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MARKET COMMENTARY

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The limits of protectionism

By Jan Dehn

Last night the US government announced details of a USD 50bn package of tariffs on Chinese imports.

Today China responded by announcing tariffs matching the size of US tariffs, targeting areas of maximum pain for Trump, such as soy, corn and aircraft. Further details are likely to emerge in the coming days and weeks. Trump's trade war with China is on, but how far will this trade war go?

Our view is that the trade war will be contained for four *specific* reasons.

- First, US protectionists are already discovering that it is difficult to identify clear domestic winners and clear foreign losers by imposing *generalised tariffs* (i.e. tariffs that apply to imports from all countries). This difficulty arises, because supply chains are both very global and complex. Cars, for example, are made in multiple countries, so tariffs on imported cars end up hurting producers in the US as much as producers abroad. Indeed, the complexity of supply chains is one of the reasons why Trump is wavering on his promise to dissolve NAFTA.

- Second, generalised tariffs lend themselves mainly to very *simple products*, such as steel and aluminium, where most of the value added chain is located in one place. However, the US is an advanced economy dominated by secondary and tertiary industries, so primary industries of the kind that lend themselves to *generalised tariffs* are now a relatively small part of the overall economy. One clear area of risk is agriculture. However, both the US and the European Union protect their agriculture sectors heavily.

- Third, while there are limitations on the imposition of generalised tariffs, there is greater scope for protectionists to target *individual countries*. However, as we have seen today, this will lead to retaliation. We expect that China's response to the US will be to match but not to exceed the level of US tariffs. China is also keeping the door open for talks. This restraint on the part of China is important: it is China's way of showing that it is open to de-escalating the trade war. Of course, the trade war can still escalate further, but only if Trump wishes it so.

- Fourth, *we do not expect other countries to follow Trump's protectionist lead*. The trade war should therefore be contained as a mainly bilateral affair between the US and China. Other countries are unlikely to go down the road of protectionism because: (a) European and Emerging Markets (EM) economies are doing better economically; and (b) US protectionist sentiment is rooted in the strong Dollar and falling US productivity growth. By contrast, EM currencies are very competitive, so EM countries are not finding it hard to export at all as reflected in the massive improvement in EM external balances in recent years.

Complexities in global supply chains limits the scope for generalised tariffs, so US protectionists are targeting individual countries

It follows that the main risk of further escalation is that the Trump Administration *targets more countries* for special treatment. Yet, this may be problematic. The largest US trade partners are Mexico, Canada, Japan, Germany and China. For now, trade relations with Mexico and Canada appear managed within the framework of the NAFTA talks. After the US withdrawal from the Trans-Pacific Partnership, Japan is still America's only ally in the Far East. Germany has a large trade surplus with the US, but if Trump picks a fight with Germany, he is likely to get punished by Germany's big brother, the European Union. The UK, increasingly isolated due to Brexit, could be more vulnerable. There is also a chance that Trump targets smaller countries, including some EM countries, but such risks are clearly country-specific rather than systemic and lend themselves to mitigation through active management.

Other countries are unlikely to share Trump's protectionist urges and China will not abandon its broader commitment to more open markets

The *rhetoric* of the US Administration is that it is responding to unfair foreign trade practices, but this explanation holds little water, in our view. There have been no major changes in global trade practices vis-à-vis the US in recent decades, that is, until Trump's unilateral imposition of tariffs. Political rhetoric always cloaks protectionism and this trade war is no different. Ultimately, however, it is irrelevant whether protectionism is happening due to economic ignorance or as the result of a ploy to deflect attention away from domestic problems by scapegoating other countries: in *economic terms* protectionism is unambiguously a major policy mistake.

Continued overleaf

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EM investors are particularly well-placed to gauge the risks of protectionism, because EM are replete with examples of countries, which have made the mistake of becoming protectionist. Famously, the Argentine government under former President Nestor Kirchner failed to shift the focus of economic policy from domestic demand stimulus to supply-side reforms as Argentina approached full employment in the mid-2000s. Instead, the government continued to stimulate demand and found itself imposing more and more tariffs in increasingly misguided attempts to treat the symptoms of real effective exchange misalignment. The Trump Administration is doing the same thing today.

This policy mix does not work. There is no happy ending. See it. Act. Or burn.

For further discussion of US-China trade relations see:

- *'Trade war'*
  Weekly investor research, 26 March 2018.
- *'Chinese reforms and American populism'*
  The Emerging View, November 2016.
- *'Trump and EM'*
  The Emerging View, January 2017.
- *'How Chinese bonds can enhance your portfolio'*
  The Emerging View, March 2018.

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