Economic Note

29 March 2019

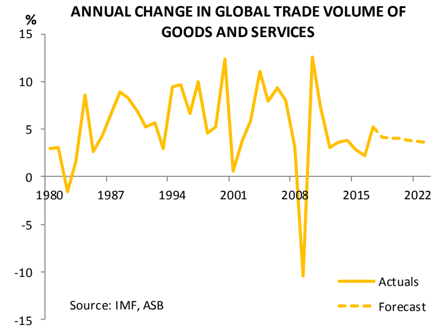
Trade: Zero-sum attitudes persist globally

Summary and implications

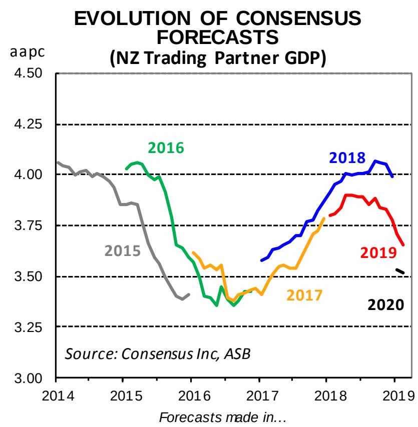
In an economic note this time last year, we highlighted the strong growth in trade that has occurred over the past 30 years. However, we did note that growing protectionist sentiment and increasing tariffs by US and China threatened to upset the status quo. 2018 saw the US impose tariffs on USD$250bn of Chinese exports, while China countered with tariffs on USD$110bn of US exports. In 2019, global trade growth is indeed slowing and trade tensions remain. As a small and open economy that is heavily reliant on international trade, New Zealand remains vulnerable to slowing global growth and further escalation in global protectionism. In March, the Reserve Bank of New Zealand highlighted the worsening global outlook as a key reason for shifting to an easing bias and potentially cutting the Official Cash Rate (OCR), and we expect 50bps of OCR cuts over 2019. Reasonably healthy commodity export prices and our elevated Terms of Trade will offer respite to some, but not all, exporters.

Trade and global growth are slowing

Global economic and trade growth look to have peaked in 2018. Global trade continued to grow during 2018 despite the headwinds we highlighted a year ago. **However, this growth in global trade volumes has been considerably slower than many had hoped.** In September 2018, the World Trade Organisation (WTO) lowered its earlier forecasts for trade growth in 2018 and 2019 after continuing trade tensions and tightening credit conditions softened the international outlook. **The WTO noted risks were skewed to the downside**, given geopolitical tensions, uncertainty surrounding potential interest rate increases in developed countries (with the potential to trigger capital outflows in emerging economies) and structural changes associated with the Chinese economy. Despite increasing policy stimulus, the Chinese government revised down its 2019 GDP growth target to 6% from 6-6.5%.



Moreover, the International Monetary Fund (IMF) expected that global trade volume growth will oscillate within a 3.5% to 4% p.a. range over the next few years. This is on the low side historically – in the twenty years prior to the Global Financial Crisis (GFC), global trade growth averaged close to 7% per annum and never fell below 4% for more than two consecutive years.



Coinciding with the deceleration in global trade has been the weakening outlook for global growth. The evolution of our forecasts (see chart) has shown a scaling back in trading partner growth prospects from late last year. Expectations for growth have been shaded down in Europe, the US and Asia.

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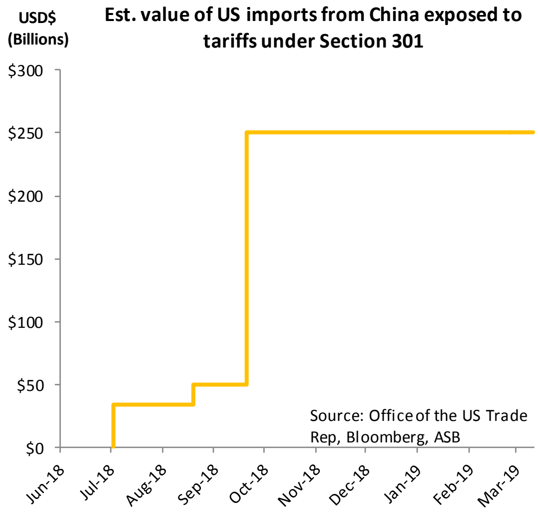
Twelve months of potent protectionism



