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September 10, 2019

The trade war: a strong risk for global growth

Highlights

- **Sharp escalation of trade tensions between China and the United States**
- **The real issue at stake is not trade but technological leadership**
- **China will not give in to Donald Trump's excessive demands**
- **The trade war is set to last or even intensify**
- **The impact is already significant on global growth and this is poised to worsen**
- **Bond yields will remain low or even lower, and equity markets under pressure**

The real issue at stake in the trade war

The US and China have been at loggerheads in a trade war since the start of 2018, as the conflict has escalated and has now taken root for a long period. Donald Trump kicked off hostilities when he launched his "America first" policy. He – wrongly – believes that trade between two countries is not mutually beneficial, but rather sees it as a zero-sum game where one country's gains are the other's losses. His primary target in this offensive is the USA's trade deficit with China.

However, tension extends well beyond the import and export of goods: what is really at stake here is technological leadership. The US president's aim is to halt China's progress in the tech arena by hindering its "Made in China 2025" program, which seeks to make the country a leader in new technologies and innovation. China already ranks first on 5G and its ambitions stretch far beyond this field. Donald Trump has accused the country of unfair trade practices, as he seeks to impede its progress, and has used this argument to justify the hike in border tariffs on Chinese goods and the radical measures he announced on Chinese telecoms heavyweight Huawei. These border duties are designed to tackle the forced transfer of technology, intellectual property theft and massive subsidies for tech companies. China denies implementing these measures and is rightly pursuing with its strategy to become the world technology leader, retaliating to counter each fresh move from the US administration.

Trade tensions have escalated severely

Trade tensions between China and the US have escalated severely since August 1, triggered once more by Donald Trump's tweet right when talks between the two countries had barely resumed. China announced retaliatory measures on August 23, and Donald Trump riposted right after.Trump went through with the threat, brandished since June 2018, to tax almost $300bn in additional Chinese goods, adding to the 25% tariffs already on $250bn in Chinese products. So virtually almost all imports from China will now see additional border duties by the end of the year.

China reacted by adding tariffs of 5% to 10% on $75bn in US goods that had mostly already been hit by extra duties. So in total, $110bn in US goods are affected, equating to two-thirds of US merchandise imported by China.

Since September 1, $112bn of chinese goods have been subject to a 15% increase in US tariffs, with two-thirds of this affecting shoes and clothing. China stepped up its retaliatory measures by increasing duties by 5-10% on some US goods.

From October 1, the tariffs applied by the United States on $250bn of Chinese products will increase from 25% to 30% following China's tit-for-tat measures.

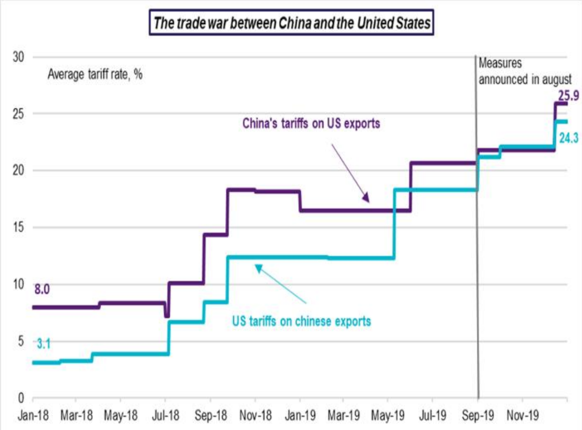
From December 15, a further $160bn in Chinese goods will be hit with an extra 15% in US duties. More than two-thirds of these products are smartphones, tablets, video consoles and toys. Imports of these goods soar in October ahead of the end-of-year holiday season, so the delay to December 15 is designed to ensure that sales of these goods are not affected during this prime period.
China will increase tariffs by 5-10% on remaining US goods. The key measure here is China's decision to reintroduce border tariffs on US cars and automotive components. These taxes, which ranged from 5% to 25%, had been suspended in January 2019 following the truce reached at the G20 summit. These tariffs will also be increased by 5-10%.

