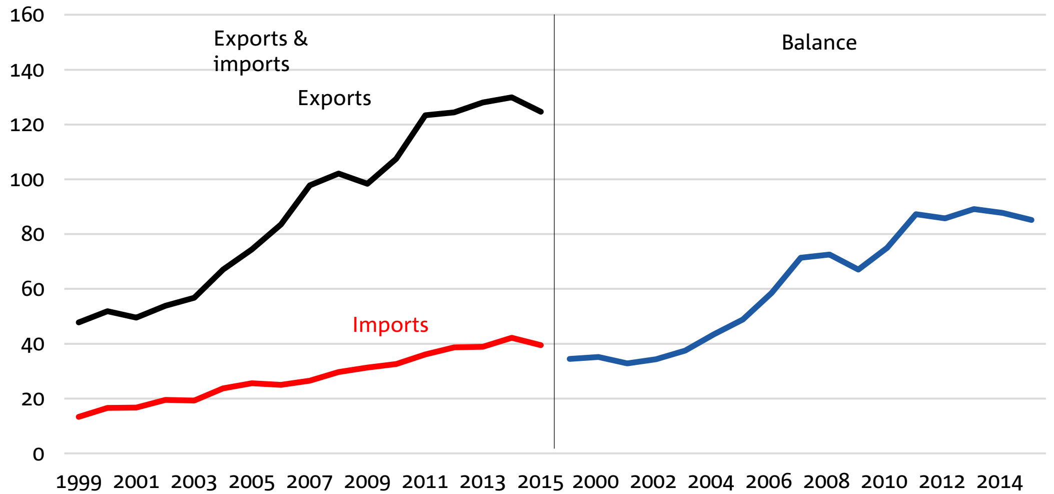
Section 301

- Mr Trump has specifically mentioned another arm of US trade legislation that can be used to curb imports – Section 301 of the 1974 Trade Act.
- Unlike the across the board tariff hikes covered in Section 122, these measures can be targeted more precisely on particular products and countries and there is no sunset provision after which Congressional approval is needed.
- The US Trade Representative must take action if the US is being denied its rights under any trade agreement or a foreign country's policies are "unjustifiable" or " burden and restrict" US commerce. Discretionary actions are also possible if foreign policies or actions are "unreasonable or discriminatory and burdens or restricts US Commerce".
- If the case is proved, the President can impose duties or other import restrictions or suspend the concessions made under a trade agreement.
- While big tariffs were imposed under this provision by US governments in the 1980s to pressure foreign suppliers, a 2000 WTO panel decision made it harder for the US to use it unilaterally as it agreed to use the WTO dispute resolution system before it unilaterally imposed higher tariffs.

How could it be used?

- Given Mr Trump's focus on China's alleged use of currency undervaluation, government subsidies to state enterprises and misappropriation of US intellectual property, the US could say that such conduct is unfair trade that is "unreasonable", "unjustifiable" and that it "burdens or restricts US commerce."
- Robert Lighthizer, Mr Trump's nominee for US Trade Representative, wrote that the US "forfeited" its ability to use Section 301 effectively when it agreed to go first to the WTO's dispute resolution systems. However he then went on to say that "WTO commitments are not religious obligations" and hinted that the US might need to consider breaching them, accepting the consequences.
- The US Trade Representative issues annual "Special 301 Reports" that assess the extent to which foreign countries protect and enforce the intellectual property rights of US creators.
- Countries are put on various watch lists, drawn up in accordance to which their actions or policies have the greatest adverse impact (actual or potential) on US intellectual property. China is on the highest grade of watch list, Canada and Mexico are on a second list reserved for less egregious offenders and the aim is to put pressure on foreign governments.
- Section 337 of the Tariff Act can be used to exclude products from the US market if they breach US intellectual property (trade marks, copyright etc).

