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The Outlook for the Trade War: Assessing President Trump's Next Move

With the trade negotiations between the United States and China appearing to gain traction, it's useful to step back and consider the outlook and prospects for the trade war. What are the key factors shaping President Trump's choice set? What are some possible outcomes for the year ahead? And what does it mean for markets?

The good news is that we see an eventual agreement as the most probable outcome. As for timing, we believe that a deal is most likely to be reached during the second half of this year. Until then, with China facing economic stresses, including those from the trade war, and the Trump Administration seeking to provide support for U.S. financial markets, both sides have incentives to keep the tone of the negotiations positive. The bad news is that we see two distinct, albeit less probable, downside scenarios. The first is the possibility that the President becomes impatient with the negotiations or judges that the U.S. economy is sufficiently strong to absorb another round of stresses, and he decides to "up the ante" by hiking tariffs on China. The second is that the Administration's attention pivots to the auto sector and hikes auto tariffs as an additional front in the trade war. Either of these scenarios could have severe implications for markets and the economy.

Our focus will be primarily on President Trump's decision framework. From the beginning of the Administration, his senior economic advisors have had split views regarding the strategy for the trade war—some have been more hawkish and others more dovish.[1] But, clearly, it's the President's position that really matters. While we don't claim any special knowledge of the President's mind, the following are our observations regarding his incentives and some lessons that we have drawn from his actions over the past year.

Framing the Negotiations: What Are China's Incentives?

We see the outcome of the negotiations as hinging primarily on the U.S. stance, yet Beijing's perspective must also be borne in mind—it takes two to tango. China did not seek the trade war and has endured a disproportionate share of the adverse effects. The Chinese economy was already slowing as a result of the de-risking campaign, and the trade war has created further headwinds. For this reason alone, China is motivated to find a resolution, and its offers are better than those from previous years. Moreover, from the outset of the trade conflict, China has sought to seize the moral high ground for geopolitical reasons and has taken pains not to escalate the conflict. For example, its trade actions against the United States have come only in response to U.S. measures and in proportion to U.S. measures. With the United States expressing ambivalence about its leadership role in the global economy, China is aiming to boost its international influence and its stature as a constructive interlocutor.

[1] *More hawkish members might be regarded as Robert Lighthizer, U.S. Trade Representative, and Peter Navarro, Assistant to the President and Director of the Office of Trade and Manufacturing Policy. More dovish members might be regarded as Steven Mnuchin, U.S. Treasury Secretary, and Lawrence Kudlow, Director of the National Economic Council.*

But there are also limits as to how far China will go. It's overall external position, best measured by the current account, is nearing balance. It has a legitimate expectation of driving further technological advances in its economy, especially given that Chinese per capita GDP is still only a fraction of the West's. And it has claim to be seen—and treated—as one of the world's leading nations given the scale of its population, economy, and geopolitical influence. Finally, some of the reforms sought by the United States are deeply structural and could take years to fully implement. These observations create a set of practical constraints and "redlines" for the negotiations that China is unlikely to cross.

Some Thoughts on the Administration's China Strategy

The Trump Administration's trade policies are best interpreted in the context of its overall China strategy. The upcoming presidential election in November 2020 and the recent volatility in U.S. markets are also constraining factors. This section briefly considers some of these issues.

The confrontation with China is about a lot more than just trade. The Trump Administration's trade policies are best interpreted in the broader context of its China strategy. The Administration has starkly defined the relationship between the United States and China as one of strategic competition. The dimensions of this competition encompass trade, but also include technology, intellectual property, investment, cyber security, diplomatic standing, and (importantly) military might. The goal of this confrontation is not to entirely block China's rise as a great power, which is inevitable, but to slow and shape that rise. If successful, a more gradually ascending China would give the West time to lengthen its lead in key areas. By pressing for reforms, these policies could ultimately make China a more constructive player in the global system. The Administration has indicated that the United States previously sought to achieve these objectives with too many carrots and not enough sticks. The risk of this strategy, of course, is that it may backfire and end up antagonizing China.

The Administration need not press China on all these issues simultaneously. Rather, we are likely to see an "ebb and flow" approach—pushing on one issue for a while and then moving to another. President Trump will always seek to use his policy tools opportunistically. Thus, progress on trade issues would not signal an end to strategic competition with China and, indeed, would not preclude the Administration from subsequently reverting with a range of other complaints. As a corollary, a wide set of issues is on the table during the current trade negotiations, and the Administration is seeking to use tariffs to gain leverage more broadly.

