How bad could it get?

Counting the cost of a global trade war

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Trump Starts Down a Slippery Slope of Protectionism

As a candidate in 2016, Donald Trump won support with a promise to redress an unbalanced trade relationship with the rest of the world. In the White House in 2018, he has started to make good on that pledge. The Trump administration has announced tariffs on steel and aluminum, and plans a 25% levy on $50 billion in Chinese goods. China's response so far has been measured – reciprocal tariffs on $3 billion of imports from the U.S. The base case remains more trade skirmish than trade war, but the risks are growing. In this report, we look at what's at stake and gauge the potential impact on the world economy.

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Contents

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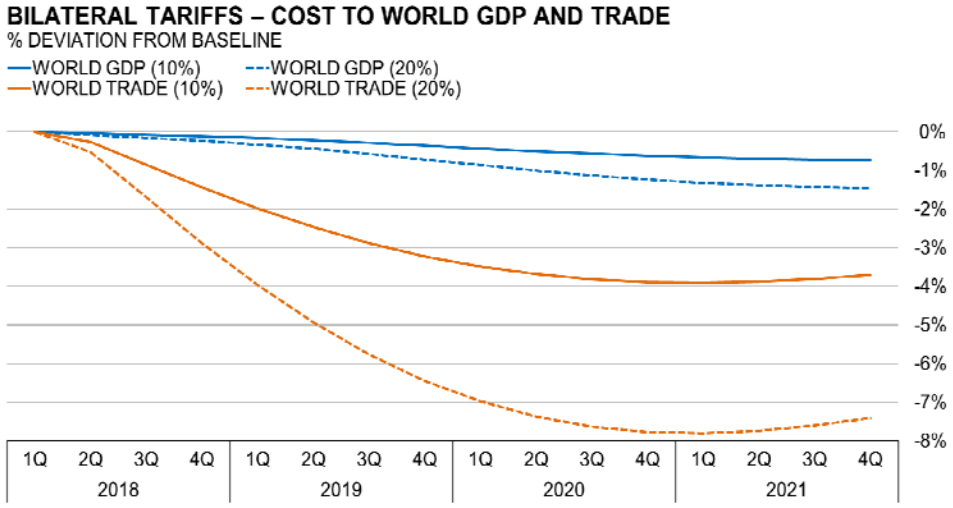
Global

Protectionism May Cost $470 Billion by 2020

By Jamie Murray and Tom Orlik

What happens to global growth if there's a trade war? Based on Bloomberg Economics' estimates, if the U.S. raises import costs by 10% and the rest of the world retaliates, raising tariffs on U.S. exports, the cost by 2020 would be 0.5% of global GDP.

To put it into perspective, that's about $470 billion – roughly the size of Thailand's output. That's an extreme scenario. The impact of measures announced so far is close to zero. But it's no longer an impossible one.



Source: Bloomberg Economics

The U.S. decision to impose tariffs on steel, aluminium and $50 billion worth of Chinese imports, the threat of counter measures from Brussels to Beijing, President Donald Trump's assertion that trade wars are "good, and easy to win," and the departure of the one free trade advocate from the White House have all brought protectionism from the realm of rhetoric to that of reality.

To estimate the implications of higher tariffs we use a global model of the economy. It covers dozens of countries, including most of the OECD and major emerging markets, all trade–linked using 2016 weights.