On August 23, Donald Trump also ordered US companies to "immediately start looking for an alternative to China" and this included bringing production back to the US. He also mentioned the possibility of forcing US companies to put an end to their business in China on the basis of the 1977 "International Economic Emergency Power Act".

The escalation of tensions in a graph

The chart below gives an overview of the surging trade tension between China and the US since the start of 2018.
The United States' average tariffs on Chinese exports coming into the country are in blue, and average tariffs China applies in retaliation on US exports coming into the country are in purple. These tariffs are weighted by the proportion of US exports to the rest of the world and the weighting of Chinese exports to the rest of the world in 2017. Data are from the Peterson Institute of International Economics.

We note that the tariffs the US applies to Chinese goods rose from on average 3.1% in January 2018 to 18.3% in June 2019, and measures announced in August will bring the figure to 24.3% as of December 15. Average tariffs that China applies to US goods increased from 8% in January 2018 to 20.7% in June 2019 and measures announced in August will bring them to 25.9% by the end of the year.



Sources : Peterson Institute of International Economics, Ostrum AM

This is a huge increase and is bound to have an impact on growth.

China strikes back and lets the yuan slide

The latest announcements from Donald Trump prompted China to take greater moves to strike back and on August 5, it let the yuan fall below the symbolic threshold of 7 yuan for a dollar for the first time since April 2008. This prompted the US to officially accuse China of currency manipulation. The yuan has continued to weaken ever since, making Chinese exports more competitive, thereby diminishing the effect of the increase in US border duties.

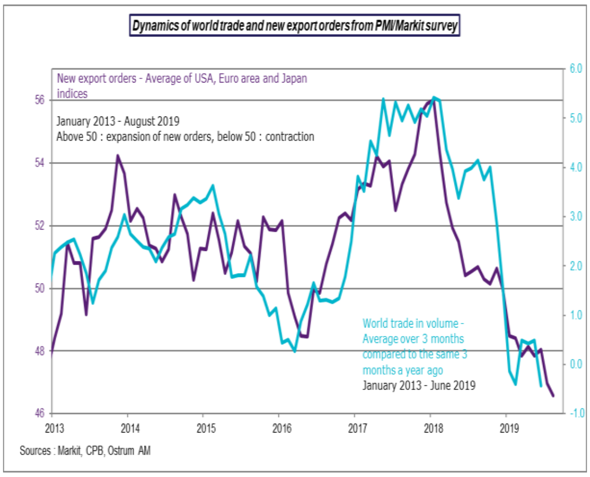
The trade war is already having a significant impact on world growth

According to the Secretary-General of the OECD, Angel Gurria, interviewed on September 2, the trade war has already cost 1% to world growth and this effect could worsen.

The impact on growth is not restricted to China and the US, it affects all economies as value chains are highly integrated worldwide. This reflects the fact that a large number of finished goods are manufactured using parts and components that are produced in other countries. So the introduction of trade barriers on Chinese and US goods has also repercussions for countries involved in the production of these goods.

Persistent negative shock on world trade

These trade measures from the US and China triggered a dramatic and massive shock for world trade last Fall, as shown by the chart below. This followed on from escalating trade tension between June and September 2018.



World trade (blue on the chart), which grew at a rate of 4% p.a. in October 2018, literally collapsed to register a decline in January 2019 for the first time since December 2009. In June, it shrank by 0.4%. The latest PMI/Markit surveys conducted with business leaders in August plead for a further contraction in world trade. New export orders (in purple on the chart) deteriorated again, falling well short of the 50 mark and heralding a sharper drop in exports. The new key information is the decline in new US export orders in August (the highest since 2009 according to the ISM manufacturing index).

