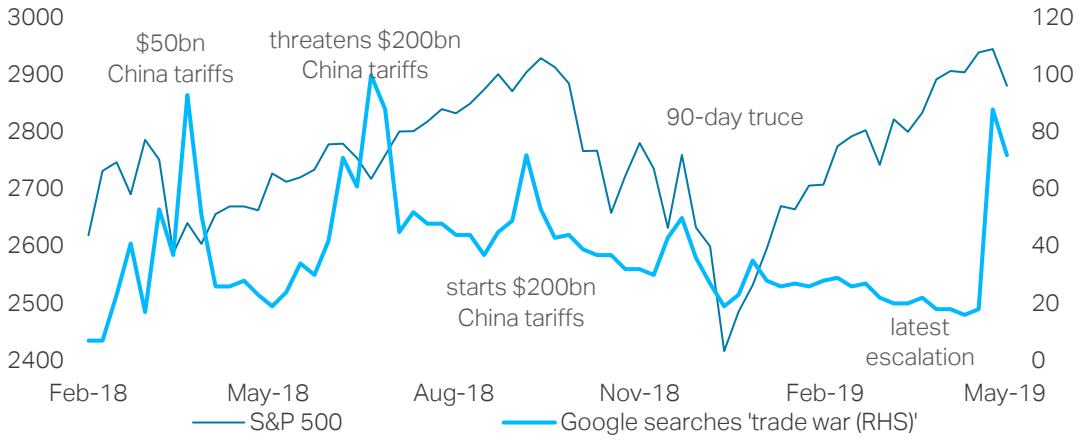
Macro Picture

TRADE RE-ESCALATION

Dario Perkins

The US-China trade war has escalated, again. Higher tariffs boost near-term inflation but the negative impact on market sentiment, world trade and global capital spending will surely dominate. This latest escalation could kill the 'green shoots' narrative. Figuring out the long-term consequences of the trade war is trickier, but they could be profound.

Chart 1: Tensions escalate



Source: Bloomberg, TS Lombard, Google Trends

ART OF THE NO-DEAL

Rather than reaching a new trade deal, tensions between the United States and China have flared up again. Jittery stock markets give President Trump a strong incentive to postpone further measures, but this latest round of tariffs will damage an already fragile global economy. New studies give a clearer guide to the macroeconomic impact of the US-China trade war.

TARIFFICALLY BAD

There is clear evidence US tariffs raise import prices, rather than Chinese exporters offsetting them in lower margins. Though US producers absorb some of these cost pressures, tariffs also raise consumer prices, eroding real incomes. Yet the impact of the trade war on global growth easily outweighs any inflationary impact, by damaging market sentiment and reducing capex.

COLLATERAL DAMAGE

Assessing the longer-term impact of the trade war is more difficult. Trade barriers damage global value chains, potentially causing serious supply disruption. This will undermine corporate profits and erode the return on the existing capital stock. We also expect major trade diversion, with the creation of new regional trading blocs. Some countries have a relative advantage.

TRADE RE-ESCALATION

Until a few weeks ago, it appeared the United States and China were slowly converging, albeit asymptotically, on a deal that would bring a ceasefire to their trade war. Together with Chinese stimulus, a dovish Fed, and scattered signs of 'green shoots', this seemed a sufficient reason for risk assets to rally further. Yet the negotiations haven't gone as smoothly as most investors were assuming. With the US administration insisting on a genuine shift in China's behaviour and the Chinese unwilling to commit to binding enforcement mechanisms, a deal now seems much more difficult. Worse, President Trump responded to this disappointment by hiking his import tariffs again, marking a serious escalation in the conflict. Understandably, the mood in markets has become decidedly shakier. With a trade settlement looking increasingly difficult, our best hope is that a skittish US stock market discourages any further intensification, at least for 3-6 months. Yet the measures already announced, which Trump is unlikely to reverse, will further damage an increasingly fragile global economy. World trade and capital spending have slumped.

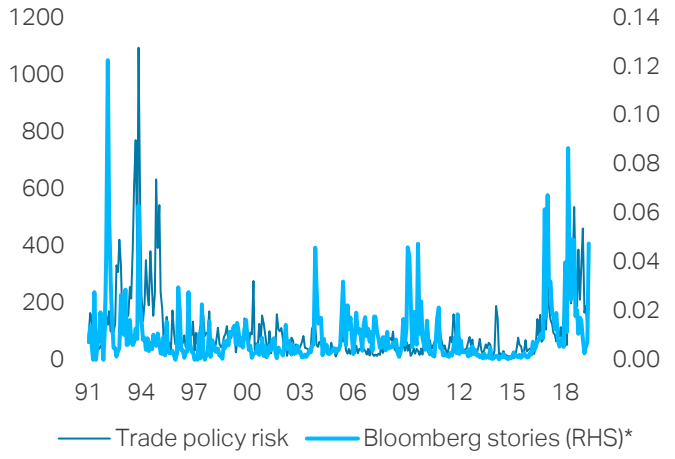
When the trade war began in 2018, there was a lot of uncertainty about what it would mean for the global economy. Would exporters or consumers pay the new tariffs? Would the trade war ultimately be inflationary or deflationary? After decades of continuous liberalization and declining tariffs, there were no recent historical episodes to illustrate the impact of such a lurch towards protectionism. Investors had to rely on textbook theory, macroeconomic models, or distant historical analogies (such as the 1930s). Today we are in a much better position to analyse the impact of this latest round of measures. Recent studies, for example, have settled the question about who bears the cost of Trump's tariffs – Americans do. Rather than Chinese exporters absorbing the cost in the margins, we see a clear rise in US import prices, which leads to a significant decline in import volumes. Researchers have also managed to trace the impact of the tariffs through to consumer prices, particularly for the earliest rounds of US protectionism. While the impact on core US inflation has been modest so far, the latest set of tariffs is likely to have a more significant impact. Fed estimates suggest it will add around 0.5% pts to consumer prices.

While the trade war will boost short-term inflation, its impact on global growth is more important. Global trade and capital spending have already deteriorated sharply, though it is hard to disentangle the impact of the trade conflict from other forces that have damaged global demand (including China's domestic downturn). Tariffs reduce world trade and hurt industrial activity 'directly', but the trade war also has a variety of 'indirect' effects, which compound the damage to the global economy. These include: (i) uncertainty about the ultimate scale of the conflict, which discourages investment even in countries that have (so far) escaped Trump's protectionism (e.g. Europe); (ii) currency moves, notably the combination of RMB devaluation and USD strength, which causes serious problems for the emerging economies; and (iii) potentially large supply-chain disruption – tariffs make existing trade networks uneconomical, rendering parts of the capital stock obsolete (reducing the return on equity). Over time, we expect large-scale trade diversion and even the creation of new regional trading blocs. This will bring new investment opportunities. But the transition will not be quick or seamless and, in the meantime, investors should brace themselves for further supply disruption and weaker industrial activity.