2018 saw the United States translate protectionist rhetoric into action. Our report 12 months ago highlighted the Trump administration's decision to impose tariffs on a range of imports, including solar panels steel (25%), aluminium (10%), and washing machines parts (16-50%). **One year on, we now know that the United States has doubled down on its protectionist policies,** with Chinese imports attracting the brunt of the Trump administration's focus. At the end of March 2018, the President announced that the **US would look at applying tariffs on Chinese goods under Section 301 of the Trade Act 1974**, citing unfair competition as justification, Chinese industry policy and the forced transfer of American intellectual property to Chinese entities. Approximately USD$34bn of Chinese goods became subject to a 25% tariff in July, followed by a further USD$16bn in August (25% tariff) and an additional USD$200bn in September (10% tariff). In total, tariffs on USD$250bn of goods imposed from China were imposed. Rumours of an additional 25% tariff on US imports of European cars surfaced in February, with retaliation promptly threatened by the European Commission.

China has retaliated through tariffs of its own. Responding to the initial steel and aluminium tariffs in April, the Chinese announced duties on USD$3bnworth of American goods. Following the Section 301 tariffs, Beijing imposed tariffs on an additional USD$50bn of American products in June and USD$60bn in September. The European Union has also placed tariffs on US exports. All up, around USD$120bn of US exports had been impacted.

The news was not all bad, with positive moves as 2018 drew to a close. In October, the United States, Mexico and Canada completed renegotiation of a trade agreement that President Trump retitled the US, Mexico, and Canada Agreement (USMCA)[1]. Japan and the EU also signed a free trade agreement in July 2018. Finally, the end of 2018 saw the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) come into force amongst eleven Asia-Pacific nations. **The US was not a signatory.**

An auspicious start to 2019?

The latter half of 2018 and the beginning of 2019 did see some easing in protectionist tendencies. The year started with hopes that the US and China would reach an agreement that would see most US tariffs come to an end in exchange for pledges from Beijing on intellectual property protection. President Trump had delayed the imposition of a new series of tariffs (originally due to come into force on March 1st).

This optimism remains even though the US and China haven't yet put pen to paper. Bloomberg reports talks have hit a snag, with US officials accusing China of backing away from key pledges. President Trump has said tariffs could remain on Chinese goods for a 'substantial period.' **Yesterday, the American Director of National Economic Council, Larry Kudlow, conceded talks could stretch on for 'months,' suggesting the standoff could drag on longer than hoped.**

Zero-sum mentality remains persistent

The picture for global trade remains far from rosy. Last year's steel/aluminium tariffs show no sign of being lifted and the possibility of a late breakdown in US-China negotiations remains. The US looks set to retain a broadly protectionist outlook given that, over the course of 2018, as several key free trade advocates departed the Trump administration, whilst key protectionists remain in office. **Many of these US policymakers subscribe to a 'zero-sum' mentality on trade, which rejects the 'win-win' logic underpinning the international system.**

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[1] This was formerly known as the North American Free Trade Agreement (NAFTA).

In a joint 2018 paper **the International Monetary fund (IMF) and World Trade Organisation (WTO) noted that recent events have been in contrast to the shift towards greater openness in trade that had been evident since the end of World War Two.** For example, developing (advanced) economies cut their average tariffs from 31% (10%) in 1980 to 9% (4%) in 2015. This has been backed up by a deepening rules-based system—notably under the GATT and WTO—that brought more openness, transparency, and stability. This system boosted productivity, increased competition, lowered prices, improved living standards and lowered poverty. **However, the current global trading system faces challenges, which has impacted groups of workers and some communities.** Trade reform has petered out over the past two decades, and has not kept pace with rapid changes in technology, global supply chains, trade practices or economic structure. **There has been little progress in reducing barriers to trade in services, a rapidly growing sector.**

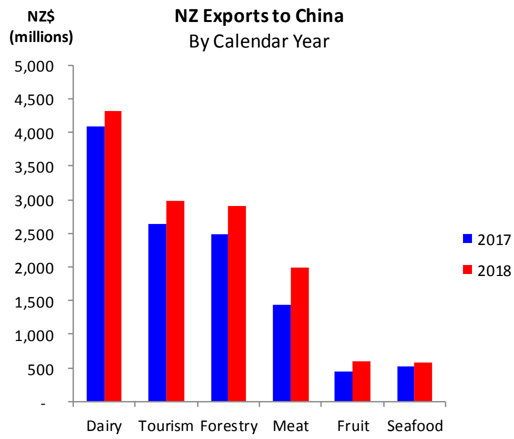
Nobody wins a trade war

According to President Trump, "trade wars are good and easy to win". **However, a recent study found that the imposition of tariffs has imposed significant costs on the US economy.** US incomes were close to USD$7bn lower over 2018, with the significant adjustment to global supply chains caused by the tariffs resulting in the loss or redirection of USD$165bn of trade. Moreover, higher US tariffs were almost completely passed through into US domestic prices, so that the entire incidence of the tariffs fell on domestic consumers and importers, with no impact so far on the prices received by foreign exporters. The study also notes trade wars can impose large costs that are hard to quantify, for example, the negative impact policy uncertainty has on investment. **Furthermore, the administration's tariffs have failed to close the US trade deficit with China, or the wider world.** The annual US goods deficit hit a 10-year peak in 2018, and the annual goods trade deficit with China was also at a record high (USD$419bn).

