MARCH 2018

TRADE AND TARIFFS: LESSONS FROM HISTORY

President Trump on Thursday introduced watered down tariffs on steel and aluminium imports into the US.

Having last week proposed the tariffs would be universal, the executive order he signed gave Mexico and Canada a pass, and allowed other countries to apply for a waiver. He also made room for carve out provisions that would allow niche products to be exempt too.

The direct impact of the tariffs in Asia per se is tiny, and even smaller now compared with the proposed version last week. Steel and aluminium account for between 0.6-1.1% of exports from China, Korea and Japan to the US. Further, with global economic growth expected to touch 4% this year and with the capex cycle returning (which tends to boost global trade), it is likely that the impact on the Asian or global economies overall will be next to non-existent.

But that's not the end of the story. The real problem surround the unanswered questions of what happens next? To start with, the tariffs follow closely behind similar import taxes imposed by the US on washing machines and solar panels in January, so is this part of a developing pattern of protectionism or merely a one off?

Next, there is the question of retaliatory measures from steel and aluminium exporters – the European Union (EU), for example, is already talking about imposing tariffs on Levi's Jeans, Harley Davidson motorbikes as well as US-made whisky.

Added to this mix are corporate investment decisions: if a European or Asian company cannot rely on the US not to impose tariffs on a key raw material over a 20-25 year period, it is less likely to make that investment. Already, we've seen Swedish electronics group Electrolux put on hold a USD250 million investment in Tennessee citing lack of certainty on the potential steel tariffs.

This is how trade wars start. And like many wars, once they start, they can easily get out of control, are hard to stop without a lot of mess, and take a long time to reverse.

A LACK OF CHECKS AND BALANCES?

The issue is that, in the US, the White House has unusually strong powers to impose sanctions at will (in other words, it does not need Congressional approval to action them) and thus trade tariffs are at the whim of the President. Many observers still think that cooler heads will prevail in the White House and this tariff tantrum won't be repeated. It is also why the markets barely blinked in January when these steel tariffs were first talked about.

Equally, it is also why markets reacted so negatively this week when Chief Economic Advisor Gary Cohn resigned. He was a fervent supporter of free trade, and was generally thought to "have the ear" of the President. The markets are worried that without Cohn, further sanctions could follow.

From an Asian perspective, an escalated trade war would particularly hurt the exporting economies of China, Japan, Korea and Taiwan, while ASEAN economies would likely fare rather better because their export partners tend to be

Fig.1: US Trade balance with major trading partners; The US has a negative trade balance with China over five times that of Japan and greater than the next eight countries combined

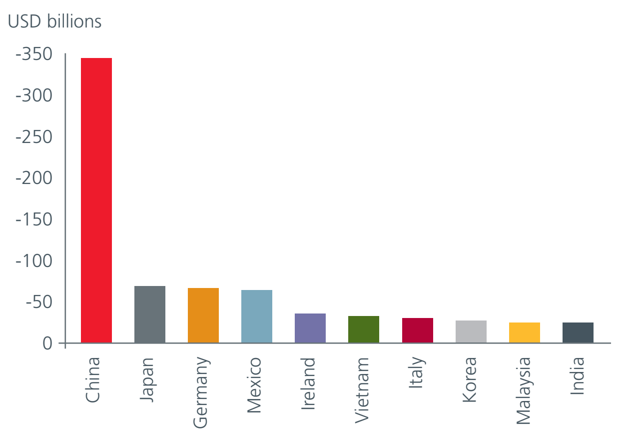
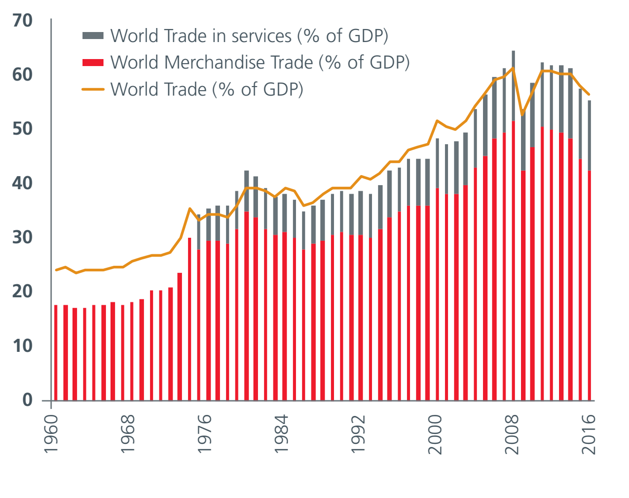


Fig.2: World Trade as percentage of World GDP, 1960-2016



Source: Fig.1. Thomson Reuters Datastream, as at 9 March 2018. Fig.2. Thomson Reuters Datastream, as at 9 March 2018.

within Asia. But this is likely to be a moot point – the good news is that an analysis of the responses from these exporting countries show they have no interest in ratcheting up a trade war.

