US-CHINA TARIFFS – AN UPDATE SEPT. 2018

Impacts contained for now, but still risk of further escalation with ending unclear

NAB Group Economics

Recent tariff announcements are a modest negative for growth in US and China although Chinese policy will look to offset the impact. If markets remain calm and the tariff war does not escalate further, particularly to other countries, the impact should be contained. US-China tariffs are a negative for the AUD but threatened future actions are largely already priced in. For interest rates, as we expect a modest economic impact we have not changed our forecasts - we still see the US Federal Reserve lifting their funds rate further and in time the RBA following with a higher cash rate – there are both upside and downside risks to our rates forecasts.

On 24 September, a 10% tariff will be imposed on $200b of Chinese imports. From 1 January 2019 this rate will go up to 25%. China has announced retaliatory tariffs of 5-10% on $60b of US imports. The US measure is on top of the 25% tariffs imposed on $50b of Chinese imports over July/August (China also imposed tariffs on $50b of US imports at this time).

Trade state of play

Measure	Status	Overseas Retaliation?
20-50% on washing machines/solar panels	In-place	
Steel (25%) & aluminium (10%)	In-place	Yes
25% on $50b China imports	$34b 6 July $16b 23 August	China - 25% tariffs on $50b of US imports
25% on $200b China imports	10% tariff on $200b from 24 Sep. 2018, increasing to 25% from 1 Jan. 2019	China - 5-10% tariffs on $60b of US imports
$267b China (rate unclear)	Threatened if China retaliates to $200b tariff	?
20-25% on autos (Europe or all, possibly includes parts)	US Section 232 investigation report delayed as EU/US work towards agreement for zero tariffs on non-auto industrial goods	Threatened
NAFTA re-negotiation	US/Mexico reached agreement in August. Canada/ US in talks; US has set end Sept. deadline	n.a.

What are the impacts going to be?

The ways tariffs can impact economies include:

- Direct impacts: most obviously on trade, but a tariff is just a tax so it represents a fiscal contraction (reducing household/business income and spending) albeit one where the burden falls more on foreign producers.
- Financial channels: as it represents a supply shock it could depress share markets (wealth effects); financial market reaction in the form of widening spreads (increasing cost of credit) could reduce investment. Note: this has not happened to date in advanced economy markets.
- Uncertainty & confidence effects: this has the potential to have the largest impact in the short to medium term if businesses defer investment and employment decisions due to uncertainty over future trading arrangements. Risk aversion may make households and businesses more cautious.
- Productivity loss (supply shock): businesses may move to alternative (less efficient) suppliers and other benefits of trade (transfer of ideas/technologies) reduced. As part of this process, production/investment may shift (divert) to other countries.

How other policy settings (e.g. fiscal/monetary policy) respond will also be important factors in the final wash up.

Markets have so far reacted calmly to the US/China tariffs; nor has there been an obvious impact on commodity prices. This may be because the moves were expected and therefore priced in. Overall, financial market indicators (outside of some EM countries equity markets and exchange rates) are not showing signs of being particularly stressed. This also suggests that potential confidence effects will be limited at least without further escalation of the dispute. The ‘supply shock’ channel is more a long-run story, so the main initial impact will be the direct impacts, although the risk of delayed investment remains real.

Looking at the US first, the 25% tariffs (from 1 January) on $250b of imports from China represents a fiscal contraction of around 0.3% of GDP. This is of course much smaller than the stimulus put in place earlier this year (over 1%) but nevertheless, in itself, is a drag on activity by 0.1- 0.2 ppts. It is not clear that policy will actively try to offset any trade headwinds; expectations around further Fed tightening have not really shifted, and while the US administration may try to compensate sectors hurt by Chinese retaliation (as it did for soybean farmers) it may be constrained by the need for congressional approval.

This is at the bottom end of estimates of tariff impacts found by past research, consistent with the absence of any major impacts to-date from the financial and confidence channels.

US exports to China will also come under pressure due to the tariffs imposed by China. All up the fiscal and trade impacts could justify taking 0.2- 0.3ppts off our US growth forecasts (spread over 1-2 years). However, this needs to be seen in the light of upside risks to our current forecasts from strong recent data. With US growth well above trend, an impact of this magnitude would not derail the US economy.