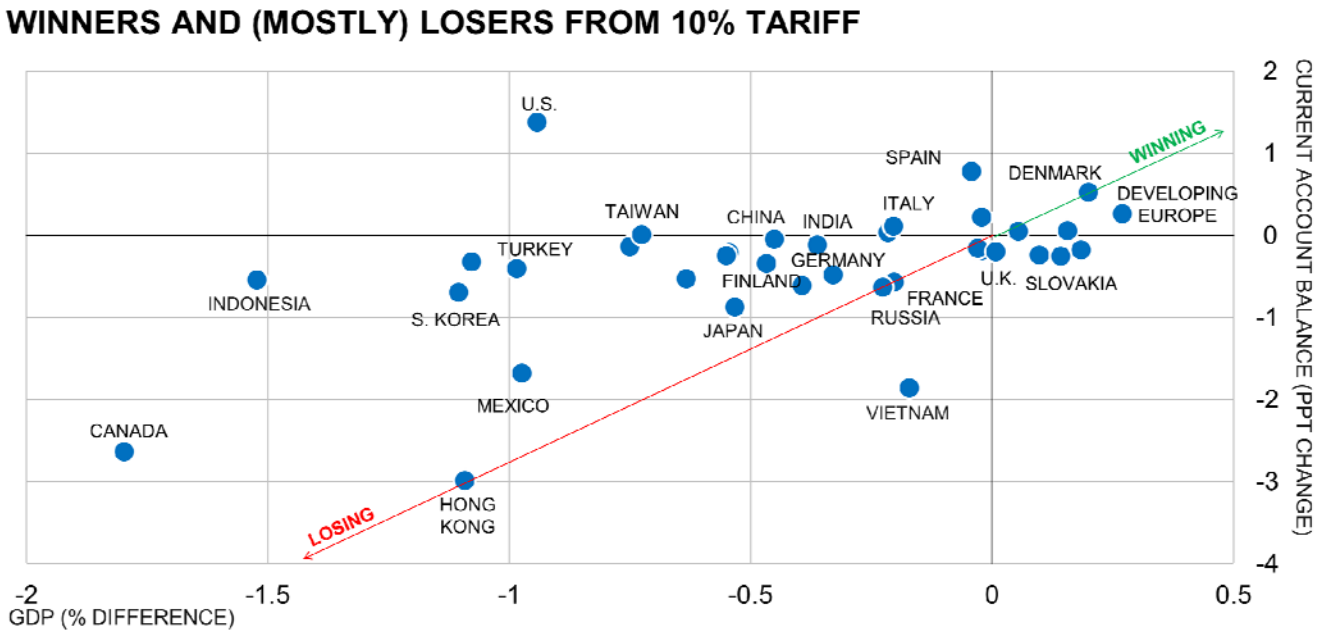
This allows us to trace not just the direct spillovers from one country's trade policies to another, but the knock–on influences as the shock works its way through the global trading system.

Higher tariffs between the U.S. and its trade partners propagate through the world economy via multiple channels:

- In the first blow, higher U.S. import costs push inflation higher – denting consumer purchasing power, which is the main driver of U.S. demand. Business investment would also weaken as slack opens up in the economy.
- Trading partners suffer immediately from the lower spending power of U.S. consumers, and over time as they switch from newly–expensive imports to domestic substitutes.
- A second blow comes as trade partners retaliate with their own tariffs, which dents their spending power (through the same inflation–shock mechanism) and causes substitution toward more domestic purchases. U.S. exports fall. By 2020, world trade could be 3.7% lower relative to the baseline of no change in tariffs.
- Central banks would face a tough choice between tackling the threat to inflation expectations from higher headline inflation and providing support to offset weaker demand in the economy. We've assumed a balanced response – monetary policy looks through the temporary influence on inflation but does not actively loosen to lift demand.
- One point to note about the model: trade between economies other than the U.S. is affected only by the knock on effect of disruption to U.S. trade – tariffs between all other countries are unchanged.

The shock begins to be felt in 2018, acting as a modest drag on annual global growth. It trims the rate of expansion by 0.2 ppt in 2019 and 0.3 ppt in 2020. Thereafter, the growth impact fades quickly. Not all the losses will be made good in later years. In fact, there would be a blow to productivity from reduced trade

connectivity and global growth would move onto a slightly lower trajectory. The simulation model is linear, so the impact of a 20% increase in tariffs would be double that of a 10% increase – reducing global output 1% by 2020 relative to the baseline.



Source: Bloomberg Economics

None of the economies in the model emerge from the conflict looking significantly healthier:

- The 10% tariff could leave the U.S. economy 0.9% smaller in 2020 relative to the no tariff benchmark. The current account would show improvement of 1.4% of GDP, and the peak impact on inflation is 2.2 ppts in 2019. We assume the Fed will look through that. If they don't and interest rates rise, the blow to growth would be much bigger.
- China would see output shrink by 0.5% compared to the baseline in 2020. The impact is smaller than on the U.S. That's because, for the U.S., tariffs apply to all imports and exports but, for China, only the subset that are part of bilateral trade with the U.S. are affected.
- For Germany output would be 0.3% lower and the current account surplus 0.5% of GDP smaller. Again, the muted impact stems from less exposure to tariffs – which affect 100% of trade for the U.S., but only German exports destined for the U.S.
- Canada suffers the most, reflecting its land–border trade links with the U.S. The economy would take a 1.8% hit and the current account deteriorate by 2.6%. That outsize impact reflects the double blow from lower consumer spending power as inflation rises and weaker exports as U.S. consumers start to substitute with domestic goods.
- Mexico also feels the pain. Output is 1% lower and the current account worsens by 1.7% of GDP. A smaller impact than that seen for Canada partly reflects a lower share of U.S. exports in Mexican imports. It's exports from the U.S. that matter because that's what determines the inflation shock.

