Ashmore

Trump and EM

By Jan Dehn

The threat of protectionism is on the rise, nowhere more so than in the United States, the erstwhile bastion of free markets. US protectionism is no idle threat. President-elect Donald Trump's proposed policy mix includes protectionist measures to ameliorate the negative side-effects of his main policy thrust – greater fiscal deficits due to lower corporate tax rates.

However, it is not an ideal time to engage in fiscal stimulus and trade protection.

The US real effective exchange rate is already overvalued and Trump's policies look set to worsen imbalances. Inflation will rise and the Fed may be forced to hike rates. The economy will get hurt. Many domestic interest groups will get upset. Foreigners will retaliate. If you don't fancy living with that particular Sword of Damocles hanging over your head then reduce your exposure to the US.

Introduction

President-elect Donald Trump is planning to use fiscal stimulus, notably corporate tax cuts, in a bid to keep the already hyper-stimulated US economy going for another four years. The immediate challenge posed by yet more stimulus is that it widens already large fiscal and trade imbalances. To address this problem Trump is also proposing to introduce tariffs on trade.[1] Tariffs would be revenue positive and discourage imports. They are also easy to 'sell' as counter-measures against alleged unfair trade practices in EM countries.

However, a descent into protectionism would pose challenges of its own. For one, it would mark a fundamental shift away from America's traditional role as sponsor of free trade and minimal government intervention in markets. Also, the empirical evidence on protectionism is unequivocal: trade barriers actually hurt the perpetrator by pushing up inflation and undermining business productivity. In other words, Trump risks turning America's world-beating companies into the US-equivalent of protected French farmers.

Perhaps the most serious problem is that the combination of additional fiscal stimulus and trade protection is not appropriate at this point of the economic cycle. They would push the real exchange rate even deeper into overvalued territory, which is exactly the opposite of what the US economy needs. The risk of Fed hikes also rises. Hence, Trump's proposed policy mix poses a threat to US financial markets in addition to the microeconomic issues.

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Trump's proposed policy mix would also have implications for the rest of the global economy. Many EM bonds are denominated in Dollars and most EM currency crosses trade against the Dollar. US companies trade with and invest in EM countries and vice-versa. EM central banks are major holders of US financial assets, including US Treasuries, having financed the US current account deficit for decades.

This note seeks to outline the economic consequences of Trump's proposed policy-mix for the US economy and the possible ramifications for the rest of the world, including EM.

Why protectionism now?

It is not entirely surprising that the United States is leaning toward protectionism at this point in the cycle. The April 2016 The Emerging View noted that:

"…when short-term stimuli lose their effectiveness and productivity deficiencies undermine competitiveness the temptation to manipulate currencies and/or intervene in free trade grows stronger. Governments are always vulnerable to the targeted lobbying efforts of focused interest groups"[2]

[1] We use the word tariffs instead of the euphemistic term "border adjustment". Like tariffs, border adjustments reduce US imports and destroy trade by pushing a wedge between domestic and foreign markets.

[2] *"Beyond 'conventional unconventional policies'"*, The Emerging View, April 2016, page 4.

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The key interest group of the moment is, of course, America's white working class, which has just been given its once-every-four-years opportunity to voice its concerns in the recently concluded US presidential election. The message from America's workers was quite clear: they are angry about the stagnation of the economy since the 2008/2009 crisis and worried about their jobs.

Again, this is hardly surprising. Instead of taking advantage of the 'good' years of hyper-easy monetary policies to address the country's underlying economic problems, including declining productivity and mounting debt burdens, the Obama Administration and the Republican-controlled Congress opted instead to pursue easy-fix solutions, such as QE, which only increased income inequality and pushed up the Dollar. This worsened the prospects for America's workers, particularly in manufacturing.

As a result, voters have now shown US mainstream politicians the door in favour of populist leadership in the shape of President-elect Donald Trump. Like all populists, Trump can be expected to favour policies that have immediate and highly visible results even if such policies undermine prosperity over the longer term. In short, the fears of protectionism are valid. America *could* actually go down this road, for political reasons alone.

Keep the party going

There may also be economic reasons for rising populism. The overriding problem Trump faces is that the US economy is already at full or near full employment. Inflation is about to return and the Fed has already begun to tighten monetary policy. The Dollar is overvalued. In addition, after years of enormous monetary stimulus stock markets are at record high levels. For these reasons there is a serious risk that Trump runs into a recession during his first term, which could spell the end of any hopes he might have of winning a second term four years from now. While the 'first-best' medicine for an over-stimulated economy would be to restart aggressive supply-side reforms and bring down the debt load such policies would be extremely costly in political terms. Trump is therefore reaching for second and third rate solutions in order to buy time, mortgaging America's future just that little bit more in the process.

