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Living in the Tail Risk

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The U.S.-China trade war has gone down a darker path. The Trump administration plans to introduce a 10% tariff on the remaining US$300 billion in Chinese goods imports starting 1 September. This will bring the total value of goods subject to tariffs to around US$550 billion, broadly equivalent to total imports from China into the U.S. The additional tariff on China would put the total effective U.S. tariff rate at 5.4%, compared with 4.4% today and 1.5% seen at the end of 2017.

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Living in the Tail Risk

BY STEVEN G. COCHRANE AND KATRINA ELL

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The latest escalation follows reportedly uneventful discussions between Washington DC and Beijing in late July, where no progress was made on complex issues like the treatment of intellectual property and foreign investment in China. The trade war has escalated beyond expectations and the stakes are high for the global economy. Our global recession odds for the next 12 to 18 months have increased to 50%.

U.S. consumers will feel the pain

Extending the tariffs to the remaining imports from China brings the trade war to a point where it starts to hurt the U.S. more than China. For the previous $250 billion of goods that are now subject to 25% tariffs, about half of this is intermediate goods with the remainder being nearly equally distributed across capital goods and consumer goods. In some cases, manufacturers have been able to absorb some of the tariffs on intermediate goods by shrinking their profit margins. Even importers of capital goods could do the same.

About half of the goods that will be subjected to a new 10% tariff on 1 September as proposed by President Donald Trump will be consumer goods, most of which reach consumers via retail channels. But profit margins for retailers are quite narrow and higher tariffs on consumer goods will likely be passed on directly to consumers via higher prices. Retailers have little capacity to further narrow their already-modest profit margins.

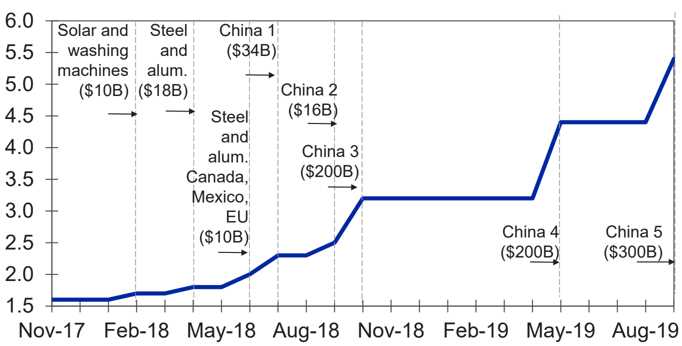
It is through the retail channel where the additional tariffs hurt the U.S. economy more than China. The tariffs cause prices to rise on an array of consumer goods in the U.S., resulting in higher inflation and weakened consumer confidence. Currently, consumer spending is the primary driver of growth in the U.S. If consumer spending falters, recession risks rise. With these new tariffs, the risk of recession in the next 12 to 18 months rises significantly to about even odds.

How is Asia impacted?

The impact on Asian economies works primarily through the disruption of supply chains. Currently, exports are down across the Asia-Pacific region as demand by manu-

The Trade War Intensifies

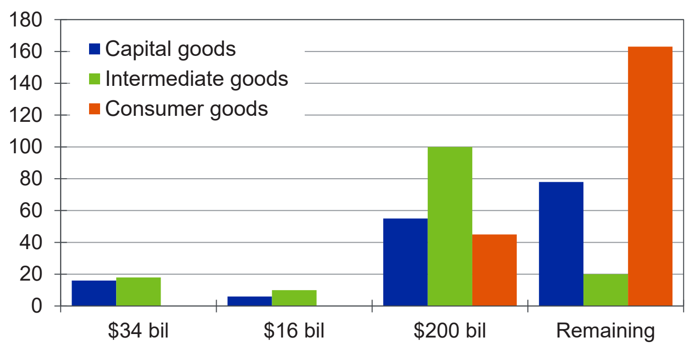
U.S. effective tariff rate, %



Sources: U.S. Census Bureau, USTR, USITC, Moody's Analytics

Who Bears the Brunt of the War?

Chinese imported goods in U.S. subject to tariffs by round, $ bil



Sources: Commerce Department, Moody's Analytics facturers in China for intermediate inputs has fallen. The additional tariffs, however, will be less disruptive to APAC economies because supply chains for consumer goods are less complex. An obvious example is sneakers, which require few intermediate inputs, versus electronic products, which are composed of hundreds of parts from multiple points of origin. Thus, the new round of tariffs will have a milder impact on the APAC region. In reality, some electronic products such as mobile phones are part of this new round of tariffs, but electronics were a much larger share of the previous $250 billion of goods already subject to tariffs.

