Economic Note

12 March 2018

Trade tensions surface

Summary and implications

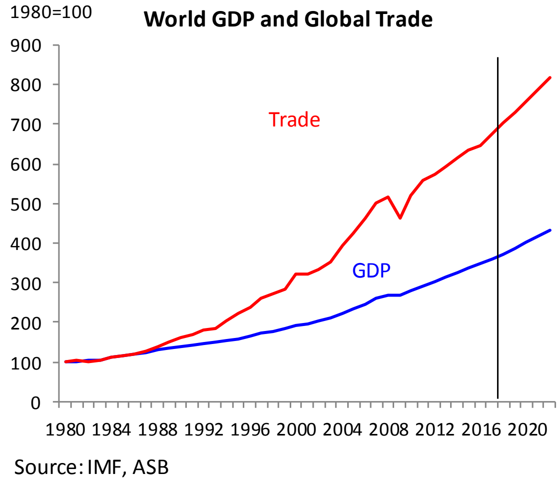
The global economy is becoming more connected by trade and investment flows. Global trade still accounts for a much larger share of national income than it did a generation or so ago. New Zealand has largely been a beneficiary of the strong growth in global trade, but persistent trade deficits in the US have seen tensions surface. It is early days, but recent measures by the Trump administration to impose tariffs on imported steel and aluminium run the risk of triggering a trade war that would significantly dampen the global outlook. For a small trade-dependent economy such as NZ, a trade war would pose considerable headwinds. In series of follow up notes, we will examine what this could mean for the New Zealand economy.

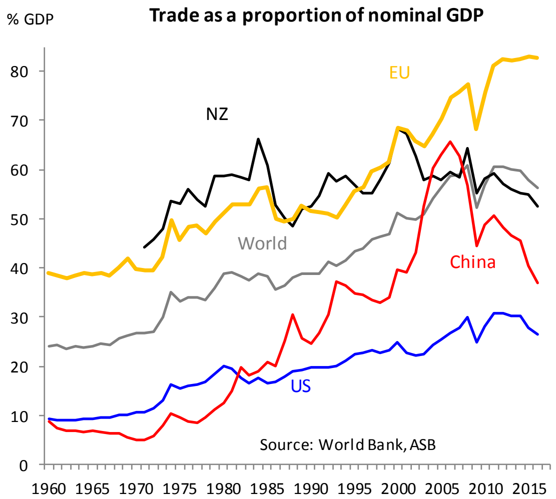
Global growth and trade are humming

A synchronised global upswing is currently underway. According to the World Bank, 2018 is on track to be the first year since the financial crisis that the global economy will be operating at or near full capacity. According to the World Trade Organisation, trade growth is set to sustain strong momentum into 2018, with the IMF also expecting world trade growth to continue to outstrip that of global GDP over the next few years.

Stronger growth in global trade is not a new phenomenon, with global trade generally having outstripped GDP growth since at least the 1960s. According to World Bank figures, global trade (sum of exports and imports) now accounts for more than half of nominal global GDP. This compares to less than a quarter in the early 1960s. **There have been periods when global trade has taken a hit (such as around the time of the Global Financial Crisis (GFC)) and subsequent trade growth has lagged that of overall GDP.** World trade is currently about 31% above 2008 levels as opposed to the 35% increase in global GDP.

Trade shares of GDP for most economies are generally lower than what they were prior to the GFC, but trade still accounts for a much larger share of national income than it did a generation or so ago. The impact of closer integration looks to have bolstered trade within the European Union (EU). The US economy by virtue of its large economic size tends to have a lower trade share relative to other economies. Also, NZ looks an outlier relative to global norms. **Increasing specialisation in production processes, increasing scale, the outsourcing of production to lower cost centres and technological change have likely driven these changes.**





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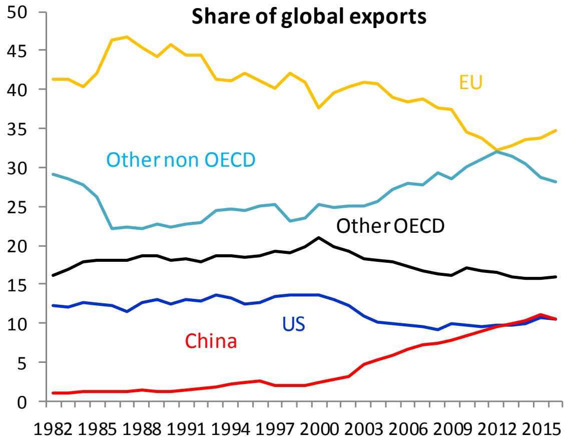
Many emerging economies have also increased their trade intensity, particularly those that have become more integrated with the global economy. Faster growth in trade in these economies has seen developing economies constitute a greater share of overall global trade. Non-OECD economies now account for 39% of global export activity as opposed to just 24% in 1990.