Other estimates present an even bleaker picture of the outlook for global growth in the event of a trade war. A 2016 exercise by the International Monetary Fund envisions a 10% increase in import prices worldwide – not just in trade between the U.S and its partners. This would lower global GDP by 1.75% after five years. Running the numbers in 2017, the World Bank estimated that a tripling of average tariffs to 10.2% from 2.7% would reduce GDP by 0.8% after three years.

How We Model Tariffs

To estimate the impact of tariffs we use a global model called NiGEM.

In NiGEM, the impact of tariffs comes through shocks to import costs. A 10% shock is applied to imports of goods and services to the U.S. from all countries for one quarter. Commodity prices are excluded. A 10% shock is also applied to the price of U.S. goods and services imported to all other countries. Implicitly, we assume non–tariff barriers to trade in services get bigger, either reflecting uncertainty over trade policy or direct measures. Both shocks occur in 2Q18 and import prices are permitted to decline thereafter, as the global economy adjusts. Trade patterns and the composition of some economies will change in response to the tariffs. And, in the long run, real exchange rates should adjust as well.

The model assumes that countries don't change their monetary and fiscal policy settings in response to the tariffs. That will be reasonable for some economies but less so for others. Some central banks may focus on fighting inflation; others may choose to support growth. We see the risks this poses to our global estimates as broadly balanced.

In the long run, there will still be a hit to global GDP, irrespective of monetary policy choices. Less trade means less competition, less focus on areas of comparative advantage, and more barriers to exchanging new technologies and good ideas – this will affect the world economy's supply potential.

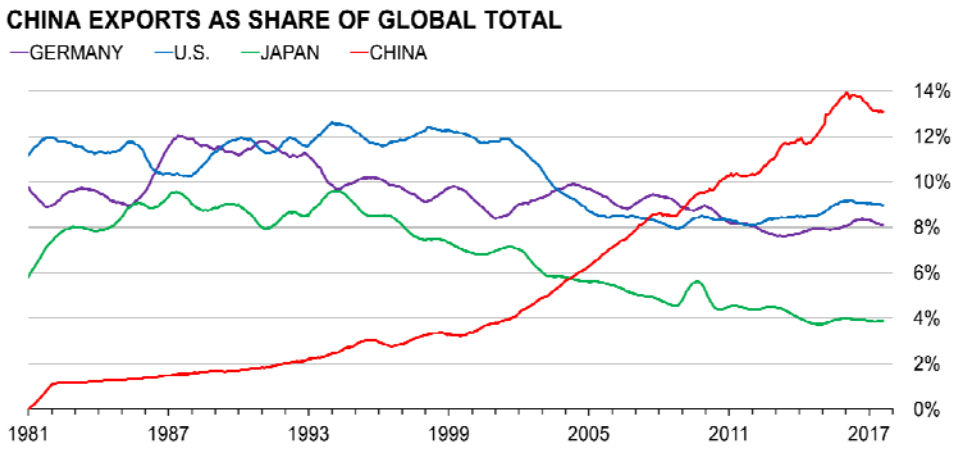
How We Got Here

By Tom Orlik and Justin Jimenez

In 2001, at a meeting in Qatar, 15 years after its original application, the World Trade Organization welcomed China as its 143rd member. Hailing the decision, then–President Jiang Zemin promised China would "strike a carefully thought out balance between honoring its commitments and enjoying its rights."

In the years that followed, as China's trade surplus with the rest of the world ballooned, it seemed the balance was more toward the latter. The entry of China into the WTO was already contentious. The Soviet Union had collapsed, removing the Cold War argument for embracing Beijing. Under Jiang, China was making major progress on market reforms but showed little sign of liberalizing on politics. U.S. labor groups were opposed – fearing the impact on blue–collar jobs and wages. Even so, with the economic case for free trade strong, businesses salivating at the prospect, and hopes capitalism would bring democracy in its wake, the deal was done.