The upshot - implications for Kiwis

New Zealand is a small player on the global stage. Our two-way merchandise trade of around USD$80bn per annum is modest in relation to the USD$35-40 trillion in global merchandise trade that occurs each year. Even for tourism, our largest export earner, NZ accounts for just 0.3% of international visitor arrivals globally. However, our **status as a small, trade-reliant economy makes it vulnerable to a slowdown in global trade if protectionism keeps stirring overseas. Closer connectivity and an integrated trading system hold the key to bolstering living standards.** An IMF and World Bank 2018 paper emphasized that reinvigorating trade integration should be a key component of the global policy agenda to boost economic growth. The NZ Treasury (2017) has a similar view, noting protectionism is a "recipe for perpetuating poverty", with openness and international connectedness as the only viable option.

International trade has thrived in New Zealand over recent decades. NZ's two way goods and services trade topped $163bn in 2018. The NZ-China Free Trade Agreement has been especially lucrative since it was signed in 2007, boosting dairy and tourism in particular**.** **However, it is worrying that some of NZ's largest trade partners (China, the US and EU) are embroiled in trade spats with each other.** Combined with Australia, these three account for over half of NZ's total trade.



Source: Stats NZ, ASB

In its March 2019 OCR review the RBNZ explicitly cited the weakening global economic outlook around some of our key trading partners – notably, Australia, Europe and China – as reasons for global central banks to adopt more dovish policy outlooks. The RBNZ also stated "the risk of a more pronounced global downturn has increased," having previously highlighted increased "uncertainty around trade policies". The weakening global outlook and the risk of a more pronounced slowdown look to be key factors justifying the RBNZ's shift to an easing bias. **We have gone a step further, and expect 50bps of OCR cuts over 2019, in part reflecting our concerns over the global outlook.**

It is not all doom and gloom. Global growth is slowing, but an outright contraction in trading partner activity still looks highly unlikely. Higher tariffs on up to USD$400bn worth of trade is significant, but this still pales in comparison to the close to USD$35-40 trillion in global merchandise trade conducted each year. **Global prices for our export commodities are expected to remain reasonable, and our Terms of Trade elevated.** Moreover, **New Zealand has low exposure to global supply chains, which should somewhat insulate the country from the trade wars.** New Zealand exports a large number of food products and other raw materials that do not require complex chains of inputs, and are consumed soon after arriving in foreign markets. **The greatest risk to NZ exporters comes not from supply chain disruption, but from the negative impact protectionism has on the economies of key trading partners, such as China. Policy** stimulus from Beijing and a favourable commodity cycle will help mitigate the impacts of any slowdown, meaning **we should end the year with the Terms of Trade still at somewhat elevated levels.**

However, there is no reason for complacency. The elevated Terms of Trade is reflective of the strong position of only about half of the NZ export sector that is currently benefitting from high export commodity prices. The remainder of the export sector may have been adversely impacted if it held the NZD higher than it would otherwise have been. Tourism and manufacturing exporters are likely to the find the mix of slowing global growth and the resilient NZD challenging.

There are other longer-lasting challenges to face. According to OECD figures, New Zealand's per-capita GDP is currently 10% below the OECD average, and a whopping 25% below Australia. We have significant structural challenges to address, given our poor nationwide saving and investment record, high household debt, and legacy of low productivity and poor productivity growth.

