Let the Trade Skirmishes Begin

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The trade skirmishes began in earnest in March 2018 with the U.S. imposing tariffs on steel and aluminum in the name of national security. The U.S. temporarily exempted Mexico and Canada pending progress on the NAFTA negotiation and held open the possibility that other countries might be exempted. Had the European Union (E.U.) not gained a temporary exemption, the E.U. would have retaliated with highly focused tariffs, from jeans to bourbon to motorcycles, designed to hit some hot-button pain points involving name-brand companies.

Also, in March, a group of 11 nations, without the U.S., signed the Trans-Pacific Partnership, renaming it the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), which cuts tariffs among the partnering nations. The signing of the CPTPP underscores the U.S. withdrawal from a leadership role in multilateral global affairs and reaffirms the intent of many other countries to strengthen mutual trade ties. This has the potential to reshape long-term trading patterns in goods, services, and commodities in a way that would disadvantage U.S.-based companies and producers.

Also in progress in the spring of 2018 are the U.S.-Canada-Mexico negotiations over the North American Free Trade Pact (NAFTA). While technical committees involved in the negotiations reportedly have made some progress on the small issues, the big issues that separate the U.S. from Canada and Mexico revolve around domestic-content rules (think autos) and how to handle disputes (the U.S. wants a system more to its liking) are far away from being solved. Indeed, while the U.S. rhetoric about unfair trade practices is often aimed at China, the steel and aluminum tariffs can also be seen as bargaining chips in the NAFTA negotiations. Our takeaway is that the U.S. is only a very short step away from announcing its intention to withdraw from NAFTA. We note that announcing the intention to withdraw triggers a 6-month waiting period. At the end of the 6-months is when the final decision to withdraw or not would be made.

Finally, the "Brexit" negotiations between the United Kingdom (U.K.) and European Union (E.U.) for the U.K. to exit the free trade zone are not going well – actually they are not moving much at all. The U.K. has tended to negotiate as if they were equals with the E.U. By analogy, though, if this were a card game, the E.U. holds four aces and the U.K. does not have a single pair – yet the U.K. continues to bluff for better terms, even though everyone's cards are on the table for all to view. The strategy is not working because there are some fundamental inconsistencies at its heart. The first problem for U.K. Prime Minister May is that the Conservative Party is split with some hard Brexit advocates and some soft Brexit advocates. Another problem for the U.K. is Ireland. U.K. Prime Minister May has promised to treat Northern Ireland the same as England, Scotland and Wales. Prime Minister May has also promised the Democratic Unionist Party (DUP), whose ten votes she needs to remain in power in Parliament in Westminster, that she will keep an open border between the Republic of Ireland and Northern Ireland. It is very hard to conceive of how one keeps an open border with Ireland, without putting some border controls in place between Northern Ireland and the rest of the U.K. And, how do you keep free trade between Northern Ireland and the Republic and yet impose different rules on the rest of the U.K. versus the E.U.? It just does not add up.

Thus, the odds have risen that either the Conservative Party will revolt and select a new Prime Minister, or the DUPs will withdraw their 10 votes and force a new election. If there is a new election, the Labour Party would have a reasonable chance to win; indeed, they might even be favored. What this means for trade between the U.K. and E.U. is that the U.K. is currently headed down a path in which it will miss the 2019 deadline for a deal to leave the E.U., and the E.U. may just say goodbye and force a hard Brexit, meaning more political repercussions in the U.K. and damage to U.K. trade with the E.U.

In short, the sources of trade tensions are getting increasingly serious. The U.S. is moving unilaterally to impose tariffs, the CPTPP-11 are moving to create a customs zone without the U.S., the renegotiation of NAFTA is about to hit major roadblocks, and no Brexit deal is in sight, increasing the odds of a "hard" exit for the U.K. and the worst case for U.K.-E.U. trade.

What are the Economic Implications of Rising Trade Tensions?

There are considerable complex interactions in play when considering the implications of the path global trade negotiations have taken. While some politicians prefer to look at trade through a bilateral lens that focuses on the net trade in goods between two countries, modern trade patterns are incredibly interconnected, involving trade in goods, services, and commodities, with direct and indirect implications on how trade flows are financed and how capital flows among countries. Our analysis here focuses on a select few of the challenges that highlight the complex network of trade and capital flows that could be potentially disrupted if growing trade tensions expand into a shift toward nationalist, protectionist policies.

<u>Global Growth</u>

2017 global growth was a solid improvement over 2016, and 2018 seems on track to exceed 4% real GDP growth. This accelerated pace of activity represents a synchronized growth path among virtually all regions and countries – a rising tide that is lifting all boats. The laggards of 2015-2016 were Brazil due to its political problems and Russia due to the oil price declines. Both of these countries are growing again. The mature industrial countries, from the U.S. to Europe to Japan, are incrementally growing just a little bit faster.