President Trump will be slow to give up the negotiating leverage that tariffs provide. Administration officials, particularly the President, seem to view the strategic competition with China in terms of a long-term, ongoing negotiation. They have learned that the Chinese economy, given its strong external orientation, is sensitive to tariffs. Clearly, both economies have been adversely affected by the trade war, but the effects on China have been more severe. Last year's slowing of Chinese growth not only reflected the legacy of the domestic de-risking campaign, but it also exposed tensions and uncertainties created by the trade war. These economic stresses have boosted the motivation of Chinese officials to find a solution to the stand-off. President Trump will be slow to give up the leverage and optionality associated with the threat of future tariffs.

As a related issue, the negotiations face a major challenge considering that many of the concessions requested by the United States require China to undertake deep economic reforms that can only be accomplished gradually. For example, it's one thing for China to commit to a more transparent intellectual property regime, a reduction in non-tariff barriers, and a more level playing field for foreign firms. But it's quite another to implement these reforms in a deep and lasting way. Slowly unwinding the tariffs as China implements reforms, with a threat of snapping them back if the reforms go off track, could be a powerful mechanism to help motivate and enforce reforms.

Of course, in the context of a negotiation, nothing is absolute—it's all about "what we give" versus "what we get." Thus, President Trump could further reverse the tariffs and forswear their future use if China put an extraordinary deal on the table (although it's not clear what such a deal would look like) or if the U.S. economy and markets encountered deeper disruptions.

A rising stock market is the only thing that President Trump likes better than needling China. It is consequential that the agreement to postpone tariff hikes from January to March 2019 came as U.S. financial market conditions were tightening appreciably. It is also notable the perceived momentum of the trade negotiations has lifted markets. These observations don't mean that the trade war is irreversibly on hold. But they do suggest that Trump is unlikely to return to offense until market and economic conditions are favorable.

As such, we see the intensification of the trade war as less of a risk that triggers a recession, but rather as a risk that caps upside scenarios for the U.S. economy. If skies clear more than anticipated, President Trump might hike tariffs further with the rationale that: "If we can get this set of concessions from China with these tariffs, just imagine what the Chinese might be willing to put on the table with a more vigorous set of tariffs."

The trade war will be wound up by early 2020 (at the latest). Tariffs inevitably bring redistributions, benefitting import-competing sectors and harming consumers and firms that are reliant on imported products. Also, U.S. exporters have been hurt by China's retaliatory tariffs. Given that there are winners and losers—and that some of the losers may be part of the President's core constituency—he will likely aim to resolve the trade war by early next year, well before the November 2020 presidential election. This will give him scope to claim victory on trade policy, point to his success confronting China (which is broadly popular), and perhaps threaten further confrontation in a second term. By then, the adverse effects of the trade war could be a fading memory in the minds of most of the populace.

Some Scenarios for the Trade War in 2019

In this section, we consider the possible trajectory of the trade war in light of the preceding observations. We believe that a "deal" is the most likely outcome. But before launching into this discussion, it's useful to define exactly what a deal might entail. We envision an agreement that is sufficiently broad and substantive that it allows President Trump to plausibly claim that the negotiations were successful and to de-escalate the trade war. It will be more than a promise from China to buy additional U.S. exports and more than an agreement to keep talking. While it will not resolve all the concerns about the way China conducts business, it will be an appreciable step forward.

With this context, the following are four scenarios as to how the trade war with China could proceed through the year ahead.

1. **De-escalation: A deal is struck this spring.** To reach an agreement so quickly, the negotiations would need to rapidly gain traction, which is possible given both sides seem motivated to find a solution. China desires to eliminate trade war uncertainties, while the U.S. Administration is looking for positive economic headlines to boost stock prices and business confidence. Given the breadth of the issues on the table, however, our sense is that the negotiations will take time. The United States is unlikely to accept a narrow agreement in which China merely promises to buy more U.S. liquified natural gas and agricultural products. The question of how to enforce an agreement also will take time to resolve. And, in any event, we are doubtful that President Trump will want to quickly give up the leverage that tariffs provide. We put a 15% probability on this outcome.[2]

2. **De-escalation Lite: A deal is struck during the summer or, more likely, the fall of 2019.** The two sides negotiate through much of the year, with each attributing the length of the discussions to the complexity of the underlying issues, particularly enforcement issues. The tone of the discussions is generally constructive and punctuated by occasional threats from the White House. Even so, markets are increasingly relaxed about the prospects. A deal is eventually struck, which includes steps forward on the trade balance, intellectual property, and a few other issues, with reasonable enforcement mechanisms. For example, the U.S. commits upfront to not impose further tariffs on China and promises to unwind the existing tariffs over the next 12 months as China implements the agreement.[3] This strikes us as the outcome that best balances the preceding considerations. We assign a 45% probability to this scenario.