MASSIVE US EARNINGS IN IP VULNERABLE TO UNFAIR TRADE



COUNTRIES TARGETTED BY US FOR MONITORING OF IP BREACHES

Priority watch list	Watch List	
Algeria	Barbados	Jamaica
Argentina	Bolivia	Lebanon
Chile	Brazil	Mexico
China	Bulgaria	Pakistan
India	Canada	Peru
Indonesia	Colombia	Romania
Kuwait	Costa Rica	Switzerland
Russia	Dominican Republic	Turkey
Thailand	Ecuador	Turkmenistan
Ukraine	Egypt	Uzbekistan
Venezuela	Greece	Vietnam
	Guatemala	

OUR GUESS - LIKELY

 Sources: BEA, Office of the United States Trade Representative, NAB Economics

National Australia Bank

HIGHER TARIFFS TO PROTECT NATIONAL SECURITY

"You pass factory after factory that's empty and rusting" – Mr Trump 24 November 2016

Section 232

- Taking action under Section 232 of the 1962 Trade Expansion Act offers another protectionist approach that Mr Trump has specifically mentioned.
- Imports of products that "threaten to impair the national security" are the focus and the President has the power to cut them to the point that they are no longer such a threat.
- What constitutes "national security' is not defined but the focus is on maintaining the domestic capacity and output of strategic defence industries and ensuring access to required inputs of skilled labour and raw materials. The other concern is to prevent the US becoming dependent on "unreliable or unsafe imports" - so there is a narrow defence-related interpretation of the cases that could flow as well as a broader one related to national economic security.
- The US President has discretion to "determine the nature and duration of the action that must be taken to adjust imports of the article and its derivatives so that imports will not threaten to impair the national security"
- The President makes this decision once the US Bureau of Industry and Security has reported on whether the case has merit.

How could it be used?

- This protectionist measure has not been used very often (the last time was in 2001) but it offers potential in two ways:

1. To cut imports of particular products and preserve US capacity – several of the cases involved small amounts of very specialised products for the defence industries but a few have been more wide-ranging e.g. steel, crude oil and uranium.
2. As legal cover for broad-based multi-product import controls – it was one of the laws used by US Government lawyers to defend Nixon's 1971 import surcharge when it was challenged in the US courts by aggrieved imports.

- If countries affected by the use of this protectionist measure appealed to the WTO, the US could rely on the "national security exception" which allows countries to deviate from WTO rules in times of "emergency in international relations". The Trump administration could say that the erosion of the US industrial base constitutes an emergency, introduce wide-ranging import controls and probably be able to fend off challenges in the WTO and domestic courts. Of course, foreign suppliers could retaliate against such a move.

Source: Paul Lowry, cropped from original

Source: cortto, cropped from original

OUR GUESS – POSSIBLE BUT UNLIKELY

EMERGENCY LEGISLATION GRANTING FAR REACHING POWERS TO THE PRESIDENT

Supposedly reserved for wars and real emergencies - but still on the law books

Trading with the Enemy Act

- This law gives the President sweeping powers to block and regulate economic activity – including imports- and it should only operate when the US is at war. It does not specifically authorise lifting tariffs.
- Free trade advocates have raised concerns it might not take a formal declaration of war by Congress to trigger the statute – the US has been involved in many military actions with no prior Congressional authorisation.
- Imposing tariffs under this law would lead to legal objections and court cases. The US administration would argue that exercising these powers did not need a Congressional war declaration and there are threats from ISIS etc. The US could also argue that any import controls were legal under WTO law as they were made under the national security exception.
- Some trade lawyers think that the statute could not be used to impose or lift tariffs as its definition of war makes it quite clear that Congressional authorisation is needed and the US is not officially at war with anyone.
- Despite some rather alarming writings about how this Act could underpin more trade protection in the US, those wanting to curb imports would appear to have better options to achieve that goal than relying on this law.

International Emergency Economic Powers Act 1977

- This law is to be used only where there is "any unusual and extraordinary threat, which has its source in whole or substantial part outside the United States, to the national security, foreign policy or economy of the United States".
- The President has to declare a national emergency with respect to that threat and then sweeping powers to regulate the economy are granted – but imposing or lifting tariffs is not specifically mentioned.
- This Act has been mainly used in the past to underpin US sanctions on countries like Iran or North Korea rather than to pursue an aggressive trade agenda aimed at improving the US trade balance or creating jobs.
- Again some trade lawyers worry that this law could be used to legally underpin moves against imports from countries like China or Mexico. The outcome would almost certainly be court cases and concern in Congress that its "essential legislative superiority" in trade law was being undermined by a president using it to pursue the White House agenda.
- There would also probably be WTO cases by aggrieved parties but again the US could use the national security exception against such a move.