For China, the two main direct impacts will be from trade – with exports to the US representing just over 3% of GDP (and about half of these exports now impacted by these tariffs) – and income effects. The depreciation of the Yuan against the US dollar by 10% since April does offset the initial 10% tariff rate for now but worsens the income effects (as imports into China will cost more). A 0.7ppt subtraction from GDP growth from these two channels appears a reasonable estimate.

However, there has already been a Chinese policy response - and this could ramp up further. So far, Chinese authorities have increased tax rebates for exporters, loosened restrictions on infrastructure investment and eased monetary policy. Our initial assessment is that the authorities have the scope to offset much of the direct impacts from the tariffs; although a concern is that the labour intensive manufacturing sector could take a hit, placing pressure on employment.

Other countries, even absent significant confidence or financial impacts, can also be affected by a decline in activity in the US or China through reduced trade.

However, there are also opportunities – US and Chinese importers will be looking for alternative suppliers of goods now subject to tariffs. These trade diversion impacts may boost activity in other countries, although this process may take time.

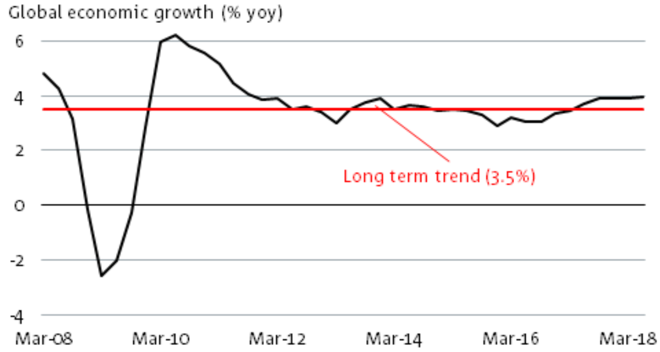
Australia is unlikely to benefit much from such trade diversion effects given where our strengths lie. Should Chinese manufacturing shift, it would be more likely to go to neighbouring low cost countries or Mexico given its proximity to the US market.

However, there may be some opportunities opened up (e.g. to replace US agricultural exports to China or Australia's LNG sector could benefit from China's decision to impose 10% tariffs on US LNG imports).

China and other East Asian countries are part of highly integrated supply chains, with exports from China including components produced in the rest of the region. As a result, a reduction in US imports of Chinese products will directly flow through to other East Asian economies.

Global growth to the June quarter 2018 was at its highest level since September 2011 (at around 4.0% yoy). Our expectation is that global growth is near the peak of the current cycle – as the signs of stresses in a number of emerging markets grow and constraints in advanced economies start to bite (leading to higher policy rates). Overall, we have been expecting global growth to ease in coming years from 3.8% in 2018 to 3.7% in 2019 and 3.5% (the long term trend rate) in 2020. While, as noted above, the tariff developments may lead us to edge down our US forecasts, this is unlikely to change this broad picture.

Global growth tracking above trend



Source: Datastream, NAB Economics

What it means for Australia

Australia's exposure to the US through trade links is limited. While our fourth largest export destination in 2017, the share of our exports going to the US is only 5.4% and so even if there is small negative impact on US growth overall, the implications for Australian exports would be small. The US is a major player in world financial markets so stress in the financial markets channel would flow through to Australia – but as noted this is not yet evident.

Australia's trade linkages with China are far more significant. China is our largest export destination – accounting for 30% of exports in 2017. Other countries in the region are also important export destinations. However, given China's policy response, and potentially some trade diversion to neighbouring countries it is difficult to quantify what the impact on Australia's trade volumes will be at this stage.

Moreover, the bulk of Australia's exports to China are consumed within its domestic economy rather than being inputs to exported goods (iron ore being nearly

50% of all exports to China). That said, while this might mean limited spillovers from lower Chinese trade to the US, the negative impact on Chinese incomes could still affect tourism or education service exports.

China is a major player in commodity markets, so lower growth could potentially see falls in commodity prices, reducing Australian national income and affecting mining sector business investment. However, export orientated manufacturing is not as large a user of bulk commodities, such as iron ore, as construction. So the China policy response – which includes infrastructure – may even make the Chinese economy more commodity-intensive limiting the downside for commodity prices. Moreover, to the extent commodity prices fall, this would tend to lower the AUD, increasing our general export competitiveness (although it has negative income effects as it increases import prices).

