No turning back

US-China trade war update

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Contents

Summary

- The US administration's decision to add a 10% tariff on the remaining USD300bn of Chinese import goods as from September 1 marks a fresh escalation in the bilateral trade war
- The developments since last Friday, which include retaliatory steps by China – in particular on the currency front – and the US's decision to brand China as a 'currency manipulator' only underscore that it will be very hard for both sides to row back now
- Whilst we can be sure that global central banks will step up to the plate to alleviate the impact of the trade war – most likely implying even lower interest rates across the board - the bottom line impact is likely to be negative for both growth and inflation
- Given the potentially significant ramifications the trade war may have for financial markets, confidence and, hence, the global economy we have further reduced our growth projections
- Indeed, going by the unofficial IMF definition, our projections now imply a 'shallow' global recession (growth below 3%) in 2020/2021

US set to hike tariffs on all imports from China

Last Friday, the Trump administration decided to up the ante in the long-running trade dispute with China by announcing another tariff hike of 10% on approximately USD 300bn of the remaining imports from China that had not been targeted by higher tariffs previously.

This decision clearly marks a new escalation in the trade war following the first G20 face-to-face round of talks between the US and China in Shanghai on 29-30th July. The main reason for the decision was that US president Trump was not satisfied with the way in which China had lived up to the agreements made during that end-June summit in Japan. This mainly concerned the limited purchases of agricultural products by China, and that China seemingly still exports fentanyl to the US. As a result, next to the already installed 25% tariff on 250bn USD, the US is now abot to increase tariffs by 10% on imports that were not targeted yet from September 1st onwards.

We have been flagging the risk of further acceleration of the trade war for quite a while. After the G20 meeting, we foresaw two major triggers that could lead to a renewed escalation in the period ahead, related to the situation regarding Huawei and (too) limited purchases of American agricultural products by China. But also in broader terms have we been arguing that it would be very difficult to reach a long-lasting and comprehensive deal on all the different topics that have been put on the table. **Indeed, we felt that the best outcome would probably be a can-kicking exercise while staying in a stable-unstable equilibrium.** Next to different views both sides may have on trade and investments, it is simply impossible for the US and China to bridge the gap on structural issues that the US wants to see resolved, such as violation of IPR, forced technology transfer and exorbitant subsidies by the Chinese government to Chinese state-owned enterprises (SOEs). China is unable and unwilling to make commitments to alter these things. The question therefore was not *if* tensions would flare up again, but *when*. Well, that time has come, to put it mildly.

From a mild to full escalation…

We previously distinguished two trade war (escalation) scenarios. One scenario assumed that the current set of tariff measures would stay in place for a longer period of time before the situation would deteriorate further; the second scenario was a full escalation scenario. In the latter we assumed that both countries would target their bilateral imports in full by higher tariffs, which now looks set to materialise from September onwards. Another key assumption in that scenario was a further depreciation of the Chinese yuan (CNY). **We anticipated a weaker CNY vis-á-vis the USD in case the Trump administration announced another round of tariffs on all Chinese exports, because China's options to strike back with equal measures are far more limited.** Given that the USD/CNY currency pair breached the psychological level of 7 last Monday (see below), **we feel there are now sufficient reasons to switch to our full escalation scenario.** Not only do we have the prospect of renewed hikes in tariffs and a 'signal' by China that it is willing to use its currency as a means to mitigate or offset the impact of tariffs on its exporters, but also do we have the increasingly belligerent language on both sides that suggests that it will become increasingly difficult to reverse course in this trade dispute.

Therefore we are likely to adjust our economic forecasts downward for most major economies in our September projection round. Given that confidence effects are hard to gauge (but are unlikely to be positive) and a further hike in tariffs to 25% on all goods from both sides remains a clear possibility, we take the estimated impact of a full escalation now into our base case. And although mitigating policy measures are likely to kick in at some stage (which may limit the negative trade war impact), we feel that the overall impact of the escalating trade war is more likely to be stronger rather than weaker than what we are assuming.

