TRADE HEADWINDS – GALE FORCE ALERT

JUNE 2019

National Australia Bank

Trade risks realised

- For some time now we have noted that the key downside risk for the global outlook was trade policy. These risks were realised in May, particularly in the form a breakdown in US-China negotiations (and an increase in tariffs) and subsequently, in a major surprise, by the US decision to raise tariffs on imports from Mexico starting next week.
- Last month we marked down our US and global forecasts following the US tariff measures on China (and Chinese retaliation). The prospective increase in tariffs on imports from Mexico is of a bigger order of magnitude again in terms of the trade flows affected. Even if there is some agreement in the near term that averts the tariffs on Mexico, the impact on sentiment (and the resulting headwind to growth) is likely to linger for much longer. This is particularly given the hardening in US-China rhetoric, other possible trade actions down the track (such as on US auto imports) and the expansion of the scope of trade actions to non-tariff measures (such as restrictions targeting specific foreign businesses). The impending US tariffs on Mexico for non-trade reasons similarly suggests that the range of trade risks is broader than previously believed.
- As a result, we will be marking down our US and global growth forecasts again when we release the Forward View – Global next week, which will also take into account the latest data flow and other developments in the global economy.
- The policy reaction will be important. While we did not consider the May increase in China tariffs was sufficient to make the Fed ease, the latest developments point to the likelihood of a period of below trend growth in the US. With the US Fed already concerned about falling short of its inflation target, it is now likely to cut the fed funds rate in the second half of 2019.

CONTENTS

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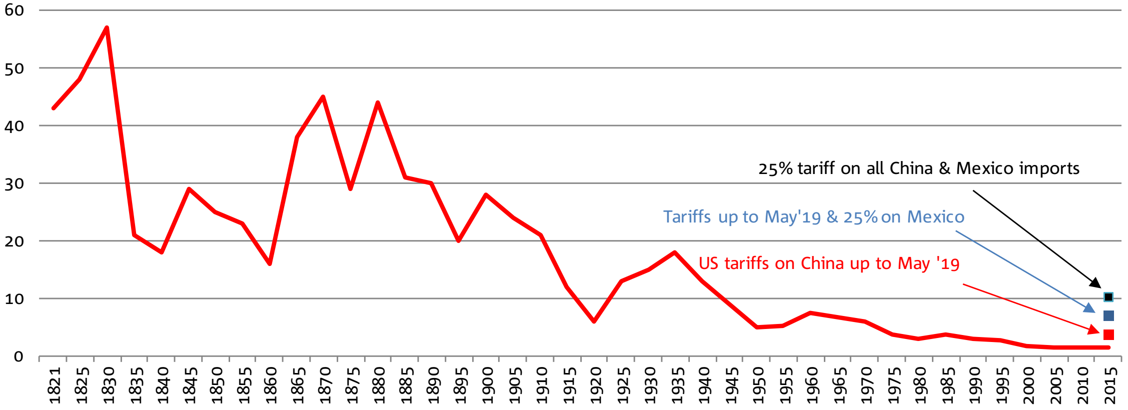
OVERVIEW OF TRADE DEVELOPMENTS *April's hopes dashed as trade risks are realised*