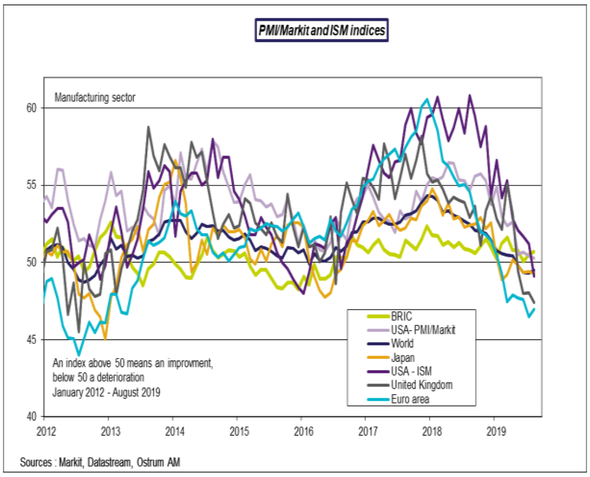
Contraction of the manufacturing sector

The manufacturing sector is the most exposed to the deterioration in trade. The most affected countries are those with the most open and integrated economies in value chains. China is in the front line along with other countries in South-East Asia, Japan and South Korea. South Korea is also affected by trade tension with Japan. Latin America is impacted as it has strong trade ties with Asia. Vietnam seems to have come out well as it has been gaining market share from China. Some companies have relocated some or all of their production from China to Vietnam or Malaysia. However, this seems to concern only a small proportion of them, as it is an expensive process and companies have trouble finding countries with the same expertise and the required infrastructure.

In the Euro area, Germany is hit hard. Output has been massively dragged down by the trade war, uncertainty on Brexit and the difficulties of the automotive sector. This has a knock-on effect for the euro area, given the extent of trade between countries in the zone as a result of their highly integrated value chains. Slovakia is also heavily affected by its high exposure to Germany, as do some Eastern European countries such as the Czech Republic and Poland. The US is less dependent on external trade, but it is still affected all the same.

Rapid deterioration in business outlook

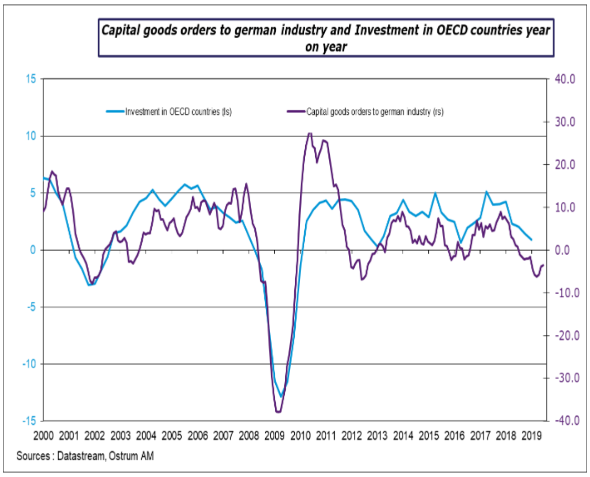
Surveys with business leaders in the manufacturing sector have deteriorated considerably since last Fall and the latest results do not point to a turnaround in trend, but quite the opposite, particularly in light of the drop in new orders.



The world activity index is below 50 for the fourth month in a row, pointing to a deterioration in activity. This is primarily due to the euro area and Germany in particular. **GDP in Germany already contracted in the second quarter of the year and these surveys herald a recession in the country.** Meanwhile in the US, the manufacturing ISM also dropped significantly to slide below the 50 mark in August for the first time since 2016. Business leaders indicate increased uncertainty over tariffs. The manufacturing sector is also contracting in Italy, Spain, Japan, and the UK, while it remains sluggish in China, and the BRIC index (Brazil, Russia, India and China) shows a stagnation in activity. The new measures announced should further dent business leaders' confidence.

Productive investment is slowing

The decline in demand is dragging down the outlook for business leaders and encouraging them to take a more cautious stance. We have already seen a clear slowdown in investment in OECD countries, as shown in the chart below, and the drop in capital goods orders in German industry is fueling fears of a further downturn.