1. ART OF THE NO-DEAL

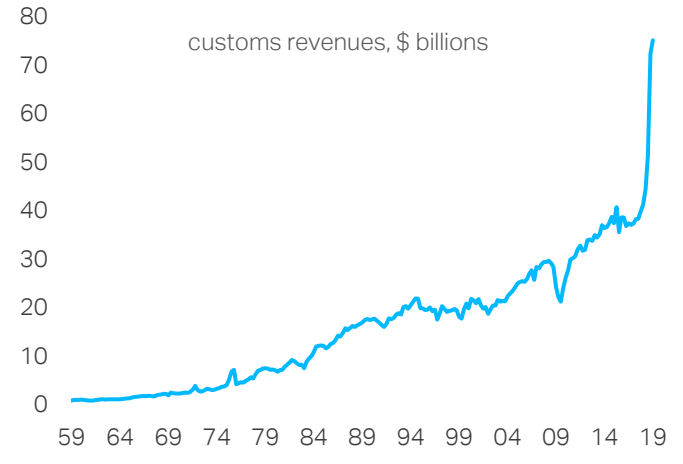
Following an impressive rally since December, risk assets have become decidedly more skittish in recent weeks. The three main foundations for the rally – Chinese stimulus, a US/China trade deal and scattered signs of 'green shoots' in global macro data – suddenly look rather shaky. The news on the trade war has been particularly disappointing. After the temporary ceasefire announced in Buenos Aires last November, it seemed the US and China were gradually moving towards a deal that would end their recent 'squabble', alleviating an important source of uncertainty for global markets. Officials had been making all the right noises, with the Chinese signalling their willingness to protect intellectual property, encourage FDI and even commit to buying more US goods and services. Yet by early-May it was clear the negotiations had gone seriously off track and President Trump re-escalated the conflict with another round of tariffs.

Chart 2: Trade war returns



Source: Bloomberg, Economic Policy Uncertainty Index, * per cent of all

Chart 3: US tax on imports



Source: US Customs

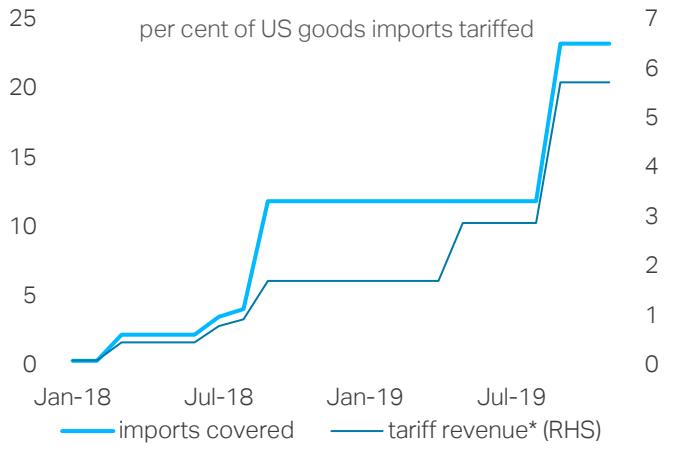
No deal?

So why were the two parties unable to reach a settlement? The US administration blames the Chinese, claiming they reneged on previous agreements. Press reports suggest China's delegation submitted a heavily re-written draft agreement in the final stages of negotiations, which tried to dilute China's commitment to what had been agreed. There is no shortage of explanations for why the Chinese attempted to rewrite the deal so late in the process, ranging from voices in the Communist Party who believe the deal went too far in capitulating to US demands, to rumours the Chinese delegation hadn't fully appreciated the precise legal implications of what they were signing up to until the last minute. Others believe Xi Jinping simply overplayed his hand, misjudging President Trump's eagerness for a deal. International investors also underestimated the US administration's desire for real change, assuming the President was desperate to avoid a further escalation. After all, the next rounds of tariffs will hit US consumers more directly, which is clearly unhelpful in the run-up to the 2020 elections.

The lesson from this latest round of hostilities is that the US government is serious about achieving a genuine shift in China's behaviour, rather than securing a symbolic victory. It wants China to sign up to binding agreements, including specific changes to Chinese laws and the introduction of various enforcement mechanisms. This is difficult for China, which believes such terms are unacceptable, especially given its history of 'national humiliations' at the hands of foreign powers. China is too big and too ambitious to constrain itself in this way. Our policy

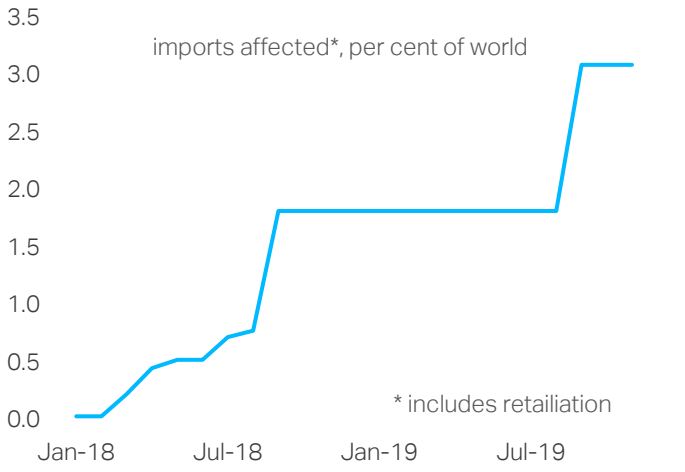
analysts now think a quick trade deal is less likely than it seemed a few months ago. Instead, we can only hope that President Trump is willing to 'kick the can' on these negotiations, delaying any further escalation in the crisis by 3-6 months. After all, we know there is a degree of 'reflexivity' in Trump's relationship with financial markets. Trump tends to escalate the conflict when US equities are close to record highs and eases off only when market sentiment deteriorates. So the current nervousness in markets improves the odds of a softer stance going forwards.

Chart 4: US protectionist timeline



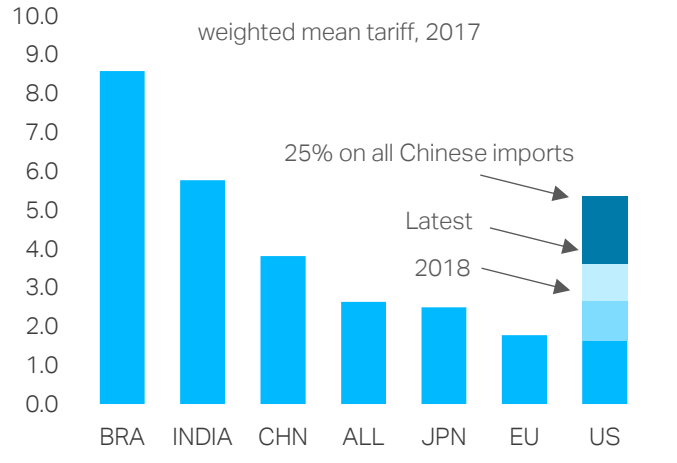
Source: TS Lombard

Chart 5: Global trade-war timeline



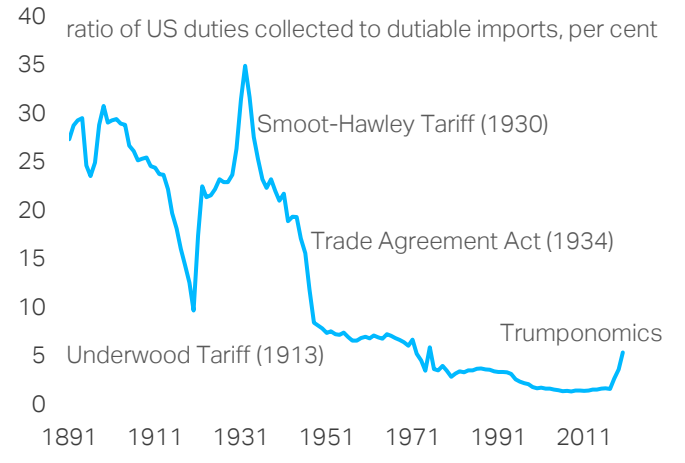
Source: TS Lombard

Chart 6: US tariffs in context



Source: World Bank, Datastream, TS Lombard estimates

Chart 7: Long historical context



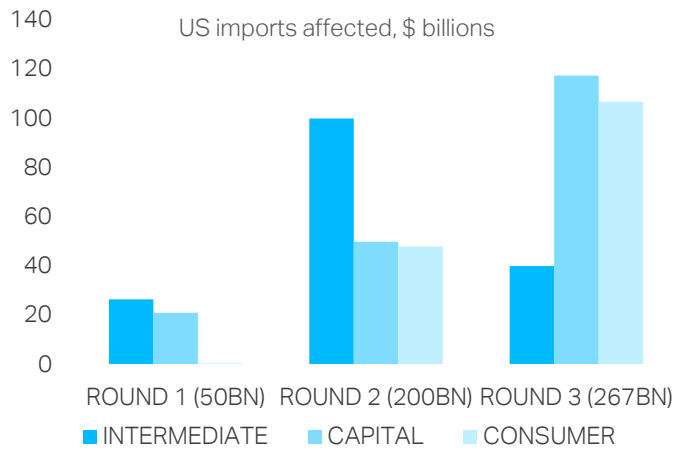
Source: TS Lombard based on historical US sources