Trade issue`	What has happened	What next?
US – China trade dispute	US 25% tariff on $50b of China imports over July/Aug. 2018 (equivalent China measures), and 10% tariff on $200b of imports in Sept. 2018 (China placed tariffs of 5-10% tariffs on $60b of US imports) which increased to 25% on 10 May (China lifted tariffs up to 25% on $60b of US imports, effective 1 June '19). Huawei added to US Entity List limiting (if not stopping) its ability to trade with US companies. China setting up a list of 'unreliable' foreign firms.	US has started the process to extend 25% tariffs to 'essentially all' other imports from China. Reports of other possible China retaliation – e.g. restrictions on rare earth sales to US. President's Trump and Xi expected to discuss the trade dispute at the G20 Summit, 28-29 June.
NAFTA /USMCA	US/Canada/Mexico have agreed to a revised NAFTA – now called USMCA. Still requires approval by each countries legislatures. US to impose 5% tariff on Mexico imports from 10 June, rising 5ppts each month through to October (up to 25%) if Mexico does not take measures to curb migration flows.	In May US tariffs on steel & aluminium imports from Mexico/Canada removed (and Mex./Can. retaliatory measures) facilitating legislature approval. However, subsequent tariffs on Mexico linked to migration clouds this. It is also unclear whether the US Congress will ratify the USMCA.
US-Euro and US-Japan trade negotiations & US auto tariffs	EU/US negotiating an agreement for zero tariffs on non-auto industrial goods but progress has been limited. The US and Japan started trade negotiations in April 2019. US Section 232 report concluded that auto imports were a national security threat. In May, the US President directed that negotiations occur with trading partners.	Reports suggest little EU-US progress has been made. President Trump's statement on auto imports indicates that if agreement is not reached within 180 days then he will determine what (if any) further action needs to be taken.
US countervailing duties	Proposed rule by US Dept. of Commerce to impose countervailing duties on countries that undervalue their currency relative to the USD.	While another weapon that could be used in trade disputes, the President already has wide powers.

US TARIFFS MAY BE HEADING TO HIGHEST LEVELS IN OVER 70 YEARS

US average tariff rate & estimated impact of recent and prospective tariff measures on China and Mexico (%)



Source: Atlanta Federal Reserve, NAB estimates.

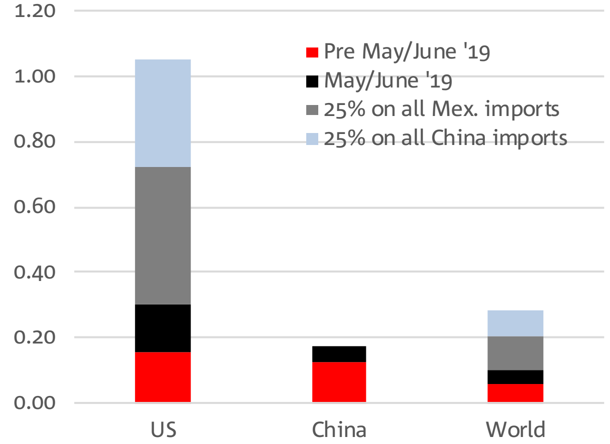
- At the start of May, concerns about the trade policy risk appeared to be alleviating. In particular, hopes were high that the US and China would soon make a trade deal which would not only prevent further tariff increases but even wind back tariffs already in place between the two countries. This was reflected in the April trade policy uncertainty index for the US, which had been at very high levels, moving to its lowest level in since early 2018 (see www.policyuncertainty.com).
- However, this improved outlook has been shattered by a series of events:
  1. A breakdown in US/China talks which led to the US increasing tariffs on around $200b of Chinese imports from 10% to 25% in May. The formal process that could see tariffs extended to 25% was also started. China retaliated by increasing tariffs on around $60b of US imports.
  2. The announcement by the US President that there would be tariffs on imports from Mexico starting on 10 June, with stepped increases through to October (to a maximum of 25%) unless measures are taken to curb movement across its border with the US.
  3. US restrictions on trade with the Chinese company Huawei (for security reasons), removal of India's status as 'beneficiary developing country' (resulting in loss of duty exemptions) and a proposed new rule that allows the US to impose duties on countries that undervalue their currency.
- The US President also accepted a trade report finding that auto imports were a national security threat, but deferred any action for 180 days pending negotiations with trading partners. The news was greeted with some relief, partly on the basis that it indicated the US wouldn't fight more than one (major) trade battle at a time. While not a trade issue (more about border control) the tariff measures on Mexico call this assumption into question.
- To put these developments into context, by our estimate, the average US tariff is now possibly at its highest level since 1975. If the measures against Mexico are put in place, it may move to a level not seen since the 1960s, and if tariffs are also applied to all China imports (at 25%) it could be at its highest level since the 1940s. (Note that these estimates are based on the current level of imports from China/Mexico, and if there is substitution away (as likely) the final result may be a bit lower.)

