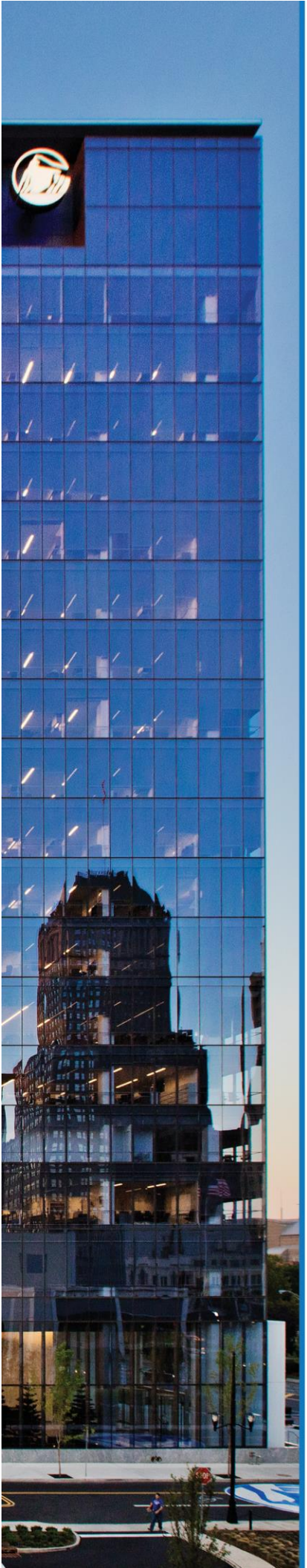

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GLOBAL MACRO MATTERS

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Trade Tensions—Still More Bark Than Bite?

Through much of last year, the Trump Administration's trade policies were more bark than bite. The President threatened to withdraw from NAFTA, but the U.S. Trade Representative (USTR) dutifully continued negotiations with Mexico and Canada on a revision of that agreement. The President criticized China's trade policies, but those concerns were not transformed from tough rhetoric into actual policies.

In recent months, however, things have taken a different turn. In February, using the rationale of national security, the U.S. Administration announced import tariffs of 25% on steel and 10% on aluminum. These measures were greeted with concern by U.S. trading partners and, in some cases, brought threats of retaliation. The European Union threatened reciprocal tariffs on U.S. exports of motorcycles, jeans, and bourbon. In response, the Administration has put into a place a system that allows some countries to be exempted. Trading partners receiving temporary exemptions to date include Argentina, Australia, Brazil, Canada, Mexico, South Korea, and the European Union. These partners represent roughly two-thirds of U.S. steel imports and over half of U.S. aluminum imports. Some analysts have argued that these measures are becoming "Swiss cheese" tariffs. But the exemptions are only temporary, and the Administration's next steps—including the possibility of quotas on the exempted countries—remain difficult to predict.

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More recently, the U.S. Administration announced its intention to put 25% tariffs on imports from China totaling $50 billion, reflecting charges that China has unfairly appropriated U.S. intellectual property. On April 3, USTR released a list of 1,300 products to which the tariffs would potentially apply. These products were wide ranging, but focused on high-tech goods and other products that USTR deemed as benefiting from China's industrial policies, including its "Made in China 2025" campaign. The proposed tariffs have now entered a period of public comment and, in any event, will not be implemented until June.

China has responded to these U.S. tariffs with measures of strictly similar size. In response to the U.S. actions on steel and aluminum, which represent roughly $3 billion of Chinese exports to the United States, China announced its intention to place reciprocal tariffs on $3 billion of its imports from the United States, including pork, steel, and aluminum. Similarly, China responded promptly to the second round of U.S. tariffs, announcing 25% tariffs—implemented when the U.S. tariffs come into effect—on over 100 U.S. products, including vehicles, aircraft, and soybeans. These products account for a similar $50 billion of imports from the United States. China's response, however, highlights some of the difficulties associated with defining reciprocity. Tariffs worth $50 billion cover less than one-tenth of China's goods and services exports to the United States, but would capture over one-quarter of U.S. exports to China.

Notably, even as trade tensions with China have escalated, soundings on U.S. trade with other partners have been more encouraging. The Administration recently announced a renegotiated deal with South Korea, and seems committed to reaching agreement with Mexico and Canada on NAFTA. Recently, Treasury Secretary Mnuchin even mentioned the possibility that the United States might at some point be willing to enter negotiations to rejoin the Trans-Pacific Partnership (TPP).