OUR GUESS - UNLIKELY

National Australia Bank

NORTH AMERICAN FREE TRADE AGREEMENT – RENEGOTIATE OR THE US LEAVES

"The trade deals like NAFTA…that have shipped your jobs to Mexico" – Mr Trump 9 August 2016

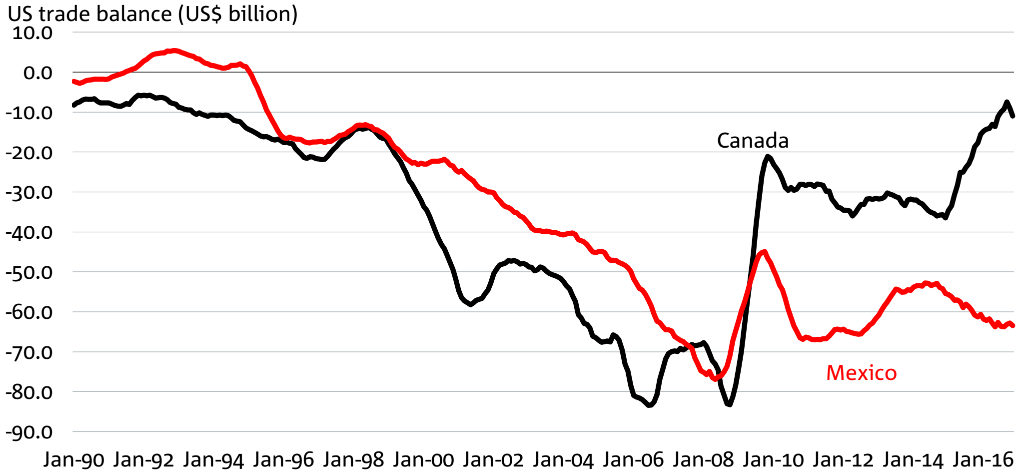
NAFTA

- NAFTA began in 1994 and it is a free trade agreement involving the US, Canada and Mexico. It has always been politically contentious with 44% of US citizens surveyed in 2016 thinking it was bad for the US economy as opposed to 29% who felt it was economically positive.
- Lower wages and job losses are blamed on NAFTA, especially as US firms outsource supply to lower wage cost Mexican plants. The trade figures show US imports from the Mexican affiliates of US multi-nationals easily exceed their exports from US plants to Mexico. Cars, auto components and electronics account for much of that intra-firm trade.
- Pre-NAFTA the US was running trade surpluses with Mexico but since then the goods deficit has widened from $US25 billion in 2000 to $US50 billion in 2005, $US66 billion in 2010 and $US63 billion in the 12 months ended November 2016. The US also runs a much smaller trade deficit with Canada.

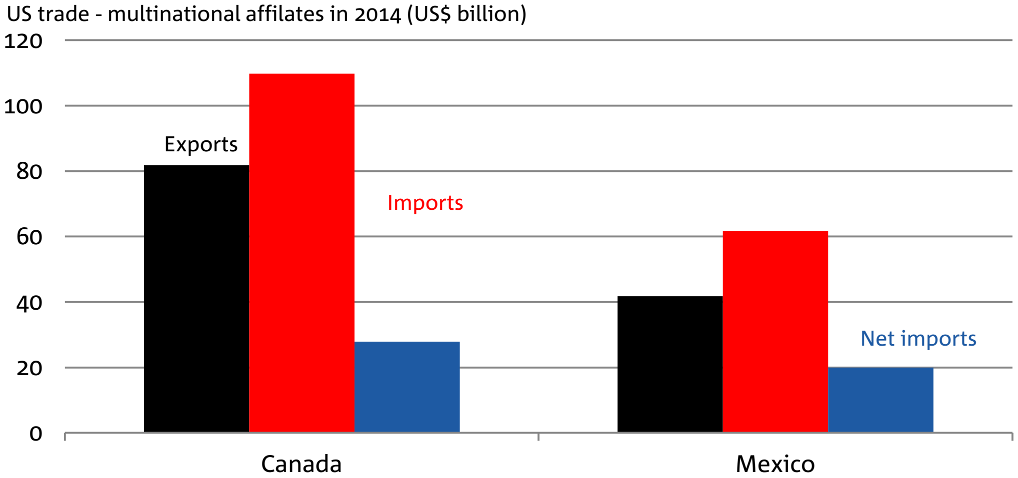
Mr Trump's agenda

- Mr Trump has been quite clear – either the NAFTA partners renegotiate the agreement or the US will leave it and he has also threatened to put a 35% tariff on imports from Mexico. How this tariff fits WTO rules remains unclear.
- The aim is to "entirely renegotiate NAFTA into a deal that will either be good for us or will be terminated" – which suggests more than minor amendments – and the outcome should be "to get a better deal for our workers".
- He has said he will start this process on his first day in office.
- There seems little doubt that Mr Trump could pull the US out of the agreement – it contains an article allowing the US to leave after giving six months notice and other laws allow the US to reimpose tariffs.
- There could be retaliation. Canada and Mexico are the biggest US export markets and Canadian opinion polls show a majority favouring re-erecting tariffs against the US if Canadian exports lose duty-free status into the US.