Table 1 gives an indication of the annual cost to growth of the current acceleration in the trade war and table 2 shows what this implies for our overall projections. The acceleration in the trade war is projected to cost the US economy some 0.4%-points of GDP until end-2021, in cumulative terms. For the main European countries the impact is expected to be broadly similar (with slightly bigger effects for open economies such as the Netherlands), whilst for China the impact is likely to be significantly stronger (around 1.2%-points cumulatively). Global GDP is set to lose at least 0.6%-points until 2021. Technically speaking this means global GDP growth will slip below the 3%-threshold, as table 2 below shows. **As such, going by the (unofficial) IMF definition, our projections now assume a 'shallow' global recession in 2020/2021.**

A full country specific breakdown of forecast adjustments will be included in our next economic quarterly update, due mid-September.

Table 1 – Assumed (annual) impact from recent trade war acceleration (%-points)

	2019	*2020*	*2021*	*2022*
United States	-0.1%	-0.1%	-0.1%	-0.1%
China	-0.1%	-0.4%	-0.7%	-0.6%
Eurozone	-0.1%	-0.1%	-0.1%	0.0%
World	-0.1%	-0.2%	-0.3%	-0.2%

Source: Rabobank

Table 2 – And what it would imply for our new forecasts (holding everything else unchanged)

	2018	*2019*	*2020*	*2021*	*2022*
United States	2.8%	2.3%	0.7%	-0.1%	1.7%
China	6.6%	6.1%	5.5%	4.8%	4.5%
Eurozone	1.9%	1.2%	1.1%	0.8%	0.9%
World	3.7%	3.3%	2.9%	2.7%	3.0%

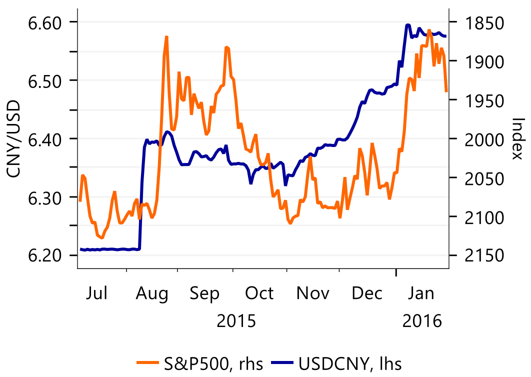
Note: These projections do not take into account recent data and other idiosyncratic factors, but give a ball-park idea of where our growth projections are heading.
Source: Macrobond, Rabobank

...has a significant impact on financial markets

Financial markets were clearly not anticipating the recent mid-summer escalation, as can be seen in the significant volatility and sharp falls in equity prices over the past several days. Arguably, the disappointment following the Fed's rate decision last week has had a negative impact as well and perhaps market moves have been amplified by thinner trading conditions.

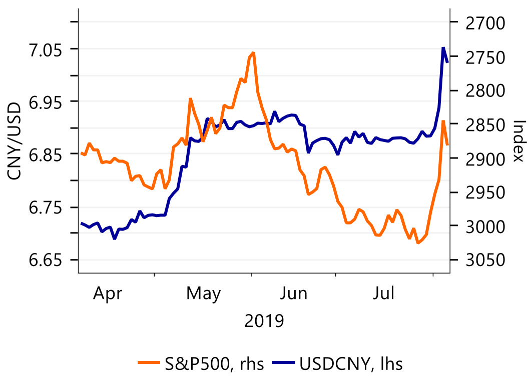
But the key point is that market participants had been hoping or expecting throughout the year that Mr. Trump's strategy would pay-off and that a trade deal would ultimately emerge. And even in the worst of times participants believed that central banks would eventually cover their backs. But recent developments clearly demonstrate that any such deal now looks further away than ever. And with the potential for further currency weakening in China now clearly in the market's cross-hairs (see also below), the resemblance to the market volatility back in 2015/early 2016 is striking. Indeed the 150 points move in the S&P500 quite closely matches the fall we saw in August 2015. But the circumstances are quite different now and, if anything, there are probably more reasons to be gloomy about the prospects for general market sentiment right now.