The consequences were not exactly as expected. China certainly prospered. Booming exports were a key factor in buoying a decade of double–digit growth. Multinationals did OK as well. Apple produced its iPhones in China, tapping cheap labor from a workforce of close to 800 million. Yum! Brands, sold more fried chicken in China than it did in the U.S. By allowing China to focus on its comparative advantage in cheap labor, and the U.S. on its advantages in advanced technology, the trading relationship boosted productivity in both countries.



Source: IMF, Bloomberg Economics

There were also losers:

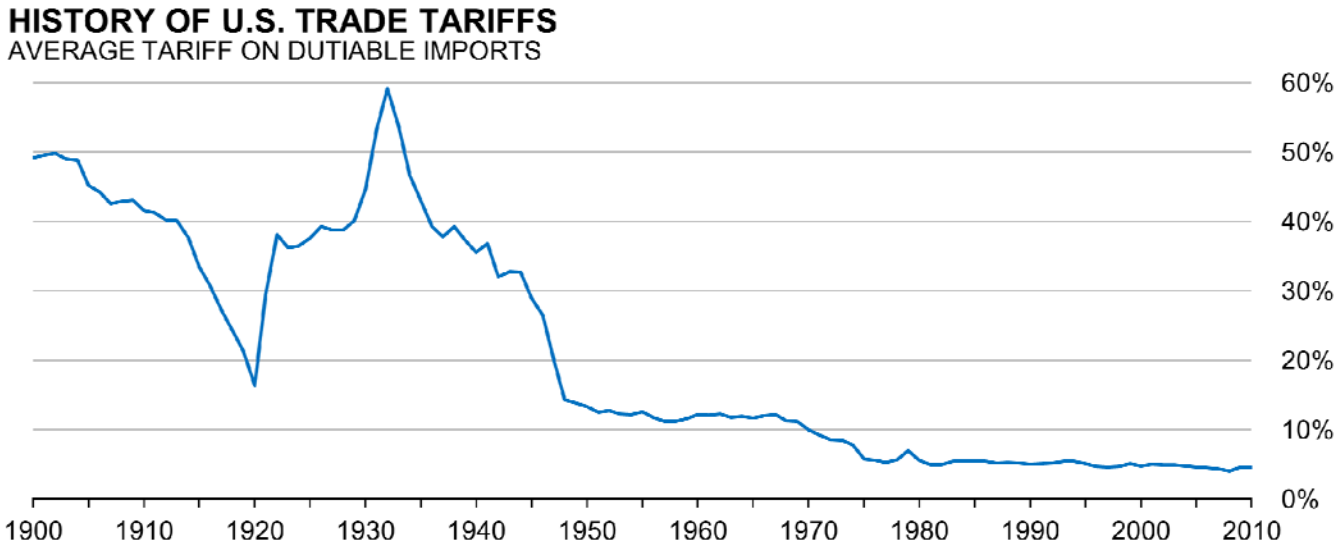
- U.S. labor groups, it turns out, were right to be suspicious of China's arrival in the global market. Taken together with a shift toward more capital–intensive production, the result was stagnant wage growth. Between 2001 and 2016, real income for the bottom 20% of U.S. households didn't rise at all, and wages for the middle 20% managed only a 4% increase.
- Mercantilist policies in China (combined with an irresponsible approach to financial regulation and mortgage lending in the U.S.) resulted in a buildup of major global imbalances. China's current account surplus ballooned to 9.9% of GDP in 2007 from 1.3% in 2001. The U.S. current account deficit peaked at 5.8% of GDP in 2006. The recycling of China's surplus back into U.S. Treasuries kept U.S. borrowing costs too low for too long, an important background condition for the real estate bubble and financial crisis.
- For foreign policy hawks, the strategic benefits were outweighed by the costs. China didn't democratize, in fact it doubled down on its single–party model. Worse still from Washington's point of view, China's rise means it now jostles with the U.S. for global influence, and on straight–line projections may overtake in terms of economic size in the next decade.

The financial crisis crystallized the politics. With unemployment in the U.S. touching 10% in 2009 and the jobless rate in many European countries even higher, voters were in no mood to listen to high–minded arguments on comparative advantage. In the U.S., a populist wave swept Donald Trump into the White House with a promise to get tough on China, renegotiate the North American Free Trade Agreement, and exit the Trans–Pacific Partnership. In the U.K., the vote for Brexit means exit from the world's biggest free–trade zone.

For the first year of the Trump administration, it seemed protectionism was more a rhetorical device than a real policy. Now that is changing. The announcement of duties on steel and aluminum, broader tariffs to retaliate for China's intellectual property theft, and the departure of free–trade advocate Gary Cohn from the White House have all raised the prospect of substantial shift toward protectionist policies.