US TRADE DEFICIT WITH MEXICO THE MAIN FOCUS OF TRUMP'S CONCERN



US MULTINATIONALS NAFTA PARTNER IMPORTS EXCEED US EXPORTS



OUR GUESS – JUST ABOUT CERTAIN

Sources: Datastream, BEA, NAB Economics

National Australia Bank

HIGH TARIFFS ON THE OUTSOURCED PRODUCTS OF US MULTI-NATIONALS

"You want to move your plant…you're going to pay a very large border tax" – Mr Trump 11 January 2017

The agenda

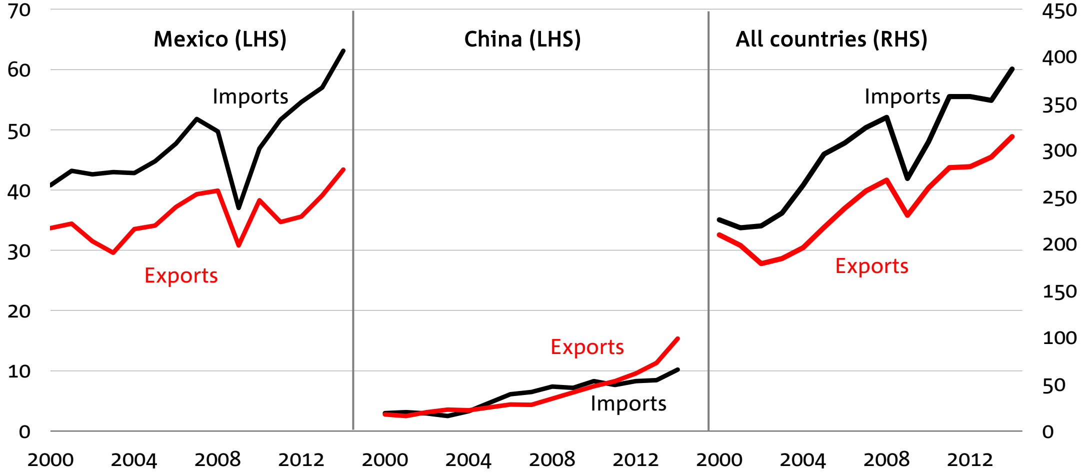
- "any business that leaves our country for another country, fires its employees, builds a new factory or plant in the other country and then thinks it will sell its product back into the US without retribution or consequence is WRONG. There will be a tax on our soon to be strong border of 35% for these companies wanting to sell their product, cars, AC units, electronics back across the border" (December 4 2016).
- "you want to move your plant and you think, as an example, you're going to build that plant in Mexico and you're going to make your air conditioners or your cars…and you're going to sell them through a very very strong border. Not going to happen. You're going to pay a very large border tax" (January 11 2017)
- Several multinationals have been criticised by Mr Trump for moving capacity from the US to Mexico or planning big investments in Mexico. In the case of a Toyota expansion, his comment was "build plant in US or pay big border tax".
- US multinationals import more into the US than they export to their foreign affiliates with Canada and Mexico being major foreign assembly platforms while China plays a much smaller role in the outsourcing activities of US multinationals.

Is this legal?

- It is not clear just how Mr Trump's mooted 35% "strong border" tariff will work and there is not much precedent to go on for applying special tariffs to particular types of firm. If a 35% tariff is simply applied to imports from the Mexican plants of US multinationals, there is a good chance someone will challenge it in either the WTO (e.g. Mexico) or in the US courts.
- Given that such a measure appears discriminatory in intent, any non-discrimination provisions in WTO trade law could offer those affected some legal avenues. There is also the chance that a 35% tariff could lead to an action based on the argument that it nullifies or impairs the supposed benefits of an agreement and undermines the security and predictability of the US tariff regime.
- There are provisions in US trade law that allow the President to lift or impose tariffs on certain products as well as provisions that allow across the board tariff increases, but imposing firm-specific tariffs would be very unusual.