One reason for this is that the tariffs are very limited and not bilateral – in other words, they are not targeting a single country so a response from a single nation in Asia would have the same effect as trying to bring down an elephant with a pea-shooter – none whatsoever.

A WAR OF WORDS RATHER THAN A WAR OF TRADE

Far more likely in the long term would be a co-ordinated effort from trading partners of the US through the legal processes of the World Trade Organisation. But that takes time. Reaction from Asia in the meantime will probably take the form of a war of words, rather than a war of trade, and thus any response that would have an actual impact on the global economy is a long way off, especially given the diluted nature of what was signed yesterday.

Thus far, it is this scenario that looks to be playing out. China said it would look for a "necessary response" but also that it would talk to the US in a bid to "create conditions of cooperation". China is highly unlikely to want a full-scale trade war given its substantial trade surplus with the US (refer to Fig.1) and as its current account surplus has narrowed substantially recently, any steep escalation in a trade war would have negative implications domestically and hurt its own deleveraging efforts. It thus has a deep incentive not to escalate this.

Elsewhere, Japan has sought 'greater clarity' rather than propose counter measures, while Korea – the third largest exporter of steel to the US after Canada and Brazil according to IHS Global Trade Atlas – has said it is continuing to talk to the US. Combined, these are hardly the words of nations intent on launching a full-scale trade war.

But that is not to say this is an impossibility and this could just be the opening salvo of a long, drawn-out global trade battle.

THE NEXT MOVE IS YOURS

Key to the next move will be the release in the summer of a US report on China's intellectual property rights which could give the US the excuse it needs for another, deeper round of tariffs on such sectors as semiconductors, telecom equipment and computers. That could sting a little more than the 0.11ppts of GDP growth Morgan Stanley estimates the combination of steel, aluminium, washing machines and solar panels would potentially have this year on the China economy.

But all is not lost in the US. Already we have seen steel and aluminium users in the US object almost in unison to the tariffs with everyone from car manufactures to soup makers facing higher costs. Already the message has been that these higher costs will be passed on to the consumer. That's not going to help tame the current inflation bogeyman nor help Republican chances in upcoming mid-term elections.

FORGET ECONOMICS, HIT THE HISTORY BOOKS INSTEAD

The final message that protectionists should perhaps pay attention to is the one from history. President George W Bush tried the same anti-dumping measures on steel in 2002, and that failed hopelessly – in under a year, the WTO ruled that the US had violated international trade agreements and forced the US to back down.

Later, attempts by President Obama to curb the imports of Chinese tyres also failed miserably: according to the Peterson Institute for International Economics, the tariffs rescued, at most, 1,200 jobs within the domestic US tyre sector but cost the retail sector almost 4,000 jobs with consumers simply switching to Korean or Thai imports instead. Further, China then imposed retaliatory anti-dumping duties on chickens exported from the United States, cutting nearly USD1 billion in sales.

And although on a different scale, the Smoot-Hawley Tariff Act also in the US introduced in 1930 is largely agreed by economists to have exacerbated the Great Depression. The lesson from history then is abundantly clear – don't do it.

ANYONE? ANYONE?

Today, the global economy is unrecognisable from the one Messrs Smoot and Hawley faced. As Fig.2. shows, the scale of global trade has more than doubled even since the 1960s and now represents 56% of global GDP. Although it has fallen from its peak just before the GFC – largely as a result of countries like Russia and India protecting their economies during the crisis and not opening up again when recovery began – the share of global GDP attributed to trade remains highly elevated by historical standards. The US imposing a tariff on steel imports from Korea and Japan won't dent this in the slightest. On the one hand an escalation by the US is the risk. On the other, the historical reality is that trade wars take decades to pan out and are usually tied up with major global conflict such as the World Wars of which we have not had.

And with more and more global trade agreements being put in place and old ones being revived such as the now signed "Comprehensive and Progressive Agreement for Trans-Pacific Partnership" (CPTPP - the old TPP but without the US), and despite the setbacks of Brexit or recent steel tariffs, the momentum is still on the side of trade and the benefits that global trading brings to global wealth. Simply put, the world would be increasingly less efficient if countries focused inwardly and not on global collaboration.

That's why it is likely that over the long term those cooler heads are likely to prevail and a full-scale trade war is highly unlikely.

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