Tariff timeline

Given all the noise and speculation of the past 18 months, it is useful to take stock of where we are in the US-China trade war (Charts 4 and 5). After implementing measures to protect specific industries in February (solar panels and washing machines) and March (steel and aluminium) the US administration became much more aggressive against China in spring 2018. Trump introduced tariffs on $50bn of Chinese imports in June, before extending the range of products in the autumn. The most profound escalation took place in September, when the United States put a 10% charge on $200bn of Chinese goods, around half of all its imports from China. Trump also threated to increase the tariff to 25%, but postponed this in November when the two countries appeared to be heading towards a deal. Yet the ceasefire didn't hold and Trump has

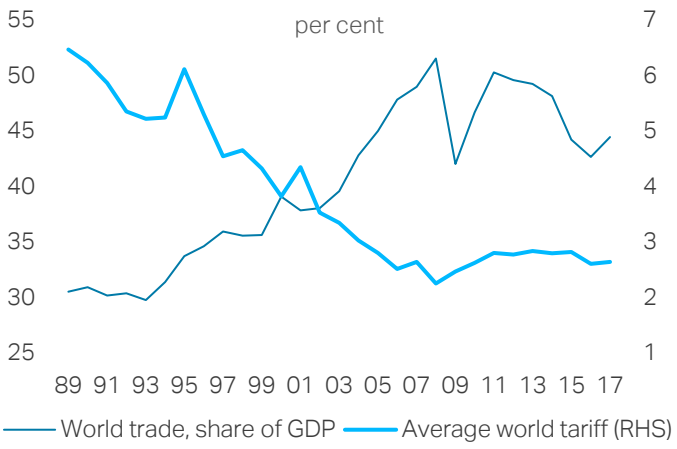
now hiked the tariff all the way to 25%. On paper, the US is now half way to full escalation. The next and final step would be another 25% tariff on the circa $300bn untaxed Chinese imports. The only good news is that the US administration has not – so far – extended the conflict to include EU autos. In fact, Trump has now given the Europeans an extra 6-months to talk.

Chart 8: Tariff rounds by product type



Source: Peterson Institute, TS Lombard

Chart 9: Free trade and globalization



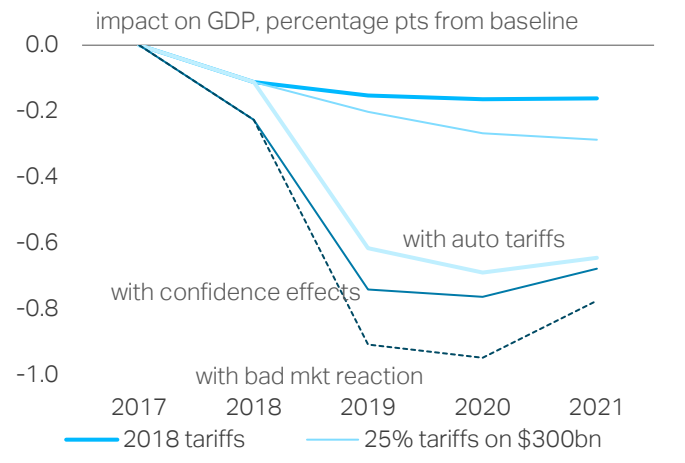
Source: OECD, World Bank, TS Lombard

Macroeconomic impact

When the trade war started in 2018, there was a lot of confusion about what it would mean for the global economy. With good reason – the previous 70 years had been a period of continuous trade liberalization, with most countries gradually reducing tariffs and lifting other barriers. This was part of the 'Washington Consensus', the belief that freer trade and steady globalization would enhance global prosperity and reduce the chance of military conflict. President Trump's election victory was a rejection of these policies and, unfortunately for economists, there were no recent historical episodes to illustrate what this would mean for the world economy. Investors had to rely on textbook theory, macroeconomic models and distant historical examples. Much of the analysis focused on the post-WW2 period, the most recent (major) outbreak of global protectionism. But as the 1930s also included the Great Depression, it was hard to disentangle the impact of trade policy from all the other things that were going wrong at the time.

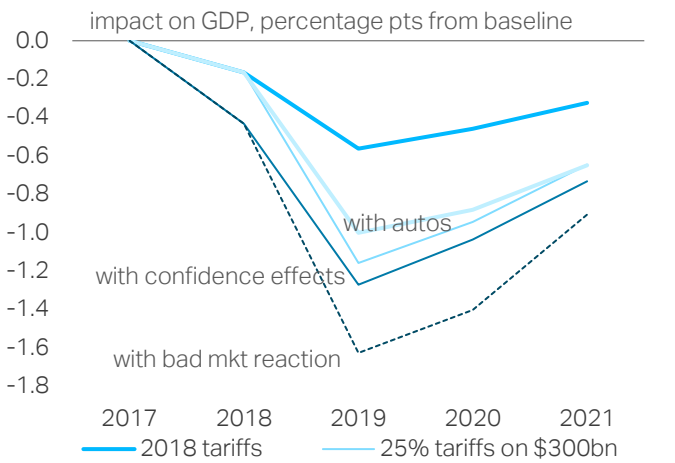
Economic theory wasn't particularly helpful either. To a degree, the impact of import tariffs depends on who pays them – foreign exporters, domestic producers, or consumers. Since the United States is the world's largest domestic market, some economists argued foreign exporters would 'price to market', absorbing all the costs of the tariff. If this was not the case, either US producers would pay by reducing their margins, or they would pass on the cost to consumers. So some investors were worried about the impact of the trade war on inflation, fearing this might force the Fed and other central banks to raise interest rates. But the trade war would also have an impact on growth, which complicated the policy response. And economic textbooks had little to say about how the new tariffs would interact with global supply chains, which had become a feature of the modern globalized economy. The only clear consensus was that US protectionism would ultimately damage the supply side, by undermining productivity and introducing new inefficiencies. If everyone benefitted from free trade, as economists and politicians had long assumed, then 'reversing' globalization would produce the opposite effect.