Protectionism and fiscal stimulus go hand in hand

Trump is proposing to buy time by means of a policy mix of fiscal stimulus and protectionism. These two policies should clearly not be seen in isolation. Trump's primary focus is corporate tax cuts, even more so than infrastructure spending. Tax cuts form the backbone of his efforts to prolong the current economic upswing and they are certain to please America's most powerful business interest groups. Protectionism belongs to the overall package, however, because tariffs can soften some of the 'side effects' of tax cuts, namely larger fiscal and trade deficits. After all, tariffs supposedly increase fiscal revenues and discourage imports. Protectionism can also conveniently be 'sold' as Trump's crusade to support America's beleaguered workers against alleged unfair foreign competition from Mexico, China and others. It all works very well politically.

What does economic theory suggest?

But will Trump's proposed mix of fiscal stimulus and protectionism actually have the desired effect? Economic theory is a good starting point for attempting to answer this question.

Let us take at face value the core messages from the President-elect's campaign and his subsequent tweets; Trump will cut corporate taxes, increase infrastructure spending and protect US workers from overseas competition using tariffs, while encouraging US exports using export subsidies. What will these policies do to the US fiscal and trade balances, the Dollar, interest rates, inflation and other macroeconomic variables?

Fiscal stimulus

First, consider the effects of US fiscal expansion: cutting taxes and increasing spending will increase the fiscal deficit and push up the level of government debt. The decline in government savings in turn lowers national savings and therefore raises the transaction demand for Dollars within the US economy.[3] For a given monetary policy stance this means that fewer Dollars are available in the rest of the world, so the Dollar must appreciate. The stronger Dollar in turn erodes the competitiveness of American exporters, so the trade deficit increases. Fiscal stimulus also pushes up inflation, particularly now when the US economy is at full or near full employment. Hence, the Fed can be expected to raise rates. The higher rates in turn 'crowd out' some private investment and reduce private consumption at the margin. When the full adjustment has taken place the economy has not grown, indeed, it may have a lower trend growth rate due to the lower marginal productivity of government spending versus private investment. The biggest change is that income distribution has changed: the government is now a bigger part of the US economy.[4] Savers are marginally better off than debtors due to higher rates. Tax payers are worse off than the beneficiaries of government spending, who, given Trump's preference for corporate tax cuts, are likely to be shareholders. Hence, overall income inequality in the US economy is likely to be higher than before.

Tariffs

Next, consider how a tariff on imports would impact the US economy. A tariff has the virtue of being revenue positive, so it can offset some of the negative impact on the public finances of Trump's tax cuts and increased infrastructure spending. Tariffs will be revenue positive even if they are matched by export subsidies, since the US is a net importer. The fiscal benefit of tariffs would however come at a cost because like all taxes, tariffs destroy some economic activity (so-called 'deadweight losses'). Taken together, the combined effect of the fiscal stimulus, tariffs and export subsidies is likely to be negative for public finances. For example, the non-partisan Tax Policy Center has estimated the fiscal cost of cutting the corporate tax rate from 35% to 20% at USD 1.8trn, while tariffs could raise some USD 1.2trn.[5] Note, however, that these estimates do not include any infrastructure spending or export subsidies the cost of which would have to be added to the fiscal deficit.

[2] This assumes that savers do not become more thrifty in response to government dissaving, aka Ricardian Equivalence. Ricardian equivalence is an economic theory which suggests that when a government tries to stimulate an economy by increasing debt-financed government spending, demand remains unchanged because the public saves its excess money in anticipation of future taxation.

[3] There are additional complexities if people regard the increase in government debt as a source of additional taxation in the future.

[4] Jim Nunns, Len Burman, Ben Page, Jeff Rohaly and Joe Rosenberg (2016) *"An analysis of Donald Trump's revised tax plan"*, Tax Policy Center, 18 October 2016.

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The impact of tariffs on the US trade balance is somewhat less intuitive. Tariffs directly lower imports by driving up their price within the US, but this also has the effect of reducing US demand for foreign currency, which therefore pushes up the Dollar. In fact, the Dollar will continue to rise until the stronger Dollar completely offsets the effect of the tariff. Exports will then fall and the trade balance ends up not doing anything at all.[6] In the short run the impact on the trade balance may of course be different depending on the speed with which imports respond to tariffs and the speed with which exports respond to the stronger Dollar.[7] The fact that a tariff does not permanently improve the trade balance, however, is important. This is precisely why Trump is considering an outright export subsidy in addition to the tariff. But since export subsidies place a direct burden on the public finances it is clear that an explicit trade-off exists between the fiscal and trade balances, which ultimately depends on size of the export subsidy. A bigger subsidy will create a stronger trade balance but a bigger fiscal deficit and vice-versa.