A recent study by the Federal Reserve estimates that the uncertainty from the trade war in 2018 would have weighed more than 1% on investment growth of US companies

High risk on global growth

Severely escalating trade tension could well further exacerbate the impact we are currently seeing in the manufacturing sector and investment, with potential repercussions for services and consumer spending, leading to a high risk for world growth.

Risk of contagion to services

The service sector is turning out to be fairly resilient for now, but it is lagging behind the impulses of the manufacturing sector. It is beginning to show signs of a slowdown particularly in Germany as well as in the US according to the latest PMI/Markit surveys.

Risk of spread to consumer spending

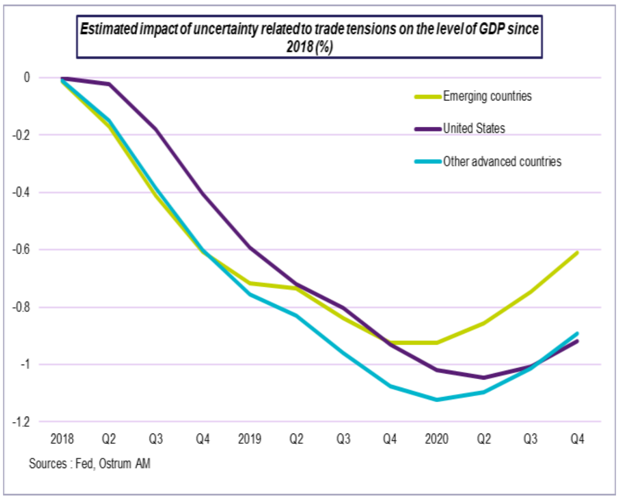
Business leaders are also becoming increasingly cautious on new hires in light of this weaker business outlook. **Surveys reveal a contraction in employment in the manufacturing sector and a slowdown across the economy as a whole.** New job creation remains relatively solid but is beginning to ease, particularly in the euro area as well as in the US, and **this could well dent household spending.**

US consumer on the front line

The United States' fresh moves against China primarily affect consumer goods which until then had been relatively unaffected by the trade war. US consumers will now be directly affected as prices are set to go up. The latest tariff announcements had a severe impact on US consumer confidence in August. The University of Michigan consumer sentiment index suffering its largest monthly drop since December 2012, one consumer in three mentioning tariffs.

Estimates from the Fed and the IMF

A recent study from the Fed estimates the impact on world growth of the sharp increase in uncertainty due to trade policy. According to these estimates, this growing trade-related uncertainty in the first half of 2018 would have shaved 0.8% off world growth in the first half of 2019.



The clear upsurge in uncertainty since May 2019 is poised to further dent growth in the second half of the year and the start of 2020, with an overall hit of slightly more than 1% of world GDP. The impact should be broadly identical in the US, other advanced countries and emergings.

The IMF chief economist, Gita Gopinath, when asked on September 4, indicated that current duties and other tariffs announced for the rest of the year should hamper world growth by 0.8% in 2020.

The central banks are aware of the impact of the trade war and its risks for world growth, so they are easing monetary policy to tackle this issue.This is the case for the Fed, the ECB and the Chinese central bank in particular, but the effectiveness of these measures could well be limited.

Risks for the financial markets

Stock markets have not priced in the impact of a long-lasting trade war

Financial markets do not appreciate the current US president's unpredictability, and this is reflected in very volatile stock indices. They drop significantly on the announcement of new tariff measures before rebounding because of hopes raised by the resumption of negociations and the anticipation of monetary policies that have to become more accommodative. Between October 1, 2018, just after the second round of tariffs were implemented, and