Chart 10: Trade war simulation – US impact



Source: IMF World Economic Outlook, October 2018

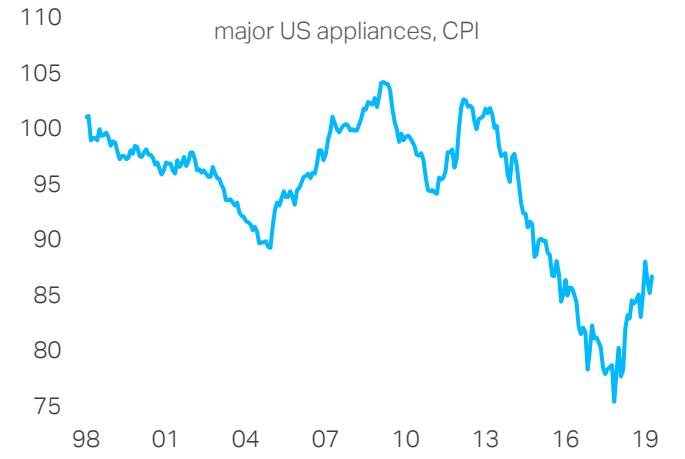
Chart 11: Trade war simulation – China impact



Source: IMF World Economic Outlook, October 2018

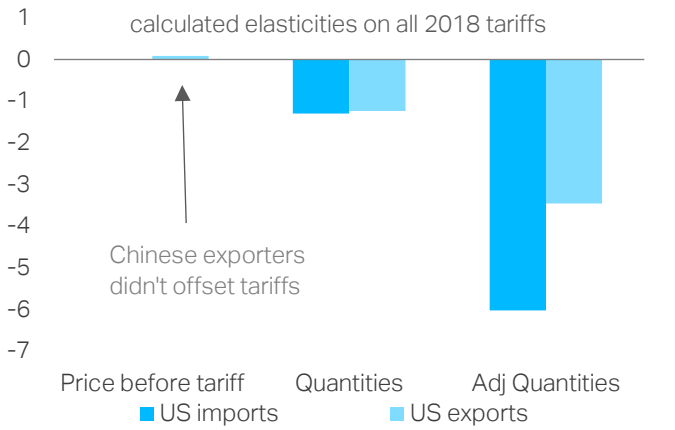
Various international institutions produced detailed macroeconomic simulations to show what a trade war might do to the global economy. The IMF's estimates, shown in Charts 10 and 11, were among the most influential. They argued that a full-scale trade war could cause a global recession, reducing US and Chinese GDP by up to 2%. But these model-based estimates are only as good at the assumptions that underpin them. To generate a global recession, the IMF had to assume large 'spillovers' via financial markets and confidence – effects standard macro models are unable to generate by themselves. In short, researchers got the results they assumed. Investors had a rough idea about what the trade war would do to the global economy, but there was substantial room for disagreement. 18 months on, we can analyse the impact of the policies that were introduced, providing a better assessment of what the trade war means.

Chart 12: Early tariffs hit specific US goods



Source: Amiti et al, TS Lombard

Chart 13: Tariffs reduced US imports



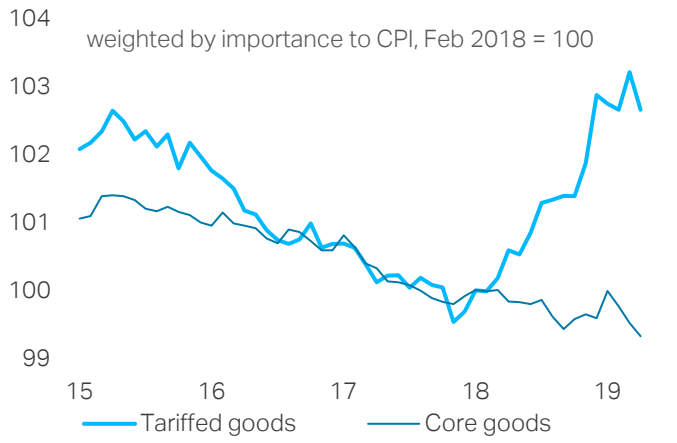
Source: Amiti et al. *Adjusted numbers include imports that went to zero

2. TARIFFICALLY BAD

So what impact is the US-China trade war actually having on the global economy? Several recent studies have attempted to answer this question, focusing on the impact of the tariffs. The first result to emerge is that, contrary to what the 'optimal tariff' literature claimed, foreign

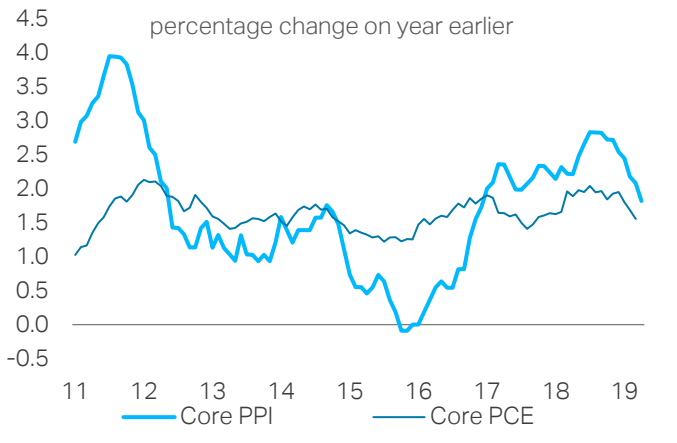
producers have not absorbed the cost of the new US duties by reducing their margins. Instead, most recent studies suggest Chinese exporters left their pre-tariff prices unchanged, passing on the full cost of the tax to US importers. This is an important result. Though US customs revenues have doubled since the introduction of Trump's tariffs (Chart 3), it seems the US government has largely been 'taxing' Americans rather than forcing the Chinese to pay. Since the tariffs boost US import prices, they have implications for US inflation and GDP.

Chart 14: Tariffed consumer prices have risen



Source: TS Lombard, US national sources

Chart 15: Yet overall trends deflationary

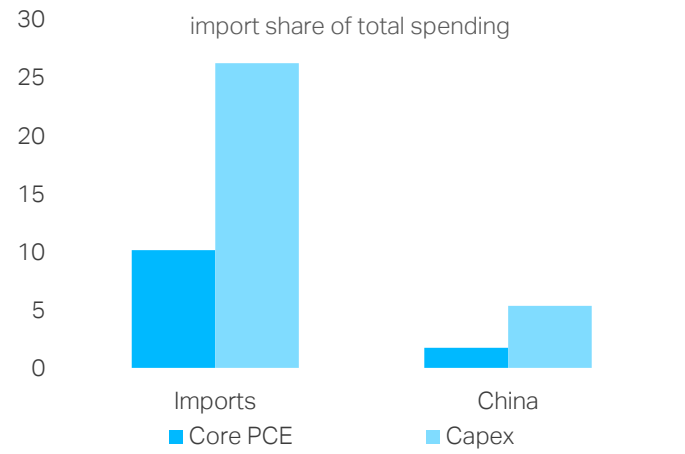


Source: Datastream, TS Lombard

Modestly inflationary

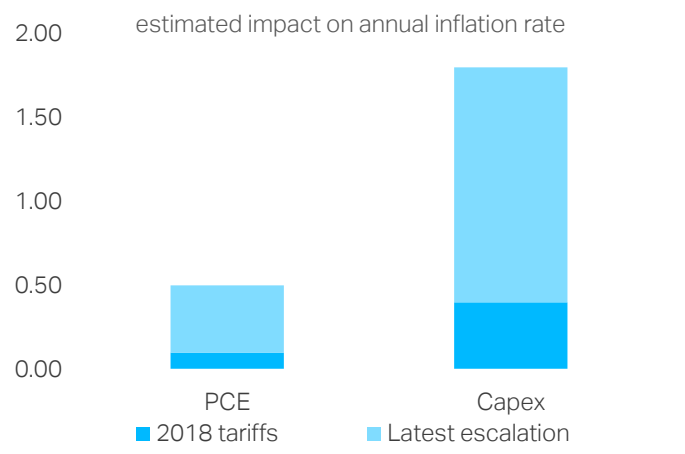
Chinese producers do not try to offset the cost of the tariff when exporting to the United States, but this doesn't necessarily mean the full price of the duty shows up in US inflation. Many of the goods that have been tariffed so far have been either industrial inputs or intermediate products, which means US producers could offset the charge by reducing their profit margins. In fact, the most influential recent study – by Mary Amiti, Stephen Redding and David Weinstein – finds partial absorption in US manufacturing margins. They estimate that all the tariffs introduced in 2018 raised US producer prices by around 1%, roughly half the average annual PPI inflation rate. Interestingly, part of this boost to US factory prices comes from manufacturers that were not importing inputs that faced higher tariffs. Instead, these manufacturers raised their prices simply because they faced less intensive competition from those goods that had been 'taxed'.