DIRECT EFFECTS OF TARIFFS

Tariffs potentially represent a large US fiscal contraction; China & Mexico to suffer from trade diversion

Tariffs are a tax – fiscal contraction

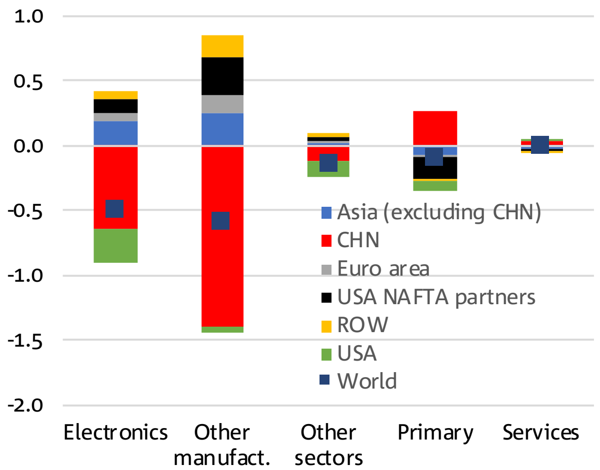
US & China tariff measure revenue as % of GDP*



* US (China) column only includes US (China) tariffs, other 2 columns based on combined US/China tariff revenue

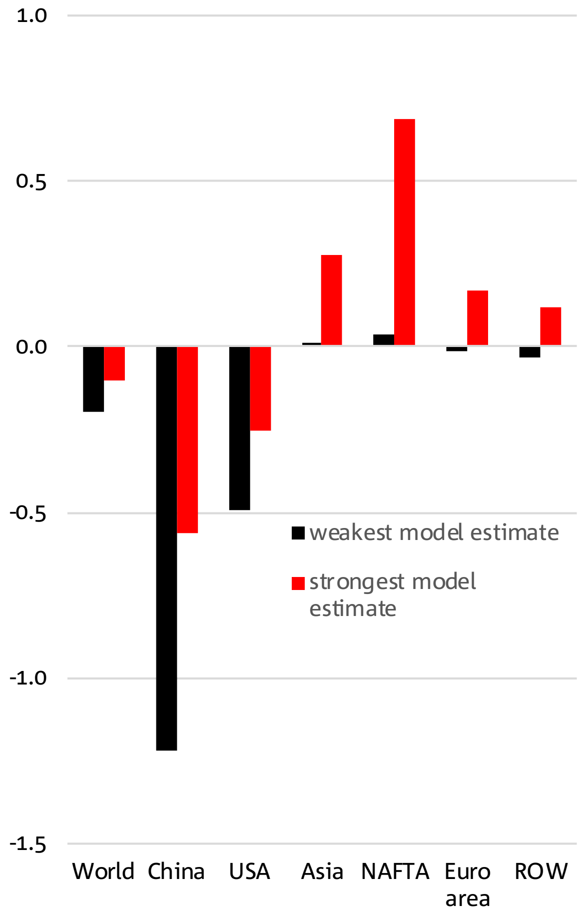
IMF estimates of industry impact of 25% tariff on all US-China trade

Contribution to % chng in world real val. added from baseline)



IMF estimates of effect of a 25% tariff on all US-China trade (excl. uncertainty effects):

Ppt change in real GDP; deviation from baseline (based on four IMF model estimates)