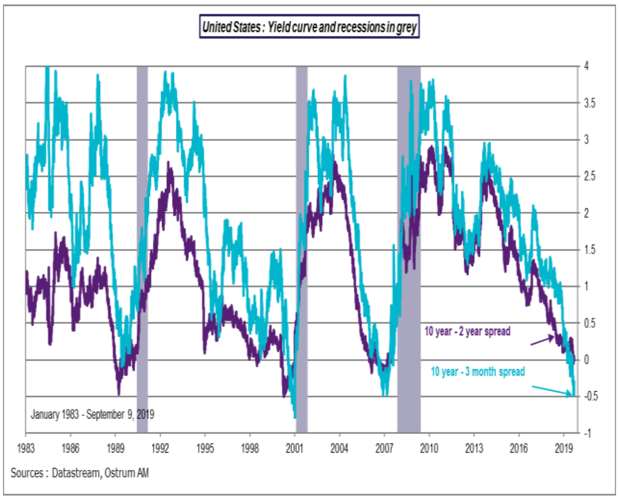
September 9, 2019, the S&P gained 1.8%, the CAC 40 rose 1.5% and the Euro Stoxx 50 was up 2.4%. The emerging equity markets (MSCI EM index) were the most severely affected, as they wiped out all their gains YTD, in a clear indication of their high exposure to world trade trends.

Hopes for a quick resolution of the trade war are in vain given unconsidered demands of the United States towards China. Meanwhile, monetary policy looks likely to have a very limited impact on domestic demand: households and businesses already enjoy very favorable financing conditions, and business leaders will not increase their investment in the absence of visibility on the future evolution of the trade war. **Stock markets have not priced in the fact that a swift US-China agreement is turning out to be a pipedream and that trade tension is set to continue and even step up a pace, pointing to high risks for world growth.**

Investor fears crystallize in sovereign bond markets

Bond yield have eased considerably over the period, particularly long-term rates. The French and German 10-year shed close to 110bps between October 1, 2018 and September 9, 2019, sliding into negative territory at -0.27% and -0.58%. Meanwhile the US 10-year lost close to 150bps over the period, returning to its lowest since August 2016 at 1.6%. This sharp drop in long-term rates reflects investors' concerns on future growth, primarily due to escalating trade tension, and the expectation of more accommodative monetary policies to address it.

In the US, the 10-year fell below the 2-year, causing the yield curve to reverse in late August and early September. The same phenomenon had already emerged on shorter maturities and particularly between the 10-year and 3-month since the end of May. The fact that long-term rates are falling below short-term rates reflects a clear deterioration in investor sentiment on the growth outlook. As shown by the chart below, in the past this inversion in the yield curve has consistently preceded a US economic recession during the following 12 to 18 months. These risks prompted the Fed to cut its key rates on July 31 and also set the stage for a fresh cut, probably on September 18.



Conclusion

The trade war between China and the US is set to last or even intensify given the excessive demands being made by the US. The issue at stake here is not the bilateral trade deficit but technological leadership and China will not give in to the White House's pressure that seeks to curb its ambitions in this area. Added to this is Donald Trump's threat to tax car imports for national security reasons. The European Union could be affected in light of insufficient progress in talks on finding a better trade agreement with the US. This potential threat has been pushed back to mid-November.

The trade war has already a major impact on world growth as a result of the decline in global trade, the contraction in the manufacturing sector and the slowdown in corporate investment. Fresh steps announced by China and the US are set to lead to a sharp rise in border tariffs out to the end of the year and directly hit US consumers, who had been relatively spared until there. The risk of this sharp escalation of trade tensions is that it could amplify the impact on world growth by spreading to the service sector and to household consumption.

Risks on world growth are increasing, prompting central banks to become more accommodative. This is the case in Asia and China in particular, as well as in the US and the euro area. The ECB is poised to announce a fresh round of measures on September 12, and the Fed will probably cut back interest rates again on September 18. In the absence of support from fiscal policy, these measures will probably only have a limited effect on domestic demand, as current financing conditions are already very favorable and business leaders remain extremely cautious. They will not invest more in the absence of visibility on the future evolution of the trade conflict. This argues for sovereign bond rates at sustainably low levels, or even lower, and equity markets that should be under pressure.

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