Chart 16: China's role in US expenditure



Source: San Francisco Federal Reserve (Hale et al)

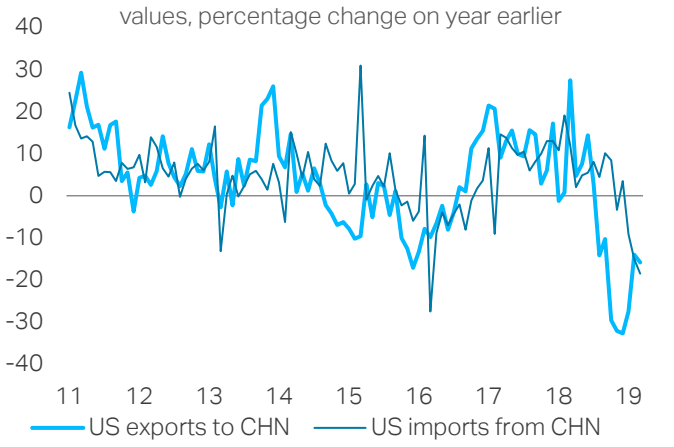
Chart 17: Tariffs' modest impact for US prices



Source: San Francisco Federal Reserve (Hale et al)

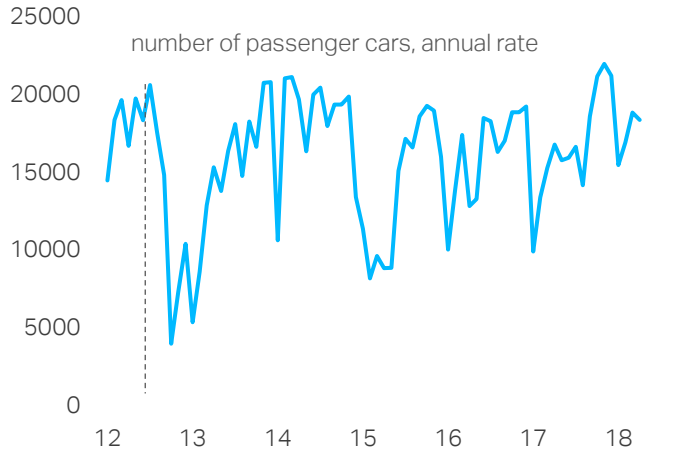
While the hit to US producer prices is interesting, policymakers (and investors) care much more about the impact of the tariffs on consumer prices. This is likely to be smaller since goods prices are a relatively modest share of consumer expenditure and only a fraction of these are derived from Chinese products. Fortunately, researchers at the San Francisco Fed have managed to put some numbers to these effects. They find that China accounts for around 2% of the products included in the PCE price index (but a larger, 5% share of US investment) and estimate that the tariffs introduced in 2018 only added about 0.1% pts to the PCE inflation rate. With the latest round of tariffs, the 25% charge on $200bn, we are now looking at a total impact on US inflation of around half a percentage point. Interestingly, while the aggregate effect on consumer prices has been modest, we see a much larger impact on specific goods within the basket. Amiti et al highlight what happened to US appliance inflation, but we can also see the impact of the tariffs on a variety of other prices in the PCE (Chart 14). Still, it is the aggregate effect that matters.

Chart 18: Bilateral US-CHN trade plunges



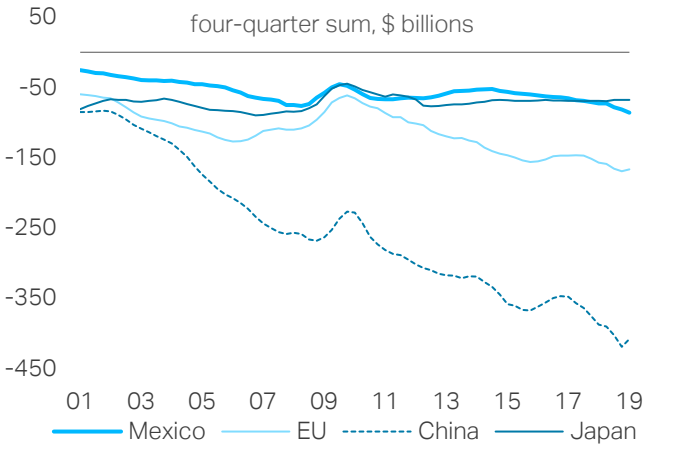
Source: US customs data

Chart 19: China boycotted Japanese autos



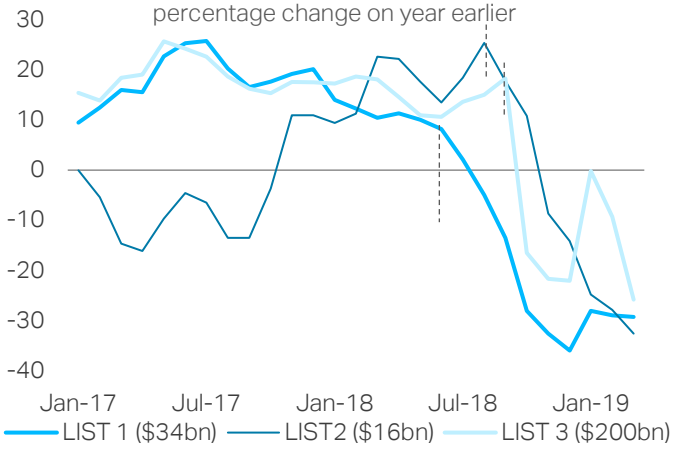
Source: Japanese auto sales, TS Lombard

Chart 20: US deficit has increased



Source: US customs data, Datastream

Chart 21: Imports by each round of US tariffs



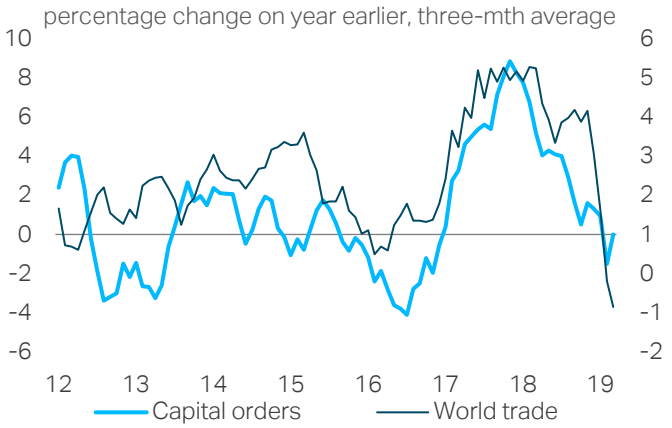
Source: US customs, TS Lombard

Sentiment destroying

Adding half a percentage point to the US inflation rate isn't really a big deal, especially as these price increases are temporary – they will eventually drop out. It seems unlikely the tariffs will have any bearing on the Federal Reserve, which is what investors were worried about in 2018 when