The Investment Issue

In addition, Chinese officials are reportedly quite anxious about the U.S. Administration's apparent intentions to limit their country's investment into the United States. At present, Chinese investors have more or less free access to the U.S. market, while U.S. investors face multiple restrictions in China. This imbalance in circumstances has long been a concern to U.S. officials. In recent years, this concern has been particularly acute as China has mobilized national resources to systematically acquire U.S. firms in high-tech industries, particularly in the semiconductor industry.

More specifically, the Committee on Foreign Investment in the United States (CFIUS) is responsible for reviewing incoming foreign investment to the United States. But this review is limited to foreign acquisitions of existing U.S. firms (i.e., the review does not include greenfield foreign direct investment (FDI) or portfolio investment), and it is focused solely on whether the acquisition raises any national security concerns. Under its existing authorities, however, the Administration could adopt new measures to constrain Chinese investment into the United States. The thorny challenge is to do this in a way that doesn't disrupt U.S. industries that have benefitted from Chinese investment or, more generally, create uncertainty about the desirability of the United States as an investment destination.

Global Economic Implications and Three Potential Scenarios

Given all of this as background, the key questions on the minds of market participants are: 1) What do these developments mean for global economic performance, and 2) What are the United States, China, and potentially other countries likely to do next?

On the first question, if the tariffs that have been announced are fully implemented, the effects would be felt in the U.S. and Chinese economies through several channels. Consumers and firms in these countries could see higher prices. These higher prices would prompt a diversion of trade away from targeted imports, toward other possibly less efficient

producers. The upshot would likely be reduced purchasing power for consumers, transition costs for firms as they reconfigure supply chains, and ultimately a less efficient overall allocation of resources. Firms that exported targeted products into the United States or China would be particularly affected. These might include, on the U.S. side, Boeing and soybean producers and, on the Chinese side, firms exporting high-tech products.

The nature of these effects is quite clear qualitatively. But quantitatively, how big would these effects be for the economy? The United States and China are both enormous economies with GDPs of over $19 trillion and $12 trillion, respectively. As such, tariff payments of $12.5 billion on $50 billion of exports is unlikely to cause much of a dent. Alternatively, with total U.S. imports of $2.9 trillion last year, the tariffs apply to less than 2% of U.S. imports. If the price of these imports went up in proportion to the 25% tariff, this would suggest an increase in overall U.S. import prices of just ½%. Given standard rules of thumb, this would mean an increase in core consumer prices of something like 5 to 10 basis points.

The tougher question is what will the United States do next? Here, we see three scenarios. First, even in recent weeks as public trade tensions have heightened, the United States and China have quietly been engaged in intermittent negotiations on ways to reduce China's bilateral trade surplus with the United States. Thus, an upside scenario is one where the United States and China reach a negotiated agreement, and the tariffs either are not implemented at all or are implemented in an attenuated form. The rationale would be that the Administration has already scored points with some of its political supporters by just announcing the tariffs, and the ultimate economic objective is reducing the trade imbalance. Actually implementing the tariffs runs the risk of alienating the business community. And other considerations, such as North Korea, could also be on the table. Thus, a negotiated settlement might be seen as artfully threading several needles. We put a probability of roughly 20% on this kind of outcome.

In a second scenario, the United States implements the tariffs that have been announced, likely augmented with some moderate-sized restrictions on Chinese investment. But no further actions are taken. As a political matter, the President wants to appear tough on trade, but for obvious reasons, he doesn't want to disrupt U.S. growth or the global economy. Implementing the currently announced measures without further escalation might be seen as achieving these competing objectives. We place a probability of about 45% on such an outcome.

The third scenario would be one of escalating tensions between the two countries and several rounds of retaliation. President Trump would see China's reciprocal tariffs as an unacceptable threat, and raise the ante with further U.S. tariffs. In addition, U.S. restrictions on Chinese investment would be more severe. The implications of this scenario for economic growth in the United States and elsewhere would be increasingly disruptive. Given this reality, our expectation is that both sides will choose more moderate policies, although flare-ups in rhetoric are likely. Nevertheless, trade tensions over the past two months have escalated more sharply than we had expected and, accordingly, the probability of an adverse outcome must be marked up. At present, we place a probability of approximately 35% on such a scenario.

Notably, we see the trajectory of Chinese policies as largely dependent on what the United States does. China has shown that it will respond at similar scale, but will not further raise the ante. More fundamentally, the Chinese leadership sees U.S. actions as an opportunity to seize the moral high ground on trade and on globalization more generally and to burnish its credentials as a leader in the international community. China cannot look weak, but it also does not want to appear as the provocateur.

As such, the overall trade situation remains fluid and will require careful scrutiny in the weeks ahead. The consequent risks to the global economy are rising. It's fair to say that President Trump's trade agenda vis-à-vis China may be shifting into more than just bark. The question now is how painful any eventual bite might be.

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