China represents one of the major risks to world growth, but the Government has successfully managed to cushion the impact of an aging population and focused on a transition to a domestic growth model. Debt loads are very worrisome for China. Since China's debt is domestic, not owed to foreigners, and not denominated in other currencies, such as the U.S. dollar or the Euro, China probably has the tools to manage this challenge. All in all, a modest deceleration of growth in China in 2018-2019 is not expected to disrupt the higher pace of global growth overall.

The big risks to global growth are the rising trade tensions. So far, the initial salvos and skirmishes amount to very small potatoes. If a tit-for-tat tariff war starts to bite, the rosy growth scenario might dim. Economists all remember the U.S. imposing the highly restrictive Smoot-Hawley Tariffs in 1930, and along with Federal Reserve inaction, trade protectionism helped to turn a recession into the Great Depression.

Retaliation

One of the big questions as the U.S. embarks on a path of unilateral imposition of selected tariffs is what kind of retaliation might occur. We enter the world of game theory, and it is not pretty. The prevailing view among the developed world nations from Asia to Europe to Canada and Mexico is that the imposition of new unilateral tariffs has to be checked. Two responses are almost certain: (a) selectively impose retaliatory tariffs and (b) simultaneously bring legal proceedings to the World Trade Organization. For the most part, if all that happens is one side fires a shot, and the other side returns fire, which is followed by a cease fire, then the damage to global economic growth is likely to be quite small. The real danger is that trade pacts that have been in place start to unravel. That would be the case if the U.S. pulled out of NAFTA or there was a hard exit for the U.K. from the Europe customs union. This heightens the importance for markets if NAFTA or Brexit go badly, and one can expect stock markets to get quite jittery if the rhetoric gets cranked up.

The question of retaliation often revolves around who feels the pain. For example, the U.S. Administration is taking a calculated bet that the gains to the steel and aluminum industries will be meaningful and measureable, while the pain felt by industries that use steel and aluminum, from beer and soft drink companies, to aircraft companies, to oil and gas well drillers will be spread wide enough not to be easily attributable to the new tariffs. The argument goes that if the impact is less than a penny a beer can, no one will notice. The reality is that the companies hit by the "friendly-fire" will see it in their bottom lines and stock prices, and they will be less able to make new investments or create jobs. So, there is a political-economic disconnect, where the offsetting economic losses are not felt politically but are felt in the stock market, labor markets, and the economy.

The strongest case for protectionism has always revolved around emerging market countries. The idea was that tariffs could protect domestic industries from international competition, giving them time to develop and flourish. A developing nation might award a monopoly to give a local telephone company a protected environment to build cell phone service. Or, a national oil company would be protected from foreign competition so as to build up the domestic capabilities. Unfortunately, protectionism of this sort also seems to breed crony capitalism and industrial-political corruption. For a case study, one can examine Brazil's "Car Wash" initiative to clean up the corruption partly caused by protectionist policies.

Most economists, although not all, have railed against protections. Mercantilist polices held sway in the 1500 and 1600s, as the national objective was focused on accumulating gold and having a strong navy. The French economics minister for the Sun King Louis XIV was Jean-Batiste Colbert, and he was a key figure in promoting trade protectionism. By the 1700s, the free trade ideas of philosopher and political economist David Hume were gaining ground. In the early 1800s, David Ricardo's theory of comparative advantage helped to build the foundation of why and how free trade led to much greater economic growth. Hume made the case eloquently as he argued:

> " … there still prevails, even in nations well acquainted with commerce, a strong jealousy with regard to the balance of trade, … This seems to me, almost in every case, a groundless apprehension; and I should as soon dread, that all our springs and rivers should be exhausted, as that money should abandon a kingdom where there are people and industry. Let us carefully preserve these latter advantages; and we need never be apprehensive of losing the former." (From David Hume, *Essays, Moral, Political, and Literary*, 1752, Part II, Section V).

Diversification of Sources of Imports

Just the risk of the demise of NAFTA or a hard Brexit has already caused trade patterns to shift a little. Mexico has started importing corn from Brazil. Mexico will also be taking a hard look at how its energy resources are managed so as to lessen its growing dependency on U.S. natural gas. The U.S. is also a big exporter of cattle and beef products to Mexico that could soon face new competition from other countries. Mexico could also target cattle and beef imports for retaliatory tariffs.

Companies have responded as well. Some financial companies have stopped hiring in London and are starting to make plans for expanded operations inside the E.U. Japanese companies have long understood the risks of relying on production facilities in China and many years ago adopted the "China plus one" approach to making sure they had supply chain capabilities outside of China.

U.S. multinationals will often find themselves between a rock and a hard place. To take advantage of the new CPTPP, production and service support facilities may need to be physically located inside one of the 11 countries in the Trans-Pacific Partnership or else the companies risk losing access to the those markets on competitive terms.