Figure 1: Back in 2015/16



Source: Macrobond

Figure 2: And now



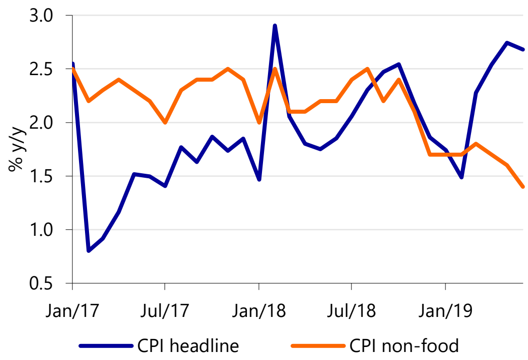
Source: Macrobond

China's ways to retaliate: agri purchases, FX and ?

The response from China to the announced tariff increase by the US was as expected. Any discussion about whether China would increase agricultural imports from the US now seems far out of sight. Without the exemption of the 25% import tariff for US soybeans (and other US agricultural crops) bought that have been bought after August 3, Chinese firms will halt further imports from the US. **Although China does have a certain amount of leverage in this area because lower US agri imports would hit Trump's farmers voters base, it is clear that there are**

also disadvantages for China itself. Prices of meat and fruits in China have already risen strongly in recent months. Suspensions on U.S. agricultural imports might add further upward pressures on China's domestic food prices in 2020. Given that food price stability is one of China's key policy priorities, this measure could therefore come at a great cost.

Figure 3: Spike in Chinese food inflation



Source: Macrobond

Another possible retaliation chip relates to **China's supply of rare earth metals,** which are also used for applications in the US high-tech industry. China [provided 80%] of these rare earths to the US between 2014 and 2017.

Next to this, the Chinese yuan was allowed to cross the often-quoted psychological threshold of 7 per US dollar for the first time in 11 years. This immediately sparked anger by Trump, lashing out at China as being currency manipulator. Whilst the weaker yuan was arguably driven by market-forces, it nevertheless seemed to be a deliberate action to signal that China is willing to use their exchange rate to offset the negative trade war impact on their exports as well.

A further depreciation in the CNY could offset the trade war effect for Chinese exporters, but this will be limited as the currency has not weakened as much against a broader basket of currencies over the last period as it has against the USD. Furthermore, there is a deterioration in the terms of trade of Chinese households, which will weigh additionally on their purchasing power next to the domestic price developments described before. In other words, such a strategy is unlikely to be painless in the longer term (indeed, it is one reason why we expect a bigger impact from the trade war on China compared to other parts of the world).

In any case, due to this currency movement, the US Treasury has decided to label China as a currency manipulator, as they see the recent direction of the CNY as a violation of agreements that were made during the G20. Although the direct effect of this is limited, the signal should not be underestimated as it is very unusual for a country to be labelled as a currency manipulator, at least recently and it can also be seen as an intermediate step towards further escalation. The last time China was assessed by the US Treasury on those grounds was a few months ago, where it **was found *not* to be a currency manipulator** as it didn't meet all three of the US' own criteria (large bilateral trade surplus – tick; current account surplus as % GDP – no tick; persistent intervention to weaken the currency – no tick). Yet now the CNY is finally moving lower in line with its real fundamentals, it is labelled a manipulator. The irony!

Another field that should be taken into account is related to geopolitics. North Korea has again launched several short range missiles after a period of relative calm. In the past, we have often referred to China as an important ally of **North Korea** (and thus China's influence on the country as being a bargaining chip in the trade war). Although it is not possible to draw a direct relation of these missile launches and the renewed tensions between the US and China, we cannot rule out such a scenario. In addition to North Korea, there are many other areas of conflict where the two countries meet in a global race for hegemony, for example around the **South China Sea and Taiwan.** These are therefore very important geopolitical flashpoints that we should not lose sight of, even if it seems that the conflict is mainly economic in nature. And last but certainly not least, the situation in **Hong Kong** is also deteriorating rapidly, with China openly accusing the US of influencing the ongoing street protests against what is seen as its growing influence. Further escalation in Hong Kong, followed by any Beijing military intervention, would likely have negative effects on China's access to foreign capital given Hong Kong's key role as a conduit for FX inflows through China's heavily ring-fenced capital account.