Sector by sector – risks and resilience

Looking specifically at our export industries and their exposures to slowing global growth and rising protectionism:

- **Tourism could be vulnerable if global growth continues to soften**. Given New Zealand's geographic isolation and the expense of travel, consumers overseas could easily substitute NZ for closer, cheaper alternatives. A decline in tourism would have a negative flow-on effect on a range of businesses and sectors, including transport, accommodation, and hospitality. International student flows have historically been more resilient than other forms of travel, as overseas consumers may perceive travel for study a 'necessity.'
- **The Dairy sector should prove more resilient to a slowdown in global growth, though protectionism still poses a risk.** As key foodstuffs, demand for many dairy products is likely to prove reasonably inelastic in the event of slower growth, though more expensive, higher-end products could be squeezed. Key trading partners, such as China, are unlikely to levy new tariffs or quotas on NZ dairy products given they would not be able to meet domestic demand without NZ supply, triggering unpopular shortages or price rises on key commodities like milk powder and butter. NZ dairy exporters could still be hurt indirectly by trade skirmishes overseas, as in 2014, when Russian bans on EU dairy products caused a supply glut that disrupted commodity markets and sent prices spiralling downwards. **Fortunately, the commodity price cycle will also offer some solace to dairy exporters.** With constrained supply globally (despite increased NZ production) and the milk price set to hit $7.00/kg of milk solids next season, a number of favourable factors should benefit the industry despite the global outlook.
- **Vulnerability in the meat sector will depend largely on the cut and type of livestock.** Quality steaks and cuts at the higher-end of the market could be hurt if growth slows further. A sizable chunk of these cuts are still exported to Europe, where slowing growth has been most pronounced. By contrast, demand for cheaper meats like offal and mutton could prove more robust. These are largely exported to China, where household consumption has held up so far. Agricultural goods are politically sensitive and thus at risk during periods of protectionism, though NZ livestock exports have so far avoided being caught in the crossfire. **Much like the dairy sector, the current favourable position in the commodity price cycle will also offer some relief to meat exporters.**
- **Forestry has held up so far, despite some headwinds.** Forestry is heavily dependent on the health of Chinese

demand, and so slowing construction in China has raised concerns that there could be a negative impact on the sector. Fortunately, demand remains robust thus far.

- **NZ steel and aluminium have been directly impacted by American tariffs, though US-destined exports in the sector are quite low.** Unlike Australia, NZ was not exempted from American steel and aluminium tariffs introduced last May, and these look unlikely to be lifted as long as the present administration is in office.
- **Manufacturing exporters are also vulnerable.** The slowing Australian economy, weak Australian housing market backdrop and elevated NZD/AUD is an unwelcome trifecta.

Things to watch out for

We will be looking at the following channels through which slower world growth and increasing protectionism would impact the NZ economy:

- **Impact of trade frictions on global demand for our exports**. As noted earlier, trading partner growth is slowing. Tourism inflows are around record highs, although the growth in visitor numbers is slowing. We will be monitoring global flows, going forward.
- **Export commodity prices.** Courtesy of elevated and broad-based strength in export commodity prices, our goods Terms of Trade is near record highs. Whilst softer global demand has the potential to push prices lower, constrained milk supply should mean that dairy prices remain supported for the time being.
- **Monetary conditions.** The historically high Terms of Trade have kept the NZD higher than it would otherwise have been and has likely dampening incomes and growth prospects for non-commodity exporters. A lower NZD could provide support to the wider export sector, but will also increase costs on importers and consumers. The OCR could be cut if a weaker global outlook dampens medium-term domestic inflationary pressures and employment.

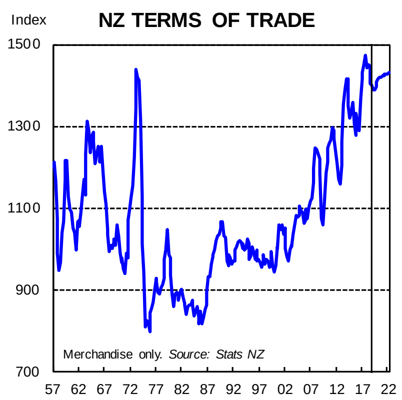
Summary

Elevated trade tensions and slowing global growth represent significant risks to the New Zealand economy. The resolution of differences between the US and China on trade would be a clear positive for the NZ economy. **Still, a breakdown in negotiations remains possible and the US looks unlikely to completely reverse its shift toward protectionist thinking.**

Slowing global growth and trade tensions have attracted the attention of the RBNZ. In its March OCR review, the RBNZ signalled a clear willingness to act with future OCR cuts if the weaker global outlook weighed heavily on the domestic economy. **We expect 25bps of OCR cuts in August and November this year, and for the RBNZ and global central banks to continue to provide considerably policy support over the foreseeable future.**

A favourable position in the commodity price cycle offers support to some exporters. However, there is no reason for complacency given that commodity prices could retrace recent increases. Not all export sectors have benefited from stronger export prices, and the resilient NZD would not have been welcomed.

The NZD remains the release valve for the wider export sector. Having a flexible exchange rate and room for further fiscal and monetary stimulus means the country has a number of buffers to help the economy withstand external shocks.



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