US OUTSOURCING SENSITIVITY FOCUSES ON MEXICO, NOT CHINA

US multinationals trade with foreign affliates (US$ billion)



Carrier	Plans to close production facilities in Indiana and build new plant in Mexico was strongly criticised by Trump during election campaign. Following the election, a tax break deal was arranged to keep jobs in the United States.
Oreo	Trump announced he'd never eat Oreo biscuits again after Nabisco announced plans to cut jobs at its plant in Chicago and move roles to Salinas, Mexico.
Ford	Cancelled plans to open $1.6 billion plant to build Focus compact car in San Luis Potosí Mexico and shift production of Lincoln models from Kentucky to Mexico. Instead will introduce $700 million expansion to Michigan plant.
General Motors	Trump attacked GM for building the Cruze compact car in Mexico and exporting to the US tax free (under NAFTA agreement). Threatened border tax on Mexican built vehicles. GM noted that most US sold Cruzes are built in Ohio, with this plant not equipped to build the hatchback model produced in Mexico.
Toyota	In response to Toyota's plan to build a $1 billion plant to manufacture the Corolla (second largest selling compact car in US) in Guanajuato Mexico, Trump tweeted 'NO WAY! Build plant in US or pay big border tax.'
BMW	In interview with German newspaper Bild, Trump threatened to impose a border tax of 35% if BMW builds a new plant in Mexico which would also export to the US.
Boeing	Critical comments made on Twitter regarding cost of Presidential Air Force One program drove Boeing's share price lower.
Lockheed-Marin	Critical comments made on Twitter regarding cost of F-35 fighter program drove Lockheed-Martin's share price lower (and Boeing's higher).