Overall, while it is difficult to quantify, at this stage the negative impact on Australia still looks to be limited from the tariff measures so far announced. The key will be how effective China's policy response is in mitigating the negative impacts on its economy.

This could quickly change, however, if domestic and international confidence was to turn down significantly or financial markets were to come under pressure as a result of the trade dispute. This could well occur if the US-China dispute were to further escalate.

AUD implications

It is clear from FX market price action this week that a lot of bad trade tariff news was 'in the price', both in Emerging Market currencies, including the CNY and the AUD (and where the latter has been trading consistently below NAB's short term fair value estimates in recent months). This should now include both the move to 25% US tariffs on China from January 2019 and a broadening out of tariffs to encompass all Chinese imports.

This is in so far as China has made clear it is retaliating against the US tariffs on the $200bn and the US administration has emphatically pre-announced the move to a 25% tariff rate. Alongside which, we have various 'source' reports indicating that President Trump will shortly instruct the USTR to start work on broadening out the range of goods to which the latest tariffs will be applied, to cover all Chinese imports. So this too should by and large now be expected/priced.

Of course, this could also reflect a degree of market complacency, or belief that the current China-US tariff stoush will prove short-lived. To the extent the latter view is misplaced, we may therefore see downward pressure on the AUD resume at some point, in particular if we see a resumption of downward pressure on commodity prices and/or deterioration in risk sentiment, in EM market in particular to which the AUD has proved extremely sensitive in recent months.

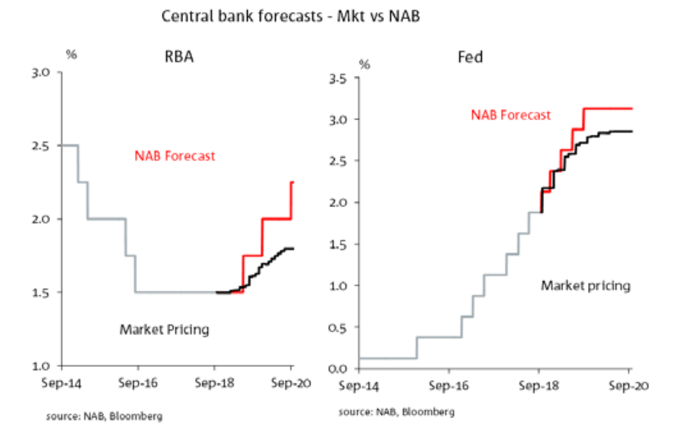
Certainly we see trade and other EM-sensitive developments capping the upside for the AUD/USD rate below about 0.75 heading into 2019. But for the nearer term at least, the current largely short-covering rally in the AUD/USD and various AUD cross rates can extend.

Implications for yields

Any impact on the rates market from higher tariffs will be driven by the outlook for growth and inflation and the performance of equity markets. Given our view that the downside risks to growth are limited and higher tariffs will not derail the US economy the impact on yields will be muted. Hence we maintain our view that yields will continue to rise as the Federal Reserve remains on its path of tightening policy.

The risks to this view come from any (perceived) inflationary impact or a negative reaction in equity markets. The former would likely place upward pressure on yields and steepen curves should the market be of the view that the Fed is behind the curve. Bond yields would likely initially head lower if equity markets came under pressure and volatility spiked. This could accentuate curve flattening if the Fed continued to tighten policy.

NAB Forecasts for Fed and RBA



Where will it end?

In announcing the latest trade measures, the US President indicated that if China were to retaliate – as it is doing – then the US would start the process of implementing tariffs on its remaining imports from China ($267b).

So there is a very real risk of further escalation. Of course, there is also the possibility that, given the negative outcomes to both countries, at some stage both sides make concessions and the tariffs are withdrawn (or further measures put on hold).

While further escalation of US-China tariffs increases the risk to the world economy and Australia, even more concerning would be if trade protectionism broadened out.

The renegotiation of the North American Free Trade Agreement is still underway and it may yet fall over. The US has been considering tariffs on auto imports (although action on imports from the European Union are on hold for now).

Moreover, as US and Chinese exporters impacted by tariffs search for alternative markets, other countries might start introducing trade barriers to protect their domestic industries.

The biggest risk to global growth would be if the dispute was to spread to other countries and we ended up in a broad-based tit-for-tat tariff dispute across the globe.

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