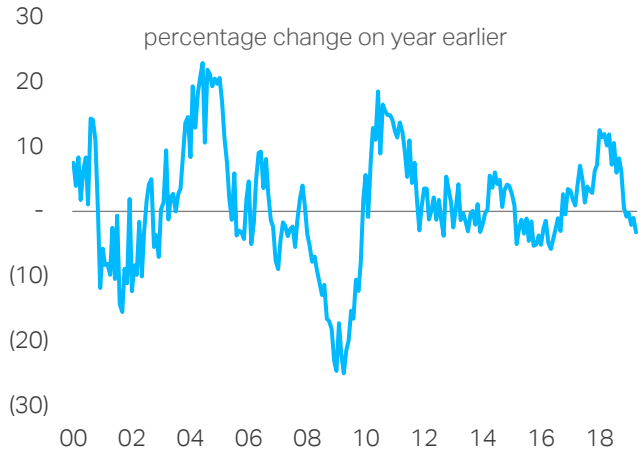
officials were tightening monetary policy. Arguably, slower global growth has already masked the impact of the tariffs, damping industrial goods prices. But, in any case, US protectionism has had a much more important (deflationary) impact on financial markets and global economic growth. While academics have been running 'event studies' to show how Trump's trade war damages the stock market, this result was clear to anybody who has followed global stock markets over the past 12 months. Each time the US President ratcheted up his rhetoric against China (which he was more inclined to do when the stock market was performing well), sentiment deteriorated and prices plunged. Peak market anxiety about the trade war occurred last autumn, when various institutional surveys showed investors had identified the conflict as the number one risk to global asset prices. The idea that there would be some sort of resolution in the conflict was firmly embedded in the 2019 'green shoots' story. According to the latest BoAML survey, from early May, up to 90% of respondents were expecting a fairly quick US-China trade deal.

Chart 22: Capex-led global downturn



Source: CPB, TS Lombard based on US and EU orders, deflated

Chart 23: US freight shipments plunge



Source: Cass Freight Index (from their website)

World trade plunges

The impact of the trade was shows up clearly in world trade and industrial activity. Bilateral trade between the United States and China plunged in late 2018. Some academics have recorded a price elasticity on US imports of up to -6 (Chart 13), suggesting the tariffs caused large declines in US trade (a one per cent tariff increase causes import volumes to drop by up to 6%). And the response from China has been even more aggressive. At the start of the conflict, we reminded our readers that China has a tendency to completely boycott the produce of countries it is having political disputes with, highlighting recent examples involving Japanese cars and Korean supermarkets. Once again it seems the Chinese State has been able to sway public opinion, causing a plunge in demand for US imports far beyond the direct impact of the tariffs. This has caused America's bilateral trade deficit with China to widen, especially as there is evidence US companies were front-running the tariffs, stocking up on Chinese goods (see Chart 21).

Global multipliers

With bilateral US-China trade in freefall, world trade has slowed significantly – CPB data show export volumes falling at their fastest pace in a decade. In principle, we might have expected to see other regions of the world provide an offset. If China was importing less from the United States, it might import more from other countries ('trade diversion'). There are some scattered signs of this (e.g. Brazilian soybean exports) but the aggregate effect of the trade war has been

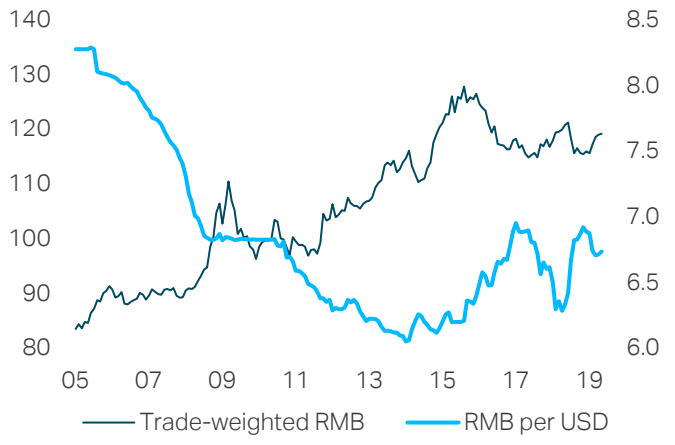
substantially negative, suggesting there are powerful global spillovers that have dwarfed any trade diversion effects. We think three main mechanisms have been particularly important:

(i) *Uncertainty damages capital spending*: The ultimate scale and range of Trump's trade war is unknowable. Not only is the US president promising to ratchet up his actions against China, but he has also repeatedly threatened Europe – especially the European auto industry. This uncertainty creates an overwhelming incentive for large exporters to postpone their capital decisions while they wait for some clarity about future trade relations. Global capital orders have plunged everywhere over the past 12 months, even in those countries not yet included in Trump's trade war. The European capex cycle has turned down particularly menacingly.

(ii) *Currency moves compound global pain:* The trade war gives China an added incentive to devalue its currency in an effort to offset the impact of US tariffs, especially as it has limited US imports it can tax in a tit-for-tat conflict. Or, since the RMB is already overvalued, we can think about this issue another way – devaluation provides a more desirable way to stimulate their economy than another 2016-style credit splurge. But from a global perspective, this is a much less desirable outcome. Chinese credit expansion adds to global demand, whereas devaluation 'steals' activity from the rest of the world. China's currency weakness is a particularly serious problem for the emerging economies, which get caught between the falling RMB (which undermines their competiveness) and the appreciating USD (since a substantial part of their borrowing is denominated in dollars). EM output, now the dominant contributor to global GDP, has deteriorated sharply since the conflict.

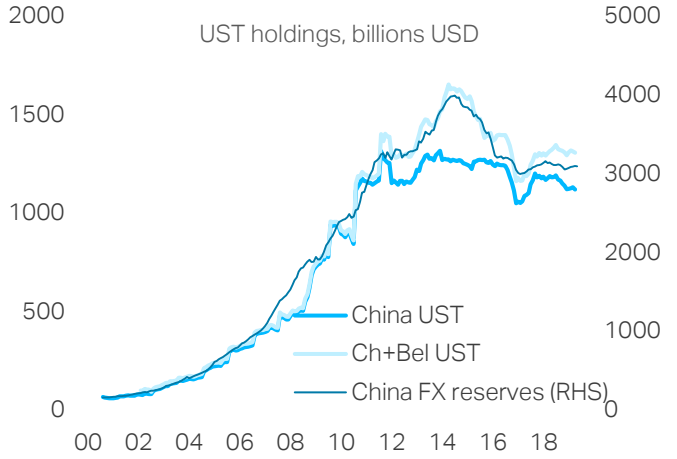
(iii) *Global value chains disrupted*: Global supply chains have become increasingly complex over the past 30 years, criss-crossing international borders. Large tariffs threaten to make these trade linkages uneconomical, causing them to shrink or relocate elsewhere. As we explain in Section 3, this could bring long-term investment opportunities, but in the short-term it is hugely disruptive. Worse, it threatens to make significant parts of the existing capital stock obsolete, with potentially serious implications for equity holders (i.e. global stock markets).