OUR GUESS – POSSIBLE BUT UNLIKELY

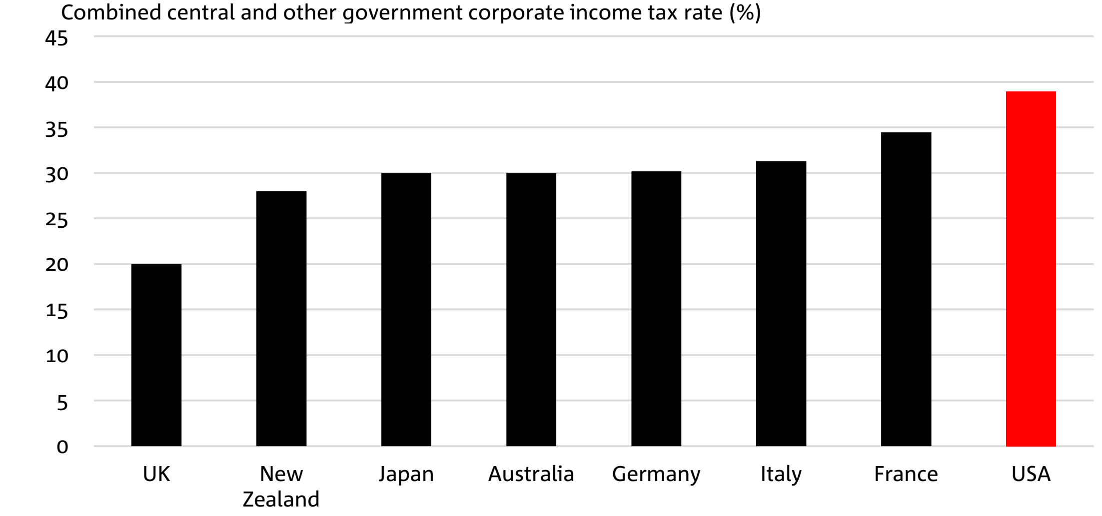
 Sources: BEA, NAB Economics

National Australia Bank

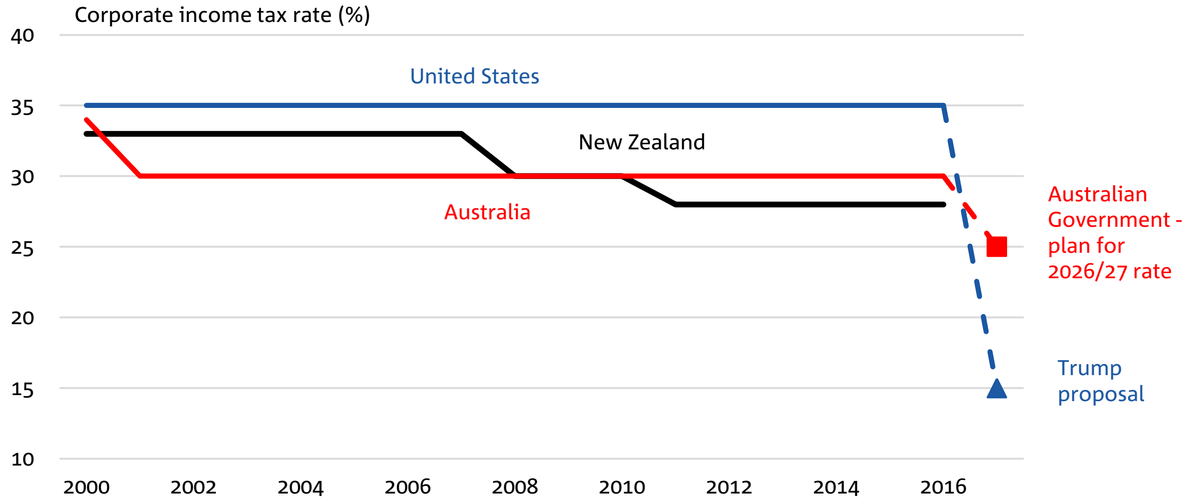
BORDER TAX ADJUSTMENTS THAT TAX IMPORTS AND HELP US EXPORTERS

"Any time I hear border adjustment, I don't love it" – Mr Trump 13 January 2017

US CORPORATE TAX RATE HIGH BY OECD STANDARDS



TRUMP TAX PLAN OVERTURNS RELATIVITIES WITH AUSTRALIA/NZ



Source: OECD (central government corporate income tax rate)

OUR GUESS – POSSIBLE BUT UNLIKELY

- The 35% federal US corporate tax rate is well above the OECD average, giving US corporates incentives to shift their place of incorporation ("inversions") and hoard the profits of their foreign operations in low tax centres rather than bring them back to face high US corporate taxes.
- Mr Trump's election platform contained drastic cuts in company taxes (from 35% to 15%) and tax concessions to encourage US firms to bring back the supposed trillions in cash they were keeping abroad for tax purposes. At the same time, the Republican Party issued its own tax plan which differed in some key respects from Mr Trump's.
- One of these differences concerned how US exporters and importers would be treated. The Republicans argued that US exporters were penalised and importers helped because most of its trading partners ran GST-type indirect tax systems that rebated taxes back to exporters and imposed taxes on imported products. By contrast, the US does not have a GST and so US exporters implicitly carry the cost of US income tax while imports to the US do not bear any US income tax cost.
- The Republican party proposes "border adjustments" and cash flow rather than "income" based taxation – to ensure that exporters do not pay US income tax while all imports will pay tax in the US. Supposedly this change will level the playing field, The "border tax adjustment" makes sure that US business is not disadvantaged compared to rivals operating in systems with GSTs and removing the incentive for US corporations to move for tax reasons.
- This would amount to a major change in global tax arrangements and the proposal has aroused a lot of concern but, judging by his recent comments, Mr Trump clearly has reservations with the idea.

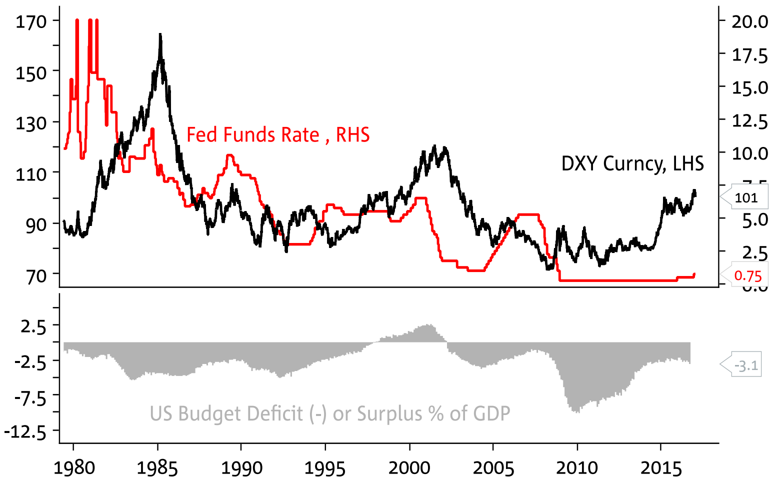
1. Powerful US businesses like Walmart and Koch plus industry lobbies like the retailers are concerned at the impact imposing an extra layer of taxes on imports would have on their profits. Many US corporations run integrated global supply networks – they brought in $US370 billion from their foreign affiliates in 2014 – and dislike higher taxes.
2. This plan would almost certainly be challenged in the WTO and it could well fail as the WTO tax rules for border adjustments are designed for indirect taxes like the GST, not direct ones like company tax.
3. The $US would be expected to appreciate if the US moves to lift the cost of imports and help exporters, offsetting at least some of the plans supposed benefits.