- A tariff is just a tax so it represents a fiscal contraction. Assuming that the burden of the tariff falls domestically, the US tariffs on China in May would raise around $30b (under 0.2% of GDP). More significant are the measures set to go ahead on Mexican imports – fully implemented the revenue would be over $80b or around 0.4% of US GDP. If the US were to go a step further and extend tariffs to all Chinese imports, the total tax increase from all the US tariffs on China and Mexico would be around 1% of GDP a sizable contraction.
- For China the implied tariff revenue is notably smaller as a % of GDP. However, in reality the burden of tariffs imposed by one country is likely to be shared between its consumers and the affected producers. Producers may have to reduce margins to maintain market share or lose sales as imports are sourced from other countries or domestic production. China's exports to the US are around 20% of its total (while US exports to China are less than 10% of its total). For Mexico the challenge is even starker, with 80% of its exports going to the US.
- In theory, US tariffs should strengthen the USD which, if it materialised, would mitigate some of the impact on China producers (and/or China might decide to 'weaponise' its currency, deliberately allowing the Yuan to weaken). However, upside risk to the USD could be limited by the Fed lowering interest rates, with the Fed having more scope to ease than other major central banks.
- The scale of the US tariff measures means China is likely to face a large loss in competitiveness in the US. As we have previously noted, Thailand and Vietnam appear to be increasing exports to the US at the expense of China. Work by the IMF illustrates the potential for trade diversion from US-China tariffs, in which production shifts from China to other countries particularly in electronics and other manufacturing (although worldwide these sectors experience a decline).
- Taking into account some broader macro effects– but still mainly direct trade related impacts – the IMF found Asia (ex China), Mexico/Canada, and Europe could gain from US tariffs on China. For Mexico, if the US tariff measures on it go ahead, trade diversion will work the other way.
- The shifting of production to another country simply to avoid a tax means that overall production is likely less efficient. Other benefits of trade (transfer of ideas/technologies) may also be reduced. Higher prices for capital goods may also discourage investment. In this way tariff increases represent not only a demand shock but a supply shock which reduces the growth potential of the world economy.

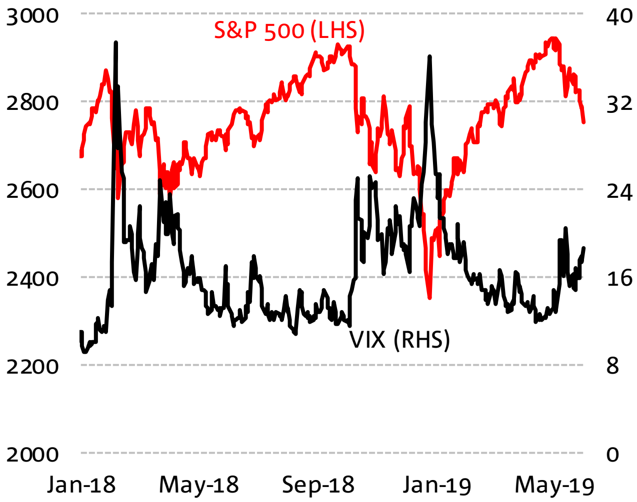
Sources: Refinitiv, IMF (April 2019 World Economic Outlook), NAB Economics

CONFIDENCE, UNCERTAINTY & MARKET REACTION

Confidence and uncertainty impacts can be just as important as the direct effects

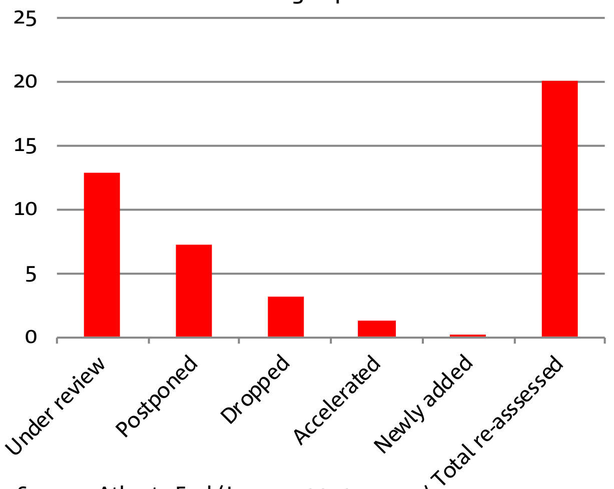
Equities down, volatility up

Equities - S&P 500 Index and volatility (VIX)



