A Damaging State of Flux

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- The Trump administration has increased tariffs to 25% on around US$200 billion of Chinese goods imports.
- The escalation comes at an already-weak point for global and Chinese sentiment.
- An important determinant of the impact on the U.S. and global economies will be how Beijing chooses to retaliate.

The trade war has escalated again. The U.S. hiked tariffs to 25% on around US$200 billion of Chinese goods imports. Beijing has announced it will retaliate, although it has not yet provided details. The increased tariff rate from 10% to 25% was the result of assessments in Washington that trade discussions with Beijing were not progressing as desired this week. The higher duties will impact more than 5,700 different Chinese goods imports but will not apply to those goods already in transit to the U.S. The trade talks will continue Friday, although the likelihood of an immediate and positive change to the new status quo is remote.

Unavoidable fallout

A look at recent history offers a hint of how the latest escalation will play out. The trade war last intensified from July to September 2018. In July and August, a 25% tariff was applied to a cumulative US$50 billion Chinese in goods imports and in September a 10% tariff was slapped on US$200 billion worth of goods. While the impact on sentiment and financial markets was swift, the impact on China’s real economy took time. Only from the December quarter onwards was the extent of slowdown in Chinese exports and manufacturing made clear. Indeed, China's fourth quarter GDP growth slowed to a decade low of 6.4% y/y, partially on the consequences of the trade war.

The fallout is expected to be broadly similar this time; the increased tariff rate will not apply to goods already at sea, so will likely take effect in around three weeks and then gradually materialise in the hard data. Unlike previous episodes, though, there is no opportunity to frontload this time since little notice was given that the higher tariffs would take effect. Financial markets have captured the adverse sentiment; the Shanghai Composite slumped by 3.2% this week as tensions flared and the likelihood of a near-term deal faded.

The escalation comes just when global and Chinese sentiment is already teetering. The Moody’s Analytics survey of business confidence shows that global sentiment is hovering around its lowest point in a decade. And in February, China’s official manufacturing PMI was at its weakest reading in three years. Sentiment is an important determinant of investment and employment decisions, and of broader GDP growth. Already-fragile sentiment could take another blow from this latest escalation, forcing the global and Chinese economies toward a weaker trajectory.

Central banks in the Philippines, Malaysia and New Zealand already cut their benchmark rates this week, and a common thread for the decision was heightened global trade tensions posing downside risks to already-slowing global demand. The damaging mindset of believing the worst, potentially then triggering the worst, is at play.

Waiting on retaliation

Crucial to the U.S. and global economies will be how Beijing chooses to retaliate to this latest escalation. China has already imposed tariffs on more than US$100 billion in U.S. goods imports, representing around 90% of all U.S. goods imports to China. But there are other potent alternatives left in China’s war chest, beyond increasing the tariff rate on imports of goods.

Targeting U.S. service exports to China would inflict pain. Global demand is shifting from goods to services. This trend is well entrenched in China as the drivers of its economy shift from urbanization and basic manufactured goods to consumption and more complex services. Well-established expertise in various industries including education and financial services means that the U.S. is in good stead to meet the rising needs of China, so long as Beijing remains open to it.

Another option is an under-the-radar approach. Since trade tensions have intensified, anecdotal evidence indicates that U.S. firms are finding it more difficult to obtain regulatory approval for various business activities, and that their goods have taken longer to clear customs. China could intensify this.

Yuan depreciation has been touted as another possibility. But while there would be benefits to China’s export competitiveness, we think Beijing would be reluctant to deliberately employ the strategy given China's overarching desire to keep economic conditions stable as it navigates through its momentous rebalancing, although it would likely be unable to completely stem the flight to haven assets under the trade war escalation.

Deliberate depreciation or more extreme devaluation could trigger worrying capital outflows. When China devalued the yuan in 2015, around $500 billion (4.5% of GDP) in capital outflows occurred that year alone, according to the Institute of International Finance. Outflows are undesirable when worries abound regarding China's ability to stabilise domestic demand and eventually reel in its elevated financial risks. If outflows intensify, this could trigger a possible crisis of confidence in China's ability to service it.

A first look at U.S. impacts

The impacts of the trade war escalation will be measurable for the U.S. as well. If the increased tariffs remain in place, they would reduce GDP growth by a couple of tenths of a percentage point. At the moment, these moves create more uncertainty than anything else as investors question whether the new tariffs will remain and whether the final round of tariffs threatened by President Trump—25% on the remaining roughly $325 billion of Chinese imports to the U.S.—will be enacted. The goods caught up in the higher tariff rates cover a high proportion of consumer goods, so the eventual pass-through to inflation and consumption will be felt.

The near-term risk is a pullback in business investment spending while certainty is sought on trade policy and its impact on supply chains. Longer term is a squeeze on already narrowed corporate profits as prices rise on intermediate goods and industrial equipment imports from China. The remaining still-threatened round of tariffs would more directly affect prices of consumer goods.

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