National Australia Bank

US DOLLAR MOVES – A CRITICAL DRIVER OF US TRADE OUTCOMES

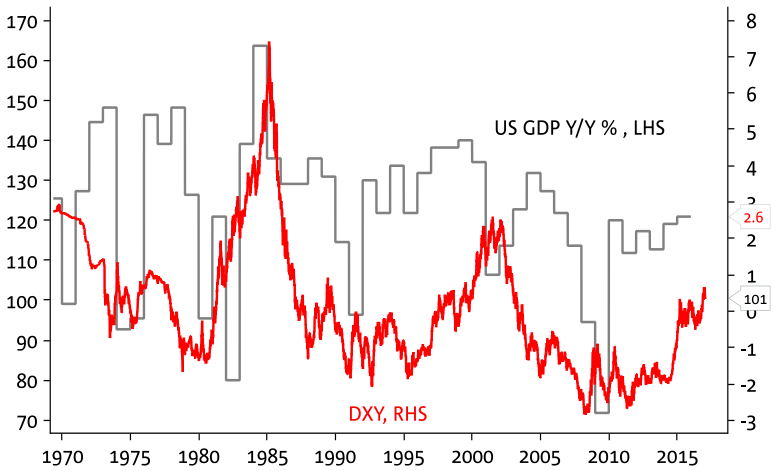
Trump will come to accept a stronger dollar

FISCAL/FED POLICY MIXES AND THE USD



Source: National Australia Bank, Macrobond

THE USD AND GDP GROWTH CYCLE



Source: National Australia Bank, Macrobond

- Assuming the US administration holds back from immediately labelling China a currency manipulator, as Mr.Trump suggests in his recent Wall Street Journal interview, there is still plenty for currency markets to fret about with regards to his soon-to-unfold trade as well as fiscal policy agendas. On both counts, there is significant potential for a high degree of US dollar volatility with policies on both fronts likely to remain in a state of flux for some months to come.

- On trade policy, repeated tweets from Trump threatening manufacturing firms with a 'big' border tax if they establish manufacturing facilities outside but then sell into the United States, is already resonating. The Republican plan for a border tax adjustment, intended as both a tariff on imports and a subsidy for exporters, is regarded as likely to produce a significantly stronger dollar. Hence the dollar sell-off when Trump signalled his dislike of a border tax adjustment in the aforementioned WSJ interview, describing it as 'too complicated'.

- If instead the border tax idea is simply reduced to a tax on imports (akin to a VAT/GST but not levied on domestic producers) it should still be inflationary, either directly by raising the cost of imported goods, or indirectly by encouraging import substitution in favour of higher priced domestically produced goods. Higher inflation would equate to tighter than otherwise Fed policy and a firmer dollar. Alternatively, the US dollar can directly rise following the imposition of an import tariff – perhaps because tariffs initially shrink the US trade deficit. Either way, import tariffs mean a stronger USD.

- US official rhetoric regarding the dollar will also be an important source of volatility, at least over short time-frames. Mr.Trump's distaste for a strong dollar is already well known ('our currency is too strong. And it's killing us'). Yet we'd doubt that 'open mouth operations' alone by the President can suffice to prevent the dollar from responding appropriately to the effects of his policies, or irrespectively to US economic performance and its Fed policy consequences. We'd rather identify with comments from Trump adviser Anthony Scaramucci, that "If you get better than expected growth in the U.S......you can have a strong dollar and fairly robust growth....that will lift the global economy". The nominee for Treasury Secretary has also indicated support for a strong dollar over the long run in his recent testimony.

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