investment insights

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Bastien Drut
Senior Strategist

Clément Honore-Rouge
Strategist

ECONOMIC ENVIRONMENT

TRADE WAR: WHAT IMPACT ON THE WORLD ECONOMY?

HOW DOES THE TRADE WAR IMPACT CONSUMPTION IN THE US ?

According to OCDE simulations, the tariff hikes implemented since 2018 would lead to a cumulative decline in US GDP that would reach 0.6% in 2021 and inflation would be 0.3 point higher in 2019 and 2020. The OCDE emphasizes that the impact on US and Chinese growth could be much higher, particularly in the short run, if all US imports were overtaxed by 25 percentage points. Such a scenario is likely to happen, especially after Donald Trump threatened to hike tariffs on all the imports of Mexican goods at the end of May for border security reasons.

In theory, it is hard to conceive that a reduction in trade deficit would not affect the purchasing power of the Americans. Indeed, a country runs a current account deficit (approximated by a trade deficit) when consumption and investment (i.e the domestic demand) exceed what is produced in the economy. Then, 2 levers can be activated in order to shrink the US trade deficit; stimulating the production or restricting consumption. The tariff hikes, by reducing private domestic demand, will decrease the US trade deficit if it is not offset by an increase in public spending. This is the decline in consumption that reduces the trade deficit whereas the hike in tariffs is a tool to achieve this goal. On the contrary, Trump's tax reform has contributed to widen the trade deficit.

Noticeably, the pre-tax price of Chinese exports targeted by the increase in tariffs has been almost unaffected by them, which suggests that the price effect has been borne by US importers[1]. If some companies have chosen to absorb the cost of the higher input prices and reduce their margins, others have fully passed it on final product price (for example, this is what happened for washing machines). All in all, the Fed of New York estimates the cost of the measures taken in 2018 and 2019 to account for 1235$ by year and by household.

HOW COULD CHINA RETALIATE?

China's retaliatory measures far outweigh the tariff hikes on the $ 130 bn of US exports to China, which are getting the attention of commentators. Indeed, the United States also exports $ 60 bn in services to China and $ 40 bn in goods to Hong Kong (before re-exporting the majority to China). In addition, we must not forget the numerous companies that set up in China to target the domestic market (Ford, General Motors, Starbucks, Mc Donald's ...). One can also think of the rare earth export restrictions, which are vital for the technology industry and of which China is the very largely biggest producer in the world. These various points are all levers for the Chinese authorities, who may decide to reduce the number of operating licenses issued, make it difficult to open a bank account for foreign companies, undergo further examinations to imported products, or encourage consumers to turn away from US products. The boycott of Korean products by Chinese consumers in 2017, in support of their government during diplomatic tensions with South Korea, had particularly weakened Hyundai and thus demonstrated that it is a very effective tool.

Exchange rate policy plays a central role here, as evidenced by the depreciation of the renminbi, which systematically followed each of the announcements of tariff increases on Chinese products. Contrary to what is often mentioned, it is unlikely that the PBoC liquidates its holdings of US Treasury securities (it holds 7% of marketable securities) because this option would also be harmful to China. The sum of holdings of US Treasury securities by China and Belgium (where China holds a number of securities) has been stable at around $ 1300 bn since early 2017 and China

1- https://blogs.imf.org/2019/05/23/the-impact-of-us-china-trade-tensions/

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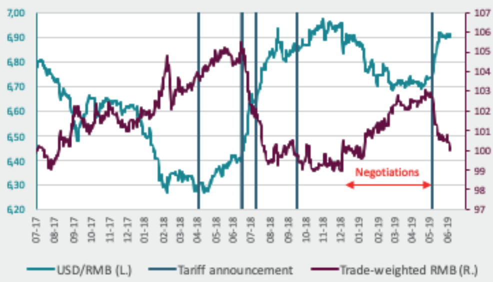
has even been a net buyer of US agency securities (Fannie Mae, Freddie Mac) since 2018.

WHAT IMPACT FOR THE OTHER COUNTRIES ?

The clash between the United States and China will make some winners and many losers. On the winners' side, we have already seen some examples of reallocation of trade flows related to the trade war. For example, the fact that the Chinese authorities, targeting Donald Trump's electorate, raise tariffs on imports of US soybeans has greatly benefited Brazil, which is a major exporter. More generally, the decline in US imports of Chinese products has been offset since the last quarter of 2018 by the increase in imports of products from the rest of the world (and particularly from Mexico).

The countries that will suffer the most from the trade conflict are those that are directly involved in the supply chain of goods exported by China. Typically, China exports nearly $ 250 bn worth of computer and electronic machinery and equipment to the United States, but the production of these goods sometimes involves up to ten Asian countries.

USD/RMB parity vs tariff announcements



Source: CPR AM, Datastream.

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