Tariffs introduce a wedge between the home market and markets abroad. The lower the share of trade to GDP the less efficient the US economy becomes and the lower the trend growth rate

Note that one of the unambiguous effects of tariffs is that they permanently reduce the share of trade in the US GDP. Tariffs introduce a wedge between the home market and markets abroad. In the case of a very high tariff, the US economy might be entirely cut off from international trade (similar to a quota). At that point, all the well-known efficiency gains from trade are lost. The extent of the reduction in trade obviously depends on the size of the tariff; the greater the tariff the bigger the reduction in trade. The lower the share of trade to GDP the less efficient the US economy becomes and the lower the trend growth rate.

Tariffs also have another sinister effect: they create dependence on government intervention. An increase in tariffs will immediately make import-competing US businesses more profitable, but only due to the tariff not their inherent competitiveness. This is why companies behind trade barriers tend to spend progressively more resources lobbying to preserve the protection afforded by tariffs rather than ploughing money into productive investments and why their productivity tends to decline over time. Rent-seeking therefore makes it much harder to reverse protectionism once it has become policy.[8] That, in turn, creates broader macroeconomic risks in any future economic crisis. For example, if tariffs have to be dismantled, there could be severe damage to public finances and if export subsidies have to be removed, exporters and the current account could both be severely damaged.

These general theoretical observations have to be qualified somewhat with respect to the special factors that apply to the US economy and various temporary effects that can impact the dynamics of the economy during transition:

1. **The US is a very large economy:** The US economy is so large that a fiscal expansion would push up rates within the US economy despite a completely open capital account. By contrast, interest rates would not rise in a small open economy in response to fiscal policy as capital inflows would immediately depress activity via the exchange rate. The rise in rates in the US would produce some 'crowding out' of domestic investment, which means that the US trade balance deteriorates less in response to a fiscal expansion than would be the case in a small open economy.

2. **The US has a large non-tradable sector:** The bulk of the US economy is non-tradable.[9] The existence of a substantial non-tradable sector means consumers can switch spending towards near-substitutes for imports in the local economy when tariffs go up. This will, all else even, create more inflation than in a more open economy. Higher domestic inflation means that the real exchange rate appreciates more and hence the Dollar must rise further to maintain equilibrium. There is also an offsetting negative income effect of higher tariffs, but in the case of the US the substitution effect is likely to dominate the income effect.[10]

3. **Pre-announcement effects:** An anticipated increase in tariffs – and note that 'border adjustments' are already the hottest topic on the Street – can induce powerful inter-temporal substitution of both consumption and production. For example, if consumers and businesses expect a material hike in import costs tomorrow they may well decide respectively to buy imports and increase production of such goods today. The rate of intertemporal substitution is difficult to quantify, but to the extent it happens it can lead to unexpected – even counter-intuitive – movements in both the current account and in the currency during the transition.[11]

4. **Will Trump tax intermediate goods?** It is not yet clear if Trump's proposed tariffs would apply to intermediate goods, such as commodities. If applied to intermediate goods, tariffs would raise the cost of production for all American goods, both for exports and domestic consumption. This depresses real incomes at home, but could also hurt exports and thereby offset any hoped-for temporary improvements in the external balance.[12]

The effect of Trump's proposed policy mix is summarised in the table overleaf. The policies – if implemented – should theoretically strengthen the Dollar and raise the rate of inflation. The overall impact on interest rates will be ambiguous, although the net effect would probably be to push rates higher. The impact on the trade and fiscal balances is unambiguously negative as long as the fiscal stimulus dominates the tariff. Finally, the existence of various transitional and US specific effects mean that any straight forward conclusion about the direction and size of movement in the main economic variables in the short-term can be very difficult to predict.

[6] To see why the nominal exchange rate must appreciate in response to an import tariff consider the following equation: $RER_{FX\ per\ USD} = ER_{FX\ per\ USD} \times \left(\frac{P_T}{P_{NT}}\right)$ [1]
where RER is the real exchange rate, ER is the nominal exchange rate, P(T) and P(NT) are prices of tradables and non-tradables, respectively. Since [1] is an equilibrium condition it follows that the RER must be constant and that any rise in PT (due to the tariff) must be offset by a higher nominal exchange rate.

[7] This too can be difficult to predict due to effects, such as the J-curve.

[8] This phenomenon is obvious in farming, where lobbying for continued state support is critical to survival.

[9] See for example Lombardi, G. and Ravenna, F. (2012) *"The size of the tradable and non-tradable sectors: Evidence from input-output tables for 25 countries"*, Economics Letters, 116 (2012), pages 558-561.

[10] Edwards, S. and van Wijnbergen, S. (1987): *"Tariffs, the real exchange rate and the terms of trade: on two popular propositions in international economics"*, NBER Working Paper Series, No. 2365, August.