Chart 24: China's RMB option



Source: Datastream, BIS

Chart 25: China's Treasury holdings

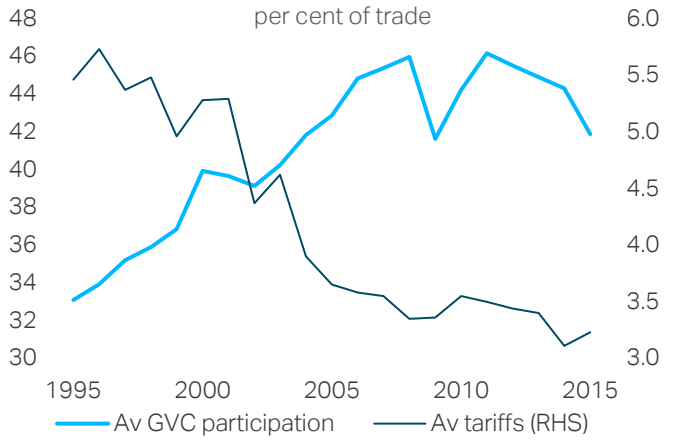


Source: TIC, TS Lombard estimates

3. COLLATERAL DAMAGE

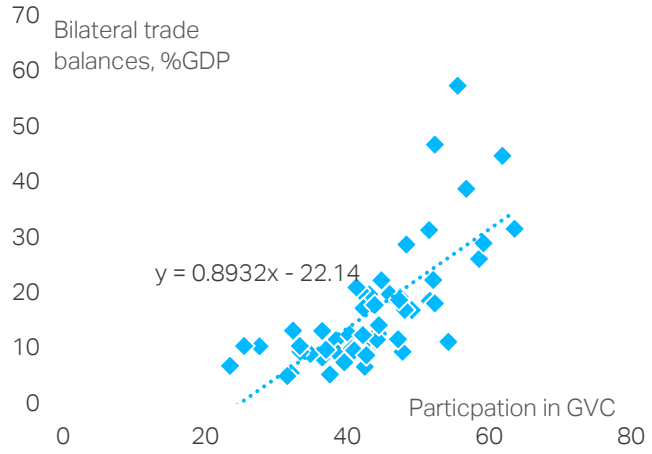
The latest escalation in trade tensions between the United States and China is a clear threat to the world economy. Cyclically, global demand is already looking rather fragile and another hit from deteriorating market confidence and falling capital spending would kill the 'green shoots' narrative that has supported asset prices in 2019. But what about the longer-term impact of the conflict? While the ultimate end-game remains highly uncertain, it is reasonable to expect some profound shifts in the structure and composition of global production. This has already started.

Chart 26: Low tariffs encouraged GVCs



Source: IMF World Economic Outlook special chapter

Chart 27: GVCs correlate to bilateral imbalances



Source: IMF World Economic Outlook special chapter

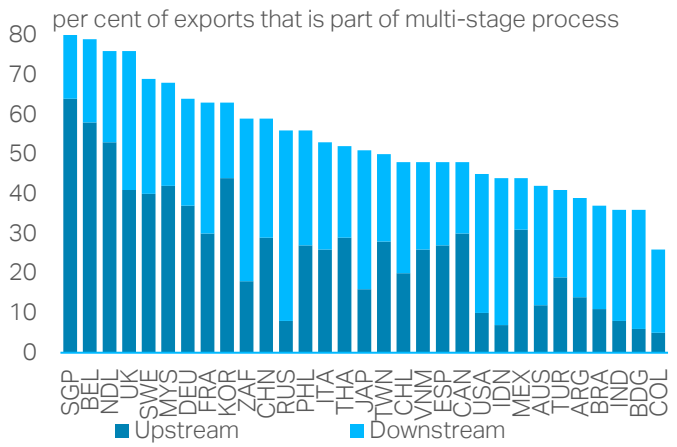
Tariffs and global value chains

The US administration seems to focus on bilateral trade positions, particularly the US vs China. But this doesn't make a great deal of sense. A recent IMF study looked at this issue in detail, showing that large bilateral surpluses and deficits are a natural consequence of globalization. In fact, at the global level, bilateral trade 'imbalances' are far larger than traditional current-account 'imbalances'. Most countries tend to run surpluses against some of their trading partners, while running deficits against others. To the extent imbalances matter, it is the overall current account that is important (and this reflects macroeconomic trends and divergences). The IMF points out that imposing tariffs with the aim of reducing one specific bilateral deficit (e.g. with China) could cause 'trade diversion', swapping one bilateral deficit for another. Perhaps the US could reduce its demand for Chinese goods, but end up buying more from countries like Taiwan and Vietnam.

The other problem with tariffs is that the era of trade liberalization encouraged a spectacular rise in global value chains (Chart 26), intricate trading linkages that run across international borders. In a global value chain (GVC), countries import components (value added) from other nations to use in their own production (value-added), which might then became part of a third country's production. Roughly speaking, GVCs measure the share of exports that cross more than two international borders and the UN tracks these in terms of both upstream and downstream exposures (Chart 28). Consider a Japanese auto manufacturer that makes engines in Japan, ships them to Canada (where the cars undergo further assembly), before sending the cars to be finished in Mexico. Or the IPhone, 'officially' made in China but including components from Korea, Taiwan, Japan and even the US. Gone are the days when cargo ships only carried finished goods from one country to another. Instead, vast streams of manufacturing components now crisscross national borders to feed globally diverse and fragmented production networks.

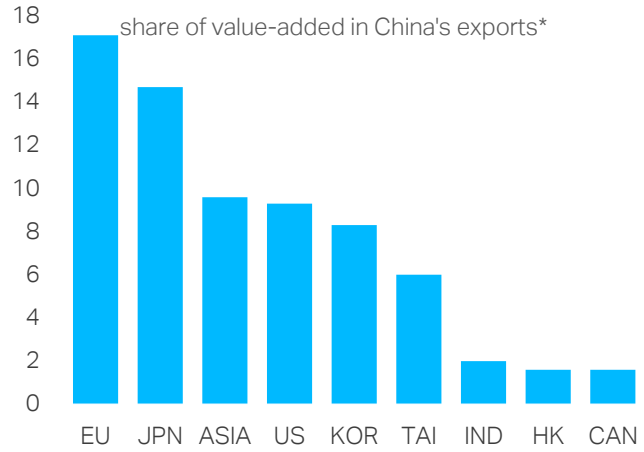
Where global-value chains are involved, imposing tariffs can become an act of self-harm. This is because the tariffs make domestic products more expensive, undermining competitiveness. A recent study by Cecilia Bellora and Lionel Fontagne from the Paris School of Economics, shows that the tariffs introduced in 2018 could reduce US exports by around 6%, mainly due to lost competitiveness. They also provide a sectoral breakdown, showing the US auto industry would be hit particularly hard (thanks to steel and aluminium tariffs, plus the rising cost of other Chinese components). And of course, there are backward linkages too. If the US demands fewer products from China, Asian supply chains will suffer. Chart 29 breaks down the foreign value-added included in Chinese exports, showing large potential losses in Asia, Europe and Japan. These spillovers are another reason global trade, capital spending and industrial output have already deteriorated by a much greater degree than most people were expecting.

Chart 28: Global value chains (GVCs)



Source: OECD, United Nations

Chart 29: Exposure to China's exports



Source: OECD, UN, *excludes Chinese value-added

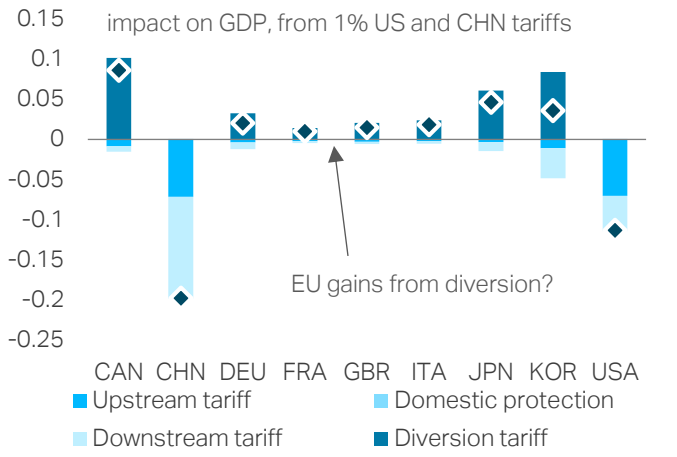
Winners and losers

Introducing large tariffs could make these supply chains uneconomical, by imposing additional costs every time components cross national borders. Supply chains would shrink, or be diverted elsewhere. Why does this matter, especially at the global level? We are essentially talking about parts of the existing capital stock becoming redundant and though trade diversion will encourage new global trading links, equity holders have a claim on the existing capital stock – not future investments. Big exporters face substantial disruption, large adjustment costs and significant short-term losses. The implications could be serious for global stock markets, even in a relatively benign environment where global value chains relocate rather than disappear. And in the more extreme scenario of 'de-globalization', where global values chains shrink substantially, we need to think about other inefficiencies that will arise. If pre-2008 globalization enhanced competition, raised productivity, facilitated the specialization of international labour, and increased the equilibrium profit share, it is surely be true that reversing this process will have the opposite effect, which is further bad news for stock markets. The equilibrium profit share falls.

