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Trade War

Below we summarize responses to common questions surrounding the trade war.

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WHAT IS THE OUTLOOK FOR TRADE TENSIONS IN 2020?

There's a widespread belief that the signing of a U.S.-China trade deal, and expected ratification of the revised NAFTA agreement, means that trade tensions—which hung like a cloud over markets for much of 2019—have gone away. I think they will continue. Corporate surveys seem to suggest that U.S. businesses aren't dropping their concerns over trade so easily either.

WHY?

Take the U.S.-China Phase I accord. It's basically a ceasefire. The Chinese will buy some soybeans and other farm products, because they want to anyway. Most new U.S. tariffs, imposed over the past year or so, will remain in place. None of the practices or disagreements that prompted the U.S. to impose those tariffs will change until there's a Phase II agreement, and talks on that probably won't even start until after the U.S. presidential election. There are a lot of remaining areas of disagreement that will continue to bubble away and cause tension and perhaps new sanctions and headlines in 2020. U.S. efforts to isolate the Chinese tech giant Huawei leap to mind, but the list could expand.

Even the Phase I ceasefire had a difficult time coming about, and it's unclear how long it will last. Even with a formal text, each side seems intent on imposing its own interpretation of what it means, at potential odds with the other side's. It's good that new tariffs, which were scheduled to take effect in December, won't happen. It's good that China will go back to buying the farm products it needs from the U.S. Both countries apparently realized they'd be shooting themselves in the foot if they continued down the path of escalation, but how long they will keep this in mind remains to be seen, as U.S.-China relationship continues to see a broader shift towards "decoupling" and heightened confrontation.

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WHAT ABOUT THE USMCA TRADE AGREEMENT WITH CANADA AND MEXICO, OR THE NEW FREE TRADE AGREEMENT WITH JAPAN?

USMCA is more of a set of tweaks to NAFTA than a new agreement. Most of the positive tweaks would have been part of the Trans-Pacific Partnership (TPP) if the U.S. hadn't quit, and with many more countries. Other tweaks, such as protective rules for the auto industry, are a net negative. Also, unlike the original NAFTA, the new agreement automatically ends after a few years if it isn't renegotiated. The Administration's own International Trade Commission (ITC) estimates that USMCA will add +0.35% to GDP growth, but that comes mainly from reducing policy uncertainty. Without that, the terms themselves are projected to reduce growth by −0.12%. The problem is that, even after the agreement was reached, the President continued to threaten Mexico with harsh tariffs, and with closing the border, over other issues. So, will the existence of a signed agreement really reduce trade uncertainty, as hoped?

The U.S.-Japan trade deal is, again, a kind of mini-deal that incorporates many things that TPP would have included. It's a positive thing but not a game-changer. The reason we quit TPP was the notion that we could have more leverage and secure better deals on a bilateral basis, country by country. That doesn't appear to be happening, and in the meantime, we're missing out.

WHAT IS HAPPENING ON OTHER FRONTS?

Recent trade deals with China, Mexico, Canada, and Japan may not quite live up to advertising, but it's better than things getting worse. On other fronts, things aren't so reassuring.

President Trump has always been harshly critical of the World Trade Organization (WTO). This is the organization that oversees the basic rules governing trade—and prohibiting protectionist tariffs—among most countries around the world. It's the culmination of a process the U.S. started just after World War II, and a lynchpin of the U.S.-led post-war economic order. Contrary to what the President claims, the U.S. does not constantly lose at WTO, in fact it usually wins the complaints it brings. But the WTO's dispute resolution mechanism is far from perfect, and the U.S. has been pushing for reforms to make it more effective. The U.S. is also afraid—probably for good reason—that WTO was preparing to strike down its recent steel and aluminum tariffs, as well as other trade measures, for violating WTO rules. So, for the past year or so, the U.S. has been blocking the appointment of new judges. By December, the tribunal was effectively shut down, unable to hand down any new judgments on trade disputes.

It's not the end of the world—in principle, international trade rules remain in force. But countries involved in disputes—not just with the U.S.—will have to work them out on their own. That may mean more trade tensions. It's certainly a striking reversal in U.S. policy. A weaker WTO should be of particular concern to Britain, which is looking to WTO rules as its main life raft in the event of a no-deal Brexit.

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ARE THERE ANY PARTICULAR AREAS WHERE NEW DISPUTES ARE BREWING?

The new focus on trade tensions could be with Europe. The U.S. is planning new 100% tariffs on wine, cheese, and other agricultural products from Europe, in retaliation for a new E.U. 3% digital services tax on large internet companies like Amazon, Google, and Facebook. This could have a major effect on some U.S. food importers and has prompted threats of more retaliation from Europe. For a while now, the Trump Administration has been considering automobile tariffs aimed at Europe and, possibly, Japan—though if Japan were included, it would probably scuttle the new U.S.-Japan trade agreement.

HOW IS ALL OF THIS AFFECTING THE U.S. TRADE DEFICIT?

The U.S. trade deficit is expected to be down slightly in 2019, compared to the year before. That's mainly because recent Fed rate cuts have caused the U.S. dollar to level off, after rising for much of 2018. But the trade deficit in 2018 was +25% larger than in 2016, driven mainly by a wider federal budget deficit, which was financed by capital inflows from abroad. This chronic imbalance between savings and investment lies behind chronic U.S. budget deficits, not "bad trade deals" or even competitiveness. Trade sanctions aimed at one country or another may shift that imbalance around, but don't change the overall picture.

WHAT DOES ALL OF THIS MEAN FOR INVESTORS?

Continued trade tensions aren't a disaster that will single-handedly derail the economy. But they are a headwind that have helped slow global growth and pushed global manufacturing, in particular, into contraction. Investors should just bear in mind that the ebullience some appear to be feeling right now, that trade peace is about to break out, is overdone. There are still likely to be further twists and turns, and continued uncertainty for many businesses, heading into the new year.

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