[11] Edwards, S. (1988) *"The determination of the equilibrium real exchange rate"*, UCLA Working Paper Number 508, September 1988.

[12] This may be very relevant in the US context, where a large share of exporters is in fact re-exporters, i.e. they import, add value and then re-export. See J. Bradford Jones (2016) *"Importers are exporters: Tariffs would hurt our most competitive firms"*, Petersen Institute for International Economics, Dec 7, 2016.

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Fig 1: **Trump's policy mix and the US economy**

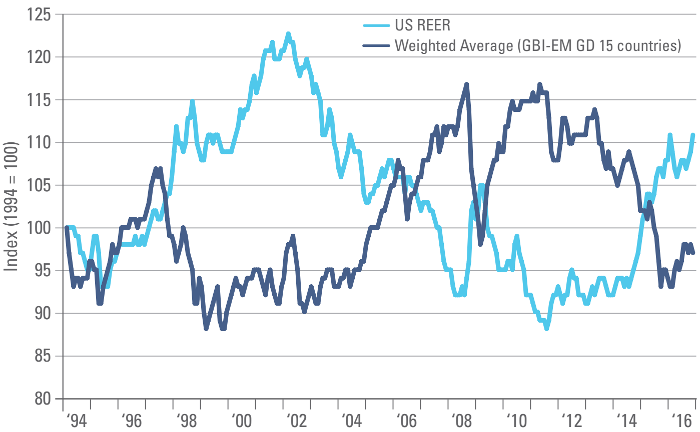
Market	Fiscal stimulus	Tariff hike	Expected overall impact
Fiscal deficit	Greater	Narrower[13]	Greater[14]
Trade deficit	Greater	Unchanged[15]	Greater
Rates	Higher	Ambiguous[16]	Higher
Inflation	Higher	Higher	Higher
Dollar	Higher	Higher	Higher

Source: Ashmore.

RER overvaluation

Armed with this overview of the likely macroeconomic consequences of Trump's proposed policies it is immediately obvious that the timing of his policies is particularly poor, at least from the perspective of macroeconomic stability. The timing problem arises because Trump's proposed policy mix is clearly stimulatory and the US economy is already at or very near to full capacity. Consider the chart below. This chart shows that the US real effective exchange rate (REER) is sitting at the most appreciated level since the Dotcom Bubble. Sure, the REER was briefly higher than today's level during that period, but we know now with the benefit of hindsight that this was due to an overshoot, because the US REER subsequently dropped for next ten years in a row.

Fig 2: **Real effective exchange rates: EM and US**



Source: BIS, Bloomberg, Ashmore.

The overvalued state of the REER means that further stimulus at this point in the cycle only worsens the disequilibrium in the US economy. This point was also emphasised by Federal Reserve Chairwoman Janet Yellen in her December 2016 press conference.[17] The best way to 'cure' real exchange rate overvaluation is to weaken the nominal exchange rate, lower non-tradable prices and inflict a positive productivity shock on the economy. Trump's policies do exactly the opposite. Fiscal expansion exacerbates the real exchange rate overvaluation by pushing up the prices of non-tradables, tariffs push up the Dollar and protectionism is a negative productivity shock. The result is that the policies increase the odds of larger future losses for the Dollar, US financial markets and the economy as a whole.

US Dutch Disease

The US economy can be characterised as suffering from a particular version of Dutch Disease, which is directly attributable to massive capital inflows as opposed to the commodity booms that traditionally cause Dutch Disease.

The high volume of capital flows to the US economy in recent years is the consequence of extraordinary stimulus of financial markets mainly via unconventional monetary policies (asset purchases). The central bank subsidy of bond markets prompted investors the world over to chase returns in US markets. While inflows can be very useful if they are put to good use in the real economy they can also be destabilising if they are not.

Unfortunately, the huge volume of flows into the US in recent years has not been matched by an equivalent set of investment opportunities in the real economy.

The bulk of the money has therefore gone into financial markets. The very fact that capital has gone into financial market speculation instead of investment opportunities in the real economy strongly suggests that the US is investment-constrained (as opposed to savings constrained).

The classic symptoms of an investment constrained economy are:

- Very low real rates;
- Banks sitting on tons of liquidity;
- No strong appetite to borrow; and,
- A big question mark that hangs over the heads of all investors right now: where on earth am I going to make my next 10% return?

Who are at risk from tariffs?

It is worth remembering that a country's trade balance is the result of billions of individual commercial and private spending and investment decisions both at home and abroad. The US trade deficit reflects what America consumes in excess of what it produces and is constrained by the extent to which savers in the rest of the world are willing to lend America the means to spend beyond its immediate means.