If one takes China's recent response to the newest US actions into account, it's hard to see either side trying to ease tensions at this stage. In fact, it only raises the risk that Trump will double down on his tariffs –raising them to 25% even before they have entered into effect– or that the US administration imposes other measures in an attempt to add more pressure on China. From the Chinese side, the willingness to let the CNY slide suggests that they also do not have much hope, or intent, that both parties can reconcile their differences any time soon.

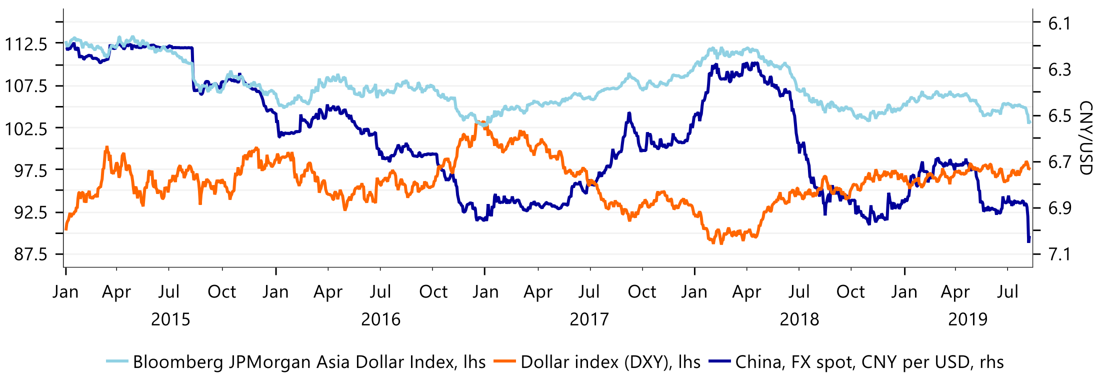
What's next?

Given the recent escalation and the reaction of both sides, it seems very likely that we need to brace ourselves for a renewed period of tension between both countries. It is even rumoured that China is questioning whether the bilateral trade talks and thus the scheduled negotiations for September should continue at all.

Further weakness in the CNY (as per our new estimates the currency could hit 7.40-7.50 by year-end) is likely to provoke weakness in other EM Asian currencies. But the strong US dollar (in trade weighted terms) that results could ultimately prove even unpalatable for the Fed (of course, it already is too strong according to President Trump).

In our downward adjustments to GDP growth (table 2) we did not explicitly incorporate any additional fiscal and monetary responses from either the US or China in case of a further trade war escalation. And, similarly, could we also expect mitigating policy measures in other parts of the world. But with monetary policy already operating at its limits, the effectiveness of such measures is questionable. Indeed, the global race to the bottom likely implies deeper negative rates in many jurisdictions and, consequently, bigger side effects. And almost certainly would it raise the risk of turning into a fresh currency war, with no winners only losers.

Figure 4: Further weakening of CNY would also impact EM FX more broadly



Source: Macrobond, Bloomberg

In any case, Chinese policymakers have already (re)started the stimulus engine due to a domestic cooling down, but further measures cannot be ruled out. However, the room for manoeuvre is becoming more and more restricted, as we have emphasized before. Especially in the area of monetary policy, the Chinese government has to weigh its options carefully, given the already high and increasing debt levels. There is some more room on the fiscal side, but this stimulus needs to be focused on productive (non-SOE) investments.

Further trade war escalation and related uncertainty will induce foreign companies to speed up plans to move their Chinese activities overseas. The knock-on effect of a drain on manufacturing activity from China is something we could not assess directly, but the impact could potentially be substantial as well. Next to all the former effects, further trade war escalation has an additional negative effect on China's economic development in terms of technology, which is another of our key assumptions why China would disproportionally bear the brunt in case of further escalation. **Due to lower trade with the US, the Chinese economy will benefit less from technological knowledge developed in the US.** This would consequently weigh on productivity growth in China going forward, which would have been much higher in case a trade war would not have occurred.

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