3. **Protraction: Negotiations continue through the year, without any resolution.** Lacking clear political direction, trade negotiations become long and protracted. Thus, if senior Administration officials lose interest in the trade war, choosing to focus instead on other issues, the trade negotiations may not reach a resolution. Such a scenario would give both sides ample time to think through the best way forward on thorny issues, which could lay the foundation for a better agreement. On the other hand, negotiations inevitably come to points at which tough choices must be made, and this requires political guidance. By our reckoning, an outcome of this sort is not likely. During his first two years in office, the President has repeatedly returned to the issue of tariffs, and China is central to the Administration's foreign policy. Thus, we give this a low probability of just 10%.

4. **Escalation: The negotiations collapse, and the U.S. expands its tariffs on China.** President Trump's tariff policies have proved notoriously hard to predict, and he may surprise again. Indeed, with market performance improving over the past few weeks, he might see scope for renewed confrontation. And there is still time to go through another cycle of intensification and negotiation before the November 2020 election. Alternatively, China's offers may fall short of the Administration's expectations, which could prompt Trump to apply additional pressure. Even so, we believe that the risks to the U.S. economy and markets, including through further adverse effects on Chinese growth, make this approach relatively unattractive for the Administration. We assign it a 30% likelihood.

[2] *In December 2018, President Trump agreed to begin negotiations with China and to delay any further moves in the trade war until early March 2019. We expect that this deadline will be extended to allow for further negotiations. When this extension is announced, the two sides might also announce some areas of early agreement. But none of this will likely be sufficient to convince the President to de-escalate.*

[3] *Another variation on this theme is that the tariffs could be removed, but re-imposed if China was judged as not implementing the agreement.*

Apart from these possible outcomes for the negotiations with China, we also worry about the possibility of a "proliferation" scenario in which the Administration shifts (or expands) the trade war to include tariffs in the auto sector. In parallel with the negotiations with China, the Department of Commerce is conducting an investigation into the sector Section 232 of the Trade Expansion Act, with its findings due in mid-February. If supportive, these findings would provide justification for the United States to impose auto tariffs on national security grounds. Given the composition of U.S. auto imports, these tariffs would fall most heavily on Europe and Japan.

Such a proliferation could arise along with any of the scenarios above. For example, rapid agreement with China might open the way for another volley in the trade war. Alternatively, negotiations that are ongoing and convergent (or protracted) might free up resources for a second front. Alternatively, with congressional investigations of the President likely, and perhaps leading to impeachment hearings, an expansion of the trade war would be a way to win back headlines and media attention. Given the importance of the auto sector in the global economy, such action would carry intense global risks. Even so, the possibility of the United States imposing tariffs on autos strikes us as too plausible. We give it a 20% probability.

Conclusions and Implications for Markets

In sum, we see the trade war as likely to reach a resolution over the next twelve months. While the road ahead may be bumpy at times, developments in this sphere are likely to be constructive for markets and risk assets. As we move into the 2020 election cycle, we anticipate that providing support for financial markets, and the economy more generally, will be an increasingly important objective for President Trump as he gears up for a re-election campaign.

Even so, we also highlight some risks. First, we recognize that President Trump may surprise us by escalating tariffs on China or initiating a confrontation on autos. Either of these actions could be distressing for markets and create potentially powerful risk-off headwinds in U.S. and global markets. Second, as noted above, no deal with China is likely to fully resolve concerns about the way that China conducts business. Thus, if re-elected, President Trump could be back with a second trade war in 2021 or 2022, pressing for further gains. Third, with the United States having now vigorously deployed these trade policy tools, other countries may be more likely to follow suit in the future. This probably doesn't mean a broad upsurge in global protectionism, but it might suggest further episodes of aggressive trade confrontation in the years ahead. This, in turn, would undermine the openness and integration that have characterized the global economy over the past few decades.

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