America's total trade with the rest of the world is sizeable at USD 3.75trn, which is roughly equivalent to 20% of US GDP. The trade balance is in deficit to the tune of USD 746bn, or 4% of GDP (based on 2015 official US full year trade statistics). The existence of a deficit fundamentally reflects global confidence in the US, though Trump clearly does not see it that way.

[12] Assumes imports>exports.
[13] This assumes that the cost of the fiscal stimulus exceeds the total revenue mobilised from trade taxes.
[14] Can be stronger in the short term depending on time it takes a stronger currency to erode exports. Also depends on the application of export subsidies.
[15] Depends on whether the substitution or income effects dominate with respect to consumption and investment.
[16] The notion of investment constraints is conventionally applied to developing countries, but today seems more appropriate when applied to developed economies. See Rodrik, D. and Subramanian, A. (2009) *"Why did financial globalisation disappoint?"*, IMF Staff Papers, Vol 56, No. 1.
[17] Janet Yellen said, *"I would judge that the degree of slack has diminished. I would say at this point that fiscal policy is not, obviously, needed to help us get up to full employment"*.

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Breaking down America's trade deficit further it can be established from the table below that 61% of America's imports of USD 2.25trn in 2015 came from EM and that some 56% of American exports went to EM. In other words, the imbalance in trade with EM is not enormous but EM trade is nevertheless more important to the US than trade with developed economies. All else even, this would seem to imply that EM is more vulnerability to US protectionism.

Fig 3: **US trade patterns (2015)**

	US imports from...		US exports to...		Trade balance with...	
	USD bn	%	USD bn	%	USD bn	%
Developed economies	883	39	661	44	-222	30
Emerging Markets	1366	61	842	56	-524	70
All countries	2248	100	1503	100	-746	100

Source: Ashmore, www.tse.export.gov

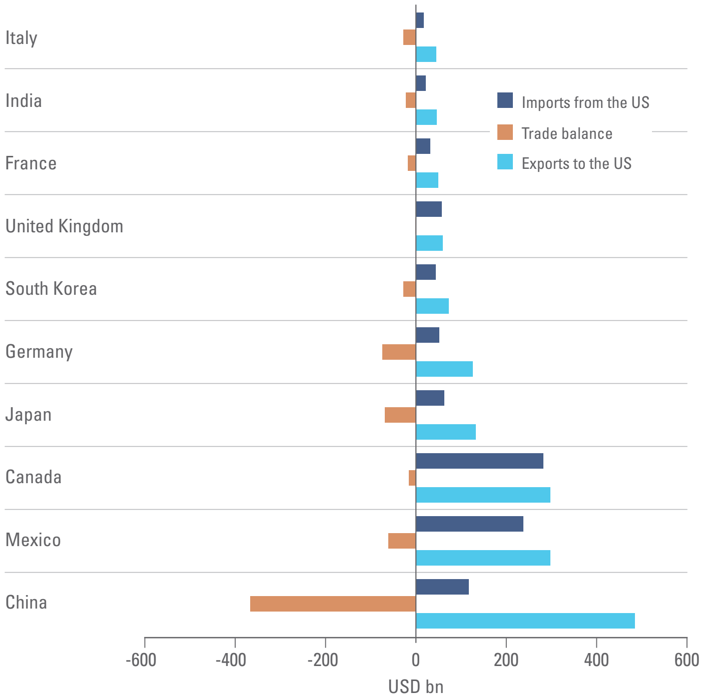
However, it would be wrong to leap to this simple conclusion, because some countries are vastly more important exporters to the US than others. Moreover, within the sub-set of important exporters to the US the split between EM and developed countries is quite even. For example, out of the 232 countries and territories that exported to the US in 2015 some 92% (213 countries) exported USD 20bn or less.[19] Some 194 countries within this group of 'insignificant exporters' are EM countries.

The conclusion from these observations is that it would be inefficient bordering on irrational for Trump to impose blanket tariffs on all imports. By doing so, the US would incur the wrath of a great many countries most of which simply do not matter very much. Every country in the world has exactly the same rights to take the US to the WTO, so many relations would be soured for very little gain. A country specific approach seems far more sensible.

The vulnerable ten

Of the 19 countries (8% of the total) that export more than USD 20bn to the US there are eight developed economies and 11 EM countries. The EM countries account for just below 60% of the total imports of the group. However, even within this group of larger exporters to the US there are huge discrepancies in terms of size. In fact, the top 10 exporters account for a whopping 71% of all US imports. Four countries within this 'top ten' group of super exporters are from EM – China, Mexico, India and South Korea – while six are developed economies (Canada, Japan, Germany, UK, France and Italy). Their individual vulnerability to US protectionism depends in part on the degree of imbalance in their trade with the US as well as their capacity to retaliate, which can be approximated roughly by the absolute size of their imports from the US. Figure 4 shows exports to and imports from the US as well as the trade balance for the 10 biggest exporters to the US.