While the short-term disruption caused by the trade war is sure to dominate the behaviour of global financial markets, some countries might eventually benefit from a US-China trade war – assuming China remains the primary focus of American protectionism. Both the IMF and the United Nations have studied the longer-term impact of the conflict, showing large 'trade diversion' effects. Charts 30 and 31 show the IMF's simulations. If China and the US are the only ones involved in the trade war (Chart 30), some countries – including parts of the euro area – might actually enjoy a positive boost to their GDP. But in a full-scale trade war (Chart 31), where

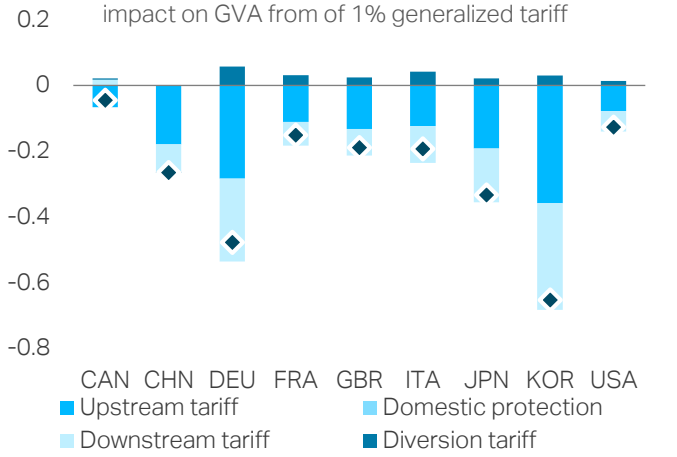
all countries impose tariffs on each other, any benefits quickly disappear. The risk for Europe (in particular) is that once Trump is done fighting China, he will turn his attention to the EU.

Chart 30: Impact of US-China tariffs only



Source: IMF analysis of tariffs with global value chains

Chart 31: Impact from full-scale trade war

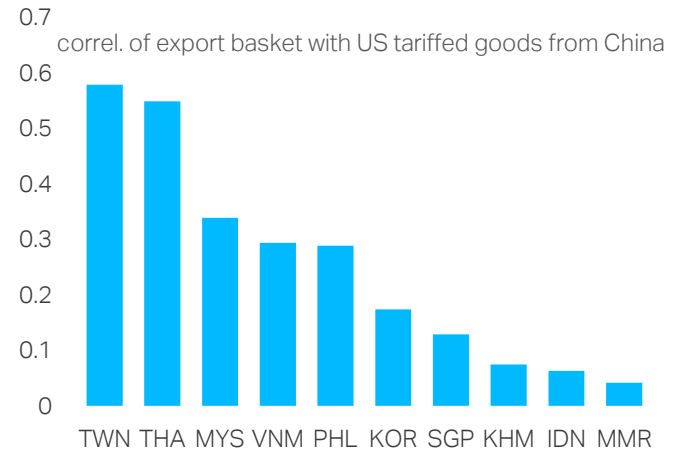


Source: IMF analysis of tariffs with global value chains

Regional trading blocs

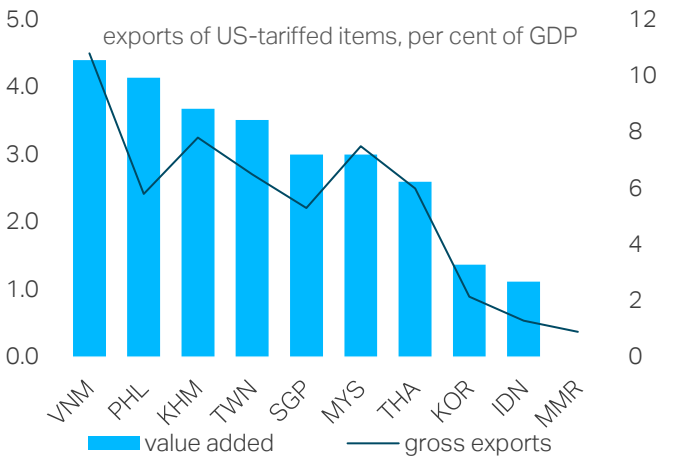
We analysed the longer-term impact of the trade war in a recent 'The View', concluding that it might eventually cause the creation of regional trading blocs. Many Chinese companies, for example, will look for ways around US tariffs by transferring production abroad, sourcing inputs from other regional economies and sending finished products to the United States via other trade partners. To illustrate, we explained how Chinese firms evaded the 2012 tariffs on solar panels by moving manufacturing to Malaysia and other Southeast Asian countries. The share of Chinese solar panels in US imports fell from 69% in 2011 to 11% in 2017, while US imports of solar panels from Malaysia and other Asian countries jumped from zero to 50%. Our estimates suggest around 60-70% of those sales were from Chinese companies that shifted operations. A new study shows the same thing happened with washing machines in 2012-2016.

Chart 32: Who benefits from Chinese 'diversion'



Source: Massimiliano Carli (CEPR)

Chart 33: Exporters that might replace China



Source: Massimiliano Carli (CEPR)

Applying this logic more broadly, we could see major relocations of production within Asia. Recent analysis by Massimiliano Cali shows which countries stand to benefit from this process, by comparing the goods they currently export with those produced in China - i.e. looking for similarities in their export baskets (Charts 32 and 33). Cali's logic is that countries that already export a non-negligible amount of the same products that have just been made subject to US tariffs on China are best placed to gain, both in terms of exports and in the relocation of Chinese investment. But a similar theme could play out in the United States given there is also now a 'Made in the US' risk for firms domiciled in America that want to export to China, including several German car manufacturers which ship American-manufactured SUVs to the PRC. So, over time, we should also see production shifting away from the United States.

The path to regional trading blocs is clear: (i) the shift of production by firms selling into the US from China to elsewhere in Asia and to the US, Canada and Mexico; (ii) the migration of existing US production destined for China to third countries in Asia and elsewhere; and (iii) the development of new two-way regional supply chains associated with these production shifts. This is the end game, but getting there could be messy and involve significant disruption.

Bottom line

The re-escalation in the trade war between the United States and China is a serious risk to global markets. The US administration seems determined to secure genuine change in China's trading practices and is demanding enforcement mechanisms that China is adamant to resist. Whereas a trade deal seemed likely a few weeks ago, the best we can now hope for is that skittish financial markets encourage President Trump to 'kick the can' on negotiations, delaying any further measures for 3-6 months. But US protectionism has already undermined global demand and these latest tensions will further damage confidence. They might even kill the 'green shoots' narrative that has supported risk assets during 2019. We think the long-term consequences of the conflict are also profound, including major shifts in trade, investment and production.

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