There has also been strong political will to promote increased trade. China, for example, became a member of the World Trade Organisation (WTO) in 2001, which preceded its increase in trade intensity and surge in exports. Chinese exports are roughly on par with those from the US as opposed to being roughly one-tenth 20 years ago.



Source: World Bank, ASB

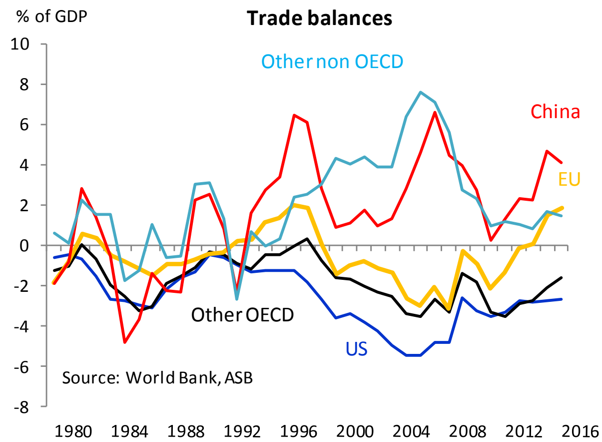
Thinking globally but acting regionally

Despite the best efforts of the Free Trade Lobby, a global free trade agreement still looks to be a distant prospect**.** What we have seen, however, have been a plethora of preferential bilateral and regional trade agreements (TAs). For example,

- The United States has 14 Trade Agreements (TAs) in force with 20 countries, and is currently in the process of negotiating regional FTAs with several others.
- The EU is actively pursuing TAs with most of the globe, with agreements/negotiations in various stages of advancement.
- China maintains 14 FTAs with its trade and investment partners, and is negotiating or implementing an additional eight TAs.
- NZ has close to 20 bilateral or multilateral agreements already signed or being pursued, accounting for more than three quarters of global GDP and about half of world population. The latest includes the Comprehensive and Progressive Trans Pacific Partnership (CPTPP).

But dark clouds are on the horizon

The increase in trade has meant that some countries have typically run persistent trade surpluses, whilst others have run persistent deficits. This has ignited tensions in the US, where some groups take the presence of US trade deficits as a signal that they are being taken advantage of. **Recent measures by the Trump administration cast doubt on whether the move to greater trade liberalisation will continue.** President Trump has pursued an economic strategy of "putting America first", stating that he would negotiate "fair, bilateral trade deals that bring jobs and industry back onto American shores". Just days after becoming President, Trump withdrew the United States from the Trans-Pacific Partnership in January 2017 believing that the agreement would "undermine" the US economy and its independence.



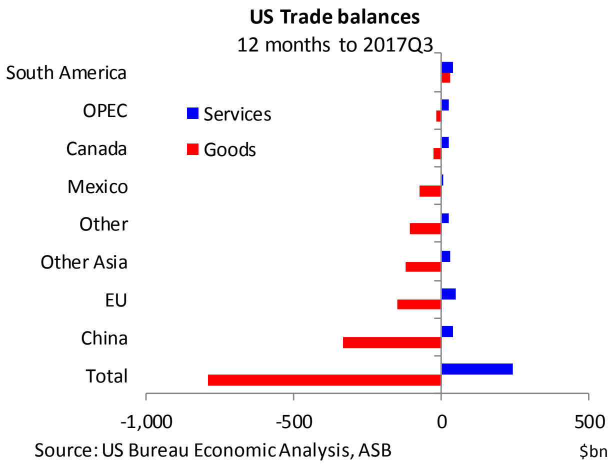
2018 has been busy so far. In January the Trump administration has moved to impose tariffs on solar panels (15% to 30%) and, washing machines and parts (16% to 50%), whilst on March 9 Trump President Trump signed a presidential proclamation imposing tariffs of 25% on imported steel and 10% on imported aluminium. The tariffs are likely to come into effect before the end of the month.

This is not the first time in recent decades that US administrations have looked to support local producers. The 2000/08 Bush and 2008/16 Obama administrations both applied steel tariffs. These, were generally withdrawn as they did not comply with World Trade Organization (WTO) rules.