Fig 4: **2015 trade imbalances: Top 10 countries**



Source: Ashmore, www.tse.export.gov.

We draw the following broad conclusions with respect to the vulnerability of these ten countries and the other nine medium-sized exporters to the US:

1. China: China exports more to the US than any other country and Chinese trade with the US is more imbalanced than any other country. However, China also has some potential to retaliate against the US, because China absorbs some USD 116bn of American exports every year. In fact, China is the third largest destination for US exports in the world after Mexico and Canada, or the fourth if one regards the EU as a single exporter.[20] Of course, China also has the option to dump US government bonds, an option whose value goes up as US rates increase, since the marginal cost of higher rates rises exponentially the higher the starting point for rates. We discuss the case of China and Mexico in greater detail below.
2. Mexico and Canada: NAFTA members Mexico and Canada have relatively balanced trade with the US, but they are nevertheless big exporters in absolute terms; each country exports about USD 296bn to the US each year.
3. Japan and Germany: Japan and Germany are much smaller exporters to the US than China, Canada and Mexico, but their trade is far more imbalanced than both Mexican and Canadian trade. Indeed, expressed as a percentage of total trade the imbalances in Germany and Japan's trade with the US are 43% and 36%, respectively, compared to just 11% for Mexico and 3% for Canada. What this means is that Germany and Japan could in principle retaliate far less effectively than Mexico and Canada, but remember that Japan is now growing in strategic importance to the US as China chips away at America's traditional allies in the region. Also, Germany would retaliate against US tariffs as part of a unified EU response and hence Germany pushes well above its weight in negotiation terms.[21]

[19] This is equivalent to 0.9% or less of total imports.
[20] The EU should be regarded as a single exporter, because the region negotiates trade as a single entity.
[21] EU exports to the US were USD 267bn in 2015 compared to German exports of USD 49bn.

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4. **Ireland, France, Vietnam, Thailand and Malaysia:** The imbalance of trade between the US and these four countries is 40% or greater, i.e. large. However, individually they are relatively small exporters: each country contributes just 1%-2% of total exports to the US.
5. **UK, Brazil and Saudi Arabia:** These countries are also relatively small exporters, but they differentiate themselves significantly from the previous group by having very balanced trade with the US (their trade imbalances are less than 10%).
6. **Taiwan, France, Switzerland, Israel, India and South Korea** fall in between (4) and (5) in terms of the extent of trade imbalances.

Watch for the American counter-revolution

The scope for American protectionism is also determined by US domestic economic and political factors. Amidst all the excitement and momentum in the markets due to Trump's election it is easy to forget that US presidents often end up achieving very little. This is because the US is a highly institutionalised country with many diverse and well-entrenched interest groups plus checks and balances that limit the powers of the Executive.

The US trades some 20% of its GDP every year. There are therefore many businesses that would be very concerned about the potential damage from a trade war. A political backlash, to the extent it materialises, will likely come from businesses and could potentially materialise quite swiftly. Congress would be the main conduit of discontent in the business community and would constrain the President by denying him the means to pass legislation.

This is important: US voters expect Trump to improve their lives during his first term. While Schadenfreude is a well-known source of elation for some people, it is doubtful that attacking Mexico or China would make most Americans feel better about their daily lives on a sustained basis. The lesson from history is very clear with respect to first term presidents getting too embroiled in foreign policy: don't! Former presidents George Bush Sr. and Jimmy Carter paid dearly for getting bogged down in foreign policy issues in their first term and were denied second terms. Trump's chances of re-election are far better served by focusing on policies that actually matter to the American electorate, such as corporate tax cuts, infrastructure spending and the repeal of unpopular reforms such as Obamacare, Dodd-Frank and climate commitments.

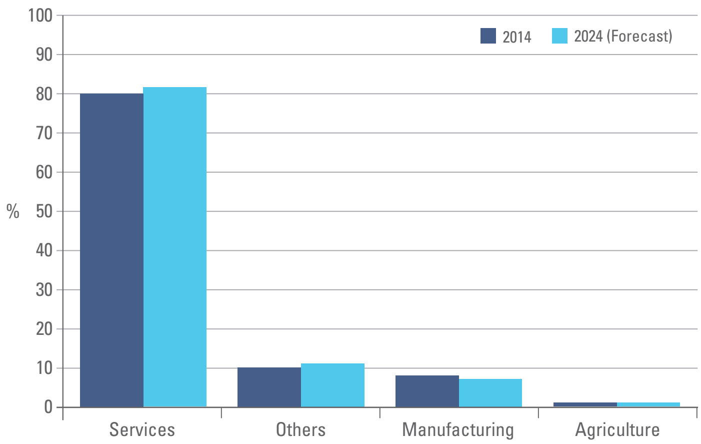
The truth is that a blanket tariff would be very costly for most Americans. First, it could increase the US price level by as much as 2%-2.5%, according to a recent report from Goldman Sachs.[22] A jump in inflation of that magnitude would hurt consumption really badly and require the Fed to hike rates. Would the Fed be able to hike enough to neutralise a 2.5% increase in prices? If yes, the US would go into recession and US stocks would be a big sell. If not, the US would have inflation and the Dollar and long bonds would be a sell. We are more inclined towards the latter scenario.