Rise of China as Global Power

One of the key global consequences of the U.S. withdrawal from a leadership role for free trade and other multilateral initiatives is the opening this policy shift has given to China to expand its influence much more rapidly than many had thought possible and to increasingly play the leading role in global affairs that it has long coveted. China is typically every nation's number one or number two trading partner. All of the small nations in the Pacific region have significant China risk regarding their own economies. Moreover, China is extremely aggressive in trying to influence the production of commodities that are essential to its economy. China's President Xi Jinping has recently moved to consolidate his power and to govern for life. While China's rise as an economic power eventually would have given it a central place on the world's stage, China's more dramatic ascendency is a game-changer for countries in the Pacific region and how they manage their own trade relationships with China.

Capital Flows

All trade flows are financed by capital flows. This accounting observation should also be viewed from the opposite perspective. Namely, countries that provide attractive investment opportunities and are net attractors of capital will naturally run deficits in the balance of trade for goods and services. The point here is that trade flows do not necessarily drive capital flows and vice versa. The arithmetic that a negative (positive) balance on goods and services will be offset by positive (negative) net capital flows implies no direction of causality.

The corollary point is that a rise in trade protectionism will impact capital flows as much or even more than trade flows as markets adjudicate prices and allocate resources in the changed environment. Indeed, we would argue that a rise in trade protectionism is likely to have quite profound impacts on capital flows, particularly for the United States because of the role of the U.S. dollar as the primary reserve currency and the primary currency of denomination for commodity pricing.

Let's take trade with China as an example. The U.S. imports large quantities of consumer goods from China. China imports large quantities of U.S. Treasury securities from the U.S. U.S. consumers acquire consumer goods at cheaper prices than they could be manufactured domestically, and China acquires the national debt of the United States. And, all of this trade, real goods for paper assets, occurred willingly and as Milton Friedman (*Capitalism and Freedom*, 1962) often said: "The most important single central fact about a free market is that no exchange takes place unless both parties benefit." If the U.S. shift toward trade protectionism causes U.S. Treasury securities to be less desirable, as might arguably be the case as U.S. economic and trade policy risk rises, then the U.S. would see a rise in yields on U.S. Treasury securities and a rise in the interest expense incurred by the federal government on new issues of Treasury securities.

The increased riskiness of the U.S. dollar may well explain a conundrum for some economists in 2017. During 2017, the U.S. Federal Reserve (Fed) was raising short-term interest rates, announcing plans to shrink its balance sheet and reverse quantitative easing, while the European Central Bank (ECB) and the Bank of Japan (BoJ) continued to expand their balance sheets and keep short-term rates near zero. The U.S. dollar weakened against both the euro and the Japanese yen. If one believes exchange rates are partially driven by relative monetary policy, then this was the opposite of what was expected. If one also believes that a change in relative risk requires a higher risk premium, then one can start to appreciate the impact of policy uncertainty on the U.S. dollar and U.S. Treasury yields.

How to Create a Trade Surplus: Have a Recession

The easiest way, although not recommended, for a major country to create a trade surplus is to have a recession. Import demand is driven by economic growth. Remove the economic growth, and import demand will collapse. While it is probably not true, if other things remained equal, then the country in recession would still export goods while its imports would collapse. If a country's economic performance outpaces the rest of the world, its demand for imports will rise relative to exports to the rest of the world. We are just trying to underscore the observation of David Hume that one should not make value judgments about trade deficits or surpluses. If a nation takes care of its economic growth, money flows; trade and capital will take care of themselves.

Endnotes

All examples in this report are hypothetical interpretations of situations and are used for explanation purposes only. The views in this report reflect solely those of the author and not necessarily those of CME Group or its affiliated institutions. This report and the information herein should not be considered investment advice or the results of actual market experience.

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Dr. Bluford Putnam is Managing Director and Chief Economist of CME Group. He manages the Intelligence & Analytics team, which includes both data science and management analytics. As Chief Economist, Dr. Putnam is responsible for leading the economic analysis on global financial markets by identifying emerging trends, evaluating economic factors and forecasting their impact on CME Group and the company's business strategy. He also serves as CME Group's spokesperson on global economic conditions and manages external research initiatives.

Prior to joining CME Group, Dr. Putnam gained experience in the financial services industry with concentrations in central banking, investment research and portfolio management. He most recently served as Managing Partner for Bayesian Edge Technology & Solutions, Ltd., a financial risk management and portfolio advisory service he founded in 2000. He also has served as President of CDC Investment Management Corporation and was Managing Director and Chief Investment Officer for Equities and Asset Allocation at the Bankers Trust Company in New York. His background also includes economist positions with Kleinwort Benson, Ltd., Morgan Stanley & Company, Chase Manhattan Bank and the Federal Reserve Bank of New York. Dr. Putnam holds a bachelor's degree in liberal arts from Florida Presbyterian College (later renamed Eckerd College) and a Ph.D. in economics from Tulane University.

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