Uncertainty weighing on investment

US: % of firms re-assessing capex due to trade tensions

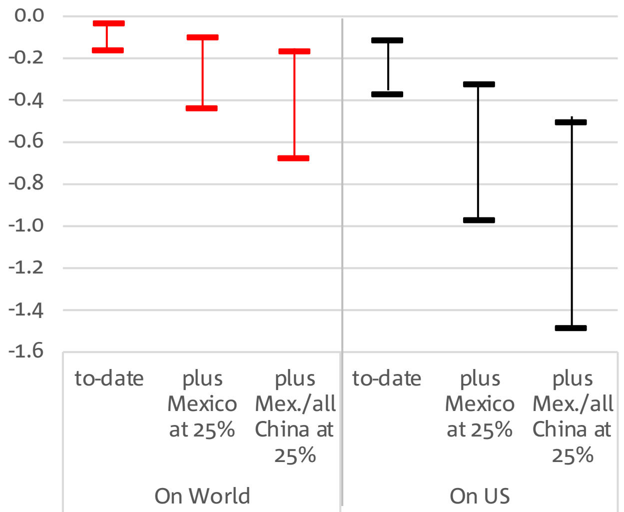


Source: Atlanta Fed (January 2019 survey)

- Indirect effects from the trade disputes could have equal, if not potentially greater, consequences than the direct effects. These indirect effects operate through financial channels, as well confidence and uncertainty.
- Financial channels include lower share market valuations and wider spreads (particularly in industries subject to disruption from the tariffs) that increase the cost of credit. Some impact is already evident with the S&P500 down around 6.5% over May, with similar size falls in a range of other stock markets. Market volatility has also increased albeit only modestly so far.
- Of particular concern will be the impact on Emerging Markets – widespread capital outflows in a 'risk-off' environment would be a headwind to EM economies and constrain central bank action.

Model estimates – wide range around possible impact

Range of model estimates of tariffs GDP impact (ppts)



- With global growth having already slowed over the last year, the additional shock coming from an escalation of trade disputes raises further doubts about the outlook for the global economy. Resulting caution can lead consumers to delay big ticket purchases and business to shelve investment plans.
- How the US-China trade dispute and the US-Mexico border issues will develop is highly uncertain. As a result businesses face considerable uncertainty about future trading arrangements and may postpone (or cancel) planned investments as they wait for a clearer picture to emerge. This tendency was already evident in the US before the latest escalation. The US decision to impose tariffs on Mexico not longer after agreement on the USMCA and removal of steel & aluminium tariffs reinforces how brittle trade relationships with the US are right now and likely means any future agreements will be discounted as they may prove to be short-lived.
- Given the possible wide range of mechanisms which the trade dispute can affect economies, it is not surprising that there are a wide range of estimates of the impact. Following the US decision to increase tariffs on $200b of Chinese imports last month we marked down our US growth forecast by 0.2ppts and world growth by just under 0.1ppt. The US decision to place tariffs on Mexican imports is of even greater magnitude. Even if Mexico and the US were to come to some agreement, the impact on global sentiment is likely to linger and we will likely revise down our US and other country forecasts in the Global Forward View next week.
- The policy reaction will be important. The US Congress may lift spending, particularly if the economy were to slow. While we did not consider the May increase in China tariffs was sufficient to make the Fed move, the latest escalation in tariffs on Mexico – and likely elevated ongoing trade uncertainty more generally – point to a period of below trend growth and Fed easing. In contrast, with rates already in negative territory any response from the ECB and Japan may be relatively restrained and delayed as they wait to assess the impact given the contradictory trade diversion and indirect affects at play. For China, policy is likely to try and offset the trade impacts, with credit already looser in 2019.

 Sources: Refinitiv, Atlanta Fed, NAB Economics. Details of the sources underlying the range of model estimates available in Trade Tensions on the Rise – July 2018

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