A blanket tariff would be very costly for most Americans. It could increase the US price level by as much as 2%-2.5%. Would the Fed be able to hike enough to neutralise a 2.5% increase in prices?

From a sector perspective the imposition of tariffs would hurt many and help few. As the chart below shows only 8% of American workers are employed in the manufacturing sector and only a subset of those compete directly with foreign firms. Some 80% of the American workforce is employed in the services sector, which happens to be overwhelmingly non-tradable. As noted previously many American businesses rely heavily on imported inputs, so they would be hurt by tariffs. They could be priced out of the re-export market.

Hence, here again it would seem more rational for Trump to target protective measures at specific vulnerable and unproductive US industries, such as steel rather than inflicting widespread collateral damage across the whole economy through blanket tariffs on all imports.

Fig 5: **US: Employment by sector**



Source: Bureau of Labour Statistics, Ashmore.

Foreign constraints

Needless to say, US protectionism would also generate significant friction among America's trade partners. As noted above, there are vulnerabilities in India, Taiwan, Vietnam, Malaysia, Thailand, Brazil, Israel and Saudi Arabia, but by far the greatest risk exists in Mexico and China. How can they respond?

(a) Mexico

Mexico's markets already reflect fears of Trump trade activism, but clearly investor caution is warranted until the full scope of Trump's policies with respect to NAFTA becomes clearer. It is difficult not to empathise with the Mexicans. More than any other EM country Mexico has been a model neighbour to the US. Indeed, Mexico has almost seen itself as the 53rd State for the past couple of decades with close coordination with its northern neighbour in all areas ranging from monetary policy, trade policy, the capital account openness, development of its financial markets to fighting the drug trade, etc. Yet, given

[22] This is equivalent to 0.9% or less of total imports.

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Trump's vicious attacks on Mexican business and Mexicans in general it is difficult to escape the conclusion that being close to the US is turning out to be major liability rather than a blessing.

Mexico does not have much bargaining power. It will therefore attempt as far as possible to negotiate a deal with Trump. Mexico is likely to shy away from retaliation as far as possible and if it goes ahead it will use the existing international frameworks for settling trade disputes. Mexico has some USD 170bn in FX reserves of which the vast majority is in Dollars. However, it is unlikely that Mexico would dump Treasuries in a direct bid to intimidate Trump. Instead, we think Banxico will allow MXN to fall and raise rates if necessary. Banxico can be expected occasionally to intervene if markets threaten to become disorderly. In the end, Mexico has no choice but to wait for the cheapness of the currency to gradually restore Mexican competitiveness. At the margin this process could be accompanied by economic reforms if necessary. Longer-term Mexico must draw a lesson from this experience – that America looks after number one – and recognise that its interests are better served by not being so dependent on the US.

(b) China

China is an entirely different kettle of fish. The US could attack China on three fronts: impose tariffs, label China a currency manipulator and refuse to grant China market economy status. Unlike Mexico, China could hit back. Hard.

Labelling China a manipulator does not in itself matter much, but would probably be used as a pretext for imposing tariffs on Chinese exports to the US.[23] Under current rules China would not actually qualify as a currency manipulator, because although China's trade surplus is big enough to qualify its current account surplus as a share of GDP and the level of reserves are both too small. Trump could easily change the rules, however. The ends would justify the means.

The importance of market economy status is that a country wishing to prove unfair practices must use the 'accused' country's data to prove the case whereas under non-market economy status it can use data from third party countries (which makes it easier to prove unfair trade practices). China does not currently have market economy status, so if Trump reverses the existing US commitment to grant China market economy status, it doesn't actually change anything. Not that it matters a great deal for the level of US protectionism anyway. The US mainly uses trade restrictions against China that fall outside the remit of the WTO, namely so-called counter-veiling duties (CVDs). The number of CVDs imposed by the US against China has actually risen in very close correlation with the volume of US imports from China. In other words, the US is already protecting itself heavily against Chinese imports. By contrast, China has reduced the number of outstanding CVDs against US exports sharply since 2013. This means that China is in a stronger position to hurt US exporters today rather than the other way around.[24]

In the final equation China could, of course, play the Treasury card. At the end of a 35 year boom in US fixed income during which Americans have doubled their debt load and at a time when stock and bond markets are both bloated by years of money printing the single biggest vulnerability is clearly a sharp rise in Treasury yields. Moreover, the value of China's option to inflict pain by selling US bonds rises with the level of US Treasury yields. This suggests that time is on China's side.