The new round of tariffs could be a positive factor for the lowest-cost countries in Southeast Asia and elsewhere. This will accelerate the shift of low-cost goods production out of China—a shift that is already taking place as labor costs rise. This could happen rather quickly for low-value-added labor-intensive industries, hastening a difficult restructuring of China's economy. One factor that could weigh on this process is the need to quickly change and customize consumer goods because of fashion trends and multiple versions of a product, like sneakers. So, even with consumer goods, the shifts in investment locations may not happen as quickly as expected, possibly delaying the positive impacts that could drive the less-developed countries of ASEAN, or even Africa.

China's potential response

It will be important how China responds, as it has already applied tariffs on around 92% of U.S. goods imports, so nontariff measures are the logical next step. China has shown that its nontariff retaliation carries ferocity, and we expect this round will not be any different. Beijing's war chest offers many options. The most likely act will be to release the "Unreliable Entity List" that would exclude U.S. businesses from engaging with Chinese firms. This option was first floated on 31 May by the Ministry of Commerce. A potential list emerged on 26 July, possibly in anticipation of tariffs being ramped up on the U.S. side.

Another likely option is halting or restricting rare earth exports to the U.S. China is the largest source of rare earth mineral imports into the U.S., accounting for almost 60% in 2018, according to the U.S. International Trade Commission. The Trump administration has previously threatened to include tariffs on China's rare earths but never followed through given the critical role they play in production across the U.S. economy. China is looking to increase its dominance in the high-tech space, and restricting foreign access to rare earths would facilitate that ambition. Beijing has positioned itself as a reluctant player in the trade war, so taking action on rare earths could be viewed as retaliation for the latest U.S. aggression, rather than playing into its longer-term strategy of moving up the high-tech value chain.

The yuan depreciated by 0.8% against the dollar on 2 August to CNY6.939 per U.S. dollar, its weakest since November. Continued escalation of trade tensions with the U.S. may exert downward pressure on the yuan, especially via expectations of increased monetary stimulus, and Beijing may allow the depreciation to support its manufacturing and export sectors. This is less severe than deliberate devaluation, which is often touted as an option. But a devaluation beyond CNY7 per USD is unlikely, as it could trigger capital outflows and broad instability in China. The pain from the 2015 devaluation is still front of mind.

Other nontariff measures that are unlikely in the immediate future include selling U.S. Treasuries or choosing not to roll over maturing bonds in its portfolio. There is also the option to introduce restrictions on U.S. service exports such as education and tourism. These are important growth areas for the U.S. with significant opportunity as China's burgeoning middle class follows the usual model of development where consumers increasingly demand services over goods.

Damage from existing tariffs

The damage that the existing tariffs have caused should not be understated and provide a good starting point to gauge the impact of the latest round. Exports and imports throughout Asia have slumped through 2019 as the trade war has exacerbated the existing cyclical downtrend. The deterioration of Japan's Tankan survey since late 2017 has coincided with the escalation of the trade war and is a good example of how the spat influences broader behavior across the region via weaker investment and employment intentions.

Central banks in Asia have already eased policy on the threat of escalation in an environment of below-potential growth, and now the outlook has worsened. Our expectation is that central banks throughout the region will ease policy to shore up domestic demand. But the problem is that local monetary stimulus does not meaningfully change the status quo; only a more permanent truce to the trade war can do that. The potency of further expansionary monetary policy is limited by the unfavourable backdrop. Additional rate cuts make credit creation more attractive, but the heightened geopolitical risk deters firms from wanting to invest. Lending rates are already ultra-low in most economies, and there is not much space to insulate against a renewed downturn in global demand.

About the Authors

Steven G. Cochrane, PhD, is chief APAC economist with Moody's Analytics. He leads the Asia economic analysis and forecasting activities of the Moody's Analytics research team, as well as the continual expansion of the company's international, national and subnational forecast models. In addition, Steve directs consulting projects for clients to help them understand the effects of regional economic developments on their business under baseline forecasts and alternative scenarios. Steve's expertise lies in providing clear insights into an area's or region's strengths, weaknesses and comparative advantages relative to macro or global economic trends. A highly regarded speaker, Dr. Cochrane has provided economic insights at hundreds of engagements over the past 20 years and has been featured on Wall Street Radio, the PBS News Hour, C-SPAN and CNBC. Through his research and presentations, Steve dissects how various components of the macro and regional economies shape patterns of growth. Steve holds a PhD from the University of Pennsylvania and is a Penn Institute for Urban Research Scholar. He also holds a master's degree from the University of Colorado at Denver and a bachelor's degree from the University of California at Davis. Dr. Cochrane is based out of the Moody's Analytics Singapore office.

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