What is different this time around is that US tariffs can be justified in terms of national security, rather than a purely economic, rationale. In a landmark case, last April the US Commerce Department began an investigation into whether steel and aluminum imports "impaired national security." It concluded in early 2018 that they did. This opened the door for Trump to apply tariffs as he sees fit. **As such, there is the risk that Trump's appeal to national security could undermine the framework of trade rules painstakingly constructed after World War II**. Other countries could challenge Trump's tariffs at the WTO, but that body's rules include exemptions for national security measures. The Trump administration is unlikely to lose such a case.

What does the trade data show?

US politicians with a protectionist bias have tended to highlight large and persistent US trade deficits as signs that trade has not been on a level playing field. Viewing global trade balances shows that the OECD economies have tended to run deficits, on average, whilst emerging economies have tended to run surpluses.



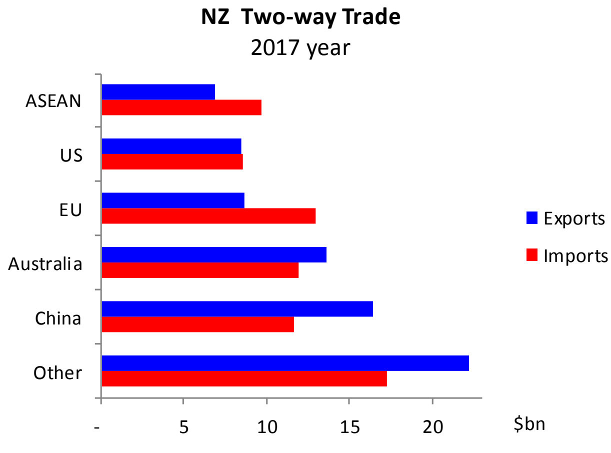
Source: US Bureau Economic Analysis, ASB

According to the latest figures the US runs an annual goods trade deficit of around USD 800bn per annum, roughly 4% of GDP. This is partly offset by a positive services surplus, with the US goods and services deficit at around 2.8% of GDP. Taking a closer look at bilateral trade flows with the US shows large goods deficits with China and to a lesser extent the European Union and other Economies in the Asian region.

The decision to impose steel tariffs looks to be based on other considerations besides bilateral trade flows. The largest exporter of steel to the US is Canada, not the EU or China. China is number 11. The Trump administration is in the process of renegotiating the North American Free Trade Agreement (NAFTA) with Canada and Mexico. It could well be that the idea to impose tariffs is a tactic to strengthen the US position in current NAFTA negotiations. Canada is the largest single market for US exports and the third largest source of US imports (behind China and Mexico), but tends to run a broadly balanced trade position with the US. Canada and Mexico may not be the only two countries getting a break from the US tariffs on imported steel and aluminum. NZ and a host of other countries are already seeking tariff exemptions.

The Upshot

The risk is that tit for tat measures may prompt the fear of an all-out trade war breaking out. Already the European Union, Canada, Mexico, China, Japan and Brazil are considering retaliatory steps. Last week, EU Trade Commissioner Malmstrom warned that the EU is circulating amongst member states a list of US goods to target with tariffs so it can respond. Foreign Minister Yi said that China will respond as necessary in the event of a trade war with the US, while warning that such a war would only harm all sides. Even if there is a relatively favourable outcome on the detail of steel tariffs, the wider issue of the potential for broader tariffs aimed at China could be a background concern for markets and a source of potential volatility over coming months.



Source: Statistics NZ, ASB

An escalation in protectionism would be considerably more damaging to a small and trade-reliant economy such as New Zealand. A trade war involving three of the major economic blocks - North America, East Asia and Europe – could significantly dampen global economic activity. In combination these economies account for roughly three quarters of global GDP and NZ goods and services trade, and more than 40% of global population. **Two of the three largest trading partner blocks with the US – the European Union and China – are also the top three trading partners for New Zealand.** Our second largest export markets – Australia – is also heavily reliant on trade with the Big 3.

So far, we assume that calm heads prevail. Still, there is always the risk that the situation deteriorates further,

which would generate considerable fallout to the NZ economy. A trade war could raise costs, add to geopolitical frictions and we could well see equity markets head south as markets attempt to gauge the potential impact on corporate earnings. We may even see the RBNZ venture towards cutting the OCR, but this would be highly conditional on a number of factors, including its impact on the NZD and the supply potential for the NZ economy. **In series of follow up notes, we will examine what those impacts might be for sectors of the NZ economy and what it might mean for NZ in general.**

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