China is of course not the only EM country with reserves. EM central banks control nearly 80% of total FX reserves in the world and the vast majority of the reserves are invested in Dollars and USD denominated fixed income securities. China is likely to have some influence over the reserve allocation decisions of other EM countries by virtue of its significant investments in other EM countries.

Given Trump's vicious attacks on Mexican business and Mexicans in general it is difficult to escape the conclusion that being close to the US is turning out to be major liability rather than a blessing

How would Europe respond to a trade war between the US and China? There is no guarantee that Europe would unequivocally support the US, especially if the US imposed blanket tariffs against all imports including imports from Europe. Recall that the UK and Europe were willing to cede room within the SDR basket to allow the RMB to join quite recently. This decision was the result of a bargain in which China promised to invest in European energy and infrastructure sectors. There is no reason to believe that this arrangement will change just because the US becomes protectionist. A recent reminder of the importance of the arrangement was provided by UK Prime Minister Theresa May, who famously dumped China as a partner in the Hinkley Point nuclear power plant shortly after taking office only to U-turn very rapidly, when a kind civil servant whispered in her ear that Britain had actually given up a big part of its share in the SDR basket in exchange for the Chinese investment! Civil servants can be useful.

Global investors are generally lightly positioned in China. Sentiment towards China is super-negative. Chinese bond and equity markets have still not been included in the main MSCI and JP Morgan benchmarks, a pre-condition for allocations by most institutional investors. Hence, while a trade war with the US would further worsen sentiment towards China. The resulting volatility in Chinese markets would simply not have much of an impact on most EM portfolios. That is not to say that the opportunities created by such volatility should go unexploited. We think it would be a very good entry point for investments in China. China's has for several years been preparing to rely more on domestic demand led growth and less on export led growth, precisely because of the poor outlook for exports to the West going forward. Over the medium term the Dollar will fall versus RBM due to QE and inflation to bring down the US debt overhang. To understand more about why China has been reforming for several years precisely to cope with a more hostile export environment please see *"China Roadmap"*, Market Commentary, 17 June 2015.

[23] Under the current rules if a country is labelled a currency manipulator the US Treasury must then engage in bilateral talks to address the cause of currency undervaluation. If there is no progress then after a year penalties could be imposed. IMF would have to be alerted and OPIC would be asked to curtail its programs in China. OPIC does not have any programs in China, however.

[24] See Chad P. Brown (2016) *"Should the United States recognise China as a market economy?"*, Policy Brief, Peterson Institute for International Economics, December 2016. See also Chad P. Brown (2016) *"Trump says China is not a market economy. That's a big deal"*, OP-EDS, Peterson Institute for International Economics, 12 December 2016.

Conclusion

There is no guarantee that Trump will not start a global trade war. However, our analysis suggests that this would be an inefficient way to help uncompetitive US businesses. The economic and political costs would be high at home and abroad. Besides, a policy mix of trade protection and fiscal stimulus would be inappropriate at this point in the cycle and increase the risks of investing in US financial markets.

Trump's appointment of known trade hawks and anti-China crusaders is consistent with the start of an acrimonious trade war, but it is equally consistent with a desire to establish the toughest possible starting position for difficult, but ultimately fair trade negotiations. Seasoned trade negotiators will tell you that trade talks are a game of smoke and mirrors. A credible threat of trade war enables Trump to 'offer' to step back from the brink in exchange for concessions and thus to achieve a stronger final outcome.

Our base case is that Trump steps back from the threat of extreme protectionism, partly due to opposition from sections of the pro-business lobby in Congress and partly due to the fact that it is quite simply a stupid policy. The ditching of the Trans-Pacific Partnership would hold no surprise, but EM investors should certainly expect noise. Relations could yet become frayed during re-negotiation of certain clauses in existing trade relationships, including NAFTA. Tough measures on China specifically could trigger serious retaliation, but cannot be ruled out. Trump's domestic agenda, however, leaves little time for serious foreign policy conflicts particularly if they hurt the American economy. If Trump becomes unpopular and 'loses' Congress he may ultimately turn out to be a source of volatility rather than actual risk.

Trump would retain his credibility for longer and do better by the American people if he aims protection at the most vulnerable and unproductive US industries, such as steel. Fiscal incentives can be used to encourage US companies to relocate back to the US. This will not be pretty and certainly not cheap, but at least it would avoid the risk of a systemic collapse in global trade.

Ultimately, America under Trump is a country, which is shrinking from its former economic spheres of interest abroad. This need not be a bad thing for EM, because it creates room for others to advance. China in particular stands to benefit.

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