What's striking is that the Trump administration appears to see trade through the lens of great power competition with China. That means all the economic arguments against tariffs – lost markets for U.S. firms, higher prices for U.S. consumers, high inflation forcing the Federal Reserve to tighten more aggressively – might not gain traction. Viewed through the lens of great power competition, economic costs might be regarded as a price worth paying for strategic gains.

The world has come a long way from the Smoot–Hawley tariffs that hammered trade and deepened the Great Depression when they were signed into law in 1930. Tariffs now are a fraction of their level back then. None of the proposals currently on the table will move the dial on global growth. Even so, the signs are alarming and the direction of travel is clearly the wrong one.



Source: U.S. Department of Commerce

China

Three Trade Scenarios for China

By Tom Orlik and Fielding Chen

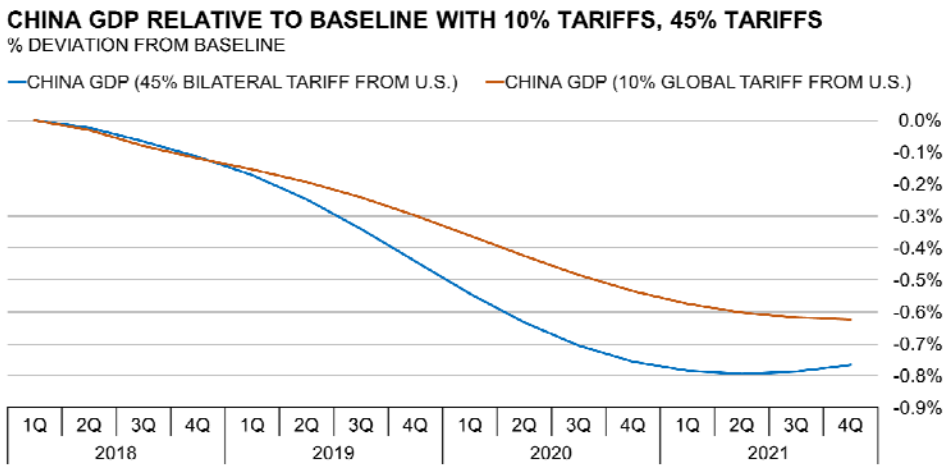
Time to panic on trade wars? Not yet. We sketch three scenarios – from the current U.S. plan for tariffs on $50 billion in goods (not much impact), to President Donald Trump's campaign trail threat of 45% tariffs (China's GDP 0.7% lower by 2020).

The signs are clearly troubling, but even in the extreme scenario, the costs for China look manageable. A bigger question longer term is what the rise of economic nationalism in the U.S. means for China's development trajectory.

The first scenario is the U.S. imposes 25% tariffs on $50 billion in Chinese imports – as announced by Trump – and China makes a proportionate response. That's obviously a big step up from tariffs on steel and aluminum. Even so, the impact on the GDP numbers would likely be difficult to discern:

- A 25% tariff on $50 billion in Chinese goods would raise $12.5 billion. Given China shipped about $505 billion to the U.S. last year, that's equivalent to an across-the-board tariff of 2.5%. That's pretty much nothing and would have close to zero impact on China's GDP.
- Should the $50 billion figure morph into a revenue target for tariffs – in line with the U.S. Trade Representative's estimate of the annual harm from China's intellectual property theft – that would be a different story, equivalent to an across-the-board tariff of 10%.
- We ran that scenario through the NiGEM global econometric model. Assuming China retaliated in kind, China's 2020 GDP would be 0.2% smaller than in the baseline scenario of no increase in tariffs.
- China would actually be better off not retaliating, as the main blow to growth comes from higher import costs hitting inflation. That – combined with the desire to avoid escalation – explains why China's response so far has been limited.

On the campaign trail, Trump casually threw out the idea of a 45% tariff on all imports from China – that's the second scenario. If it happens, and China retaliates in kind, the impact on China's growth would be more marked – with the model spitting out a drop in GDP of 0.7% by 2020 relative to the baseline. That's significant, especially as China attempts to advance a deleveraging agenda that crimps domestic demand. But it wouldn't be disastrous.



Source: Bloomberg Economics

How Trump turns his attention to the rest of the world is a major variable. We used the NiGEM model to explore a third scenario: What would happen if the U.S. raises imports costs by 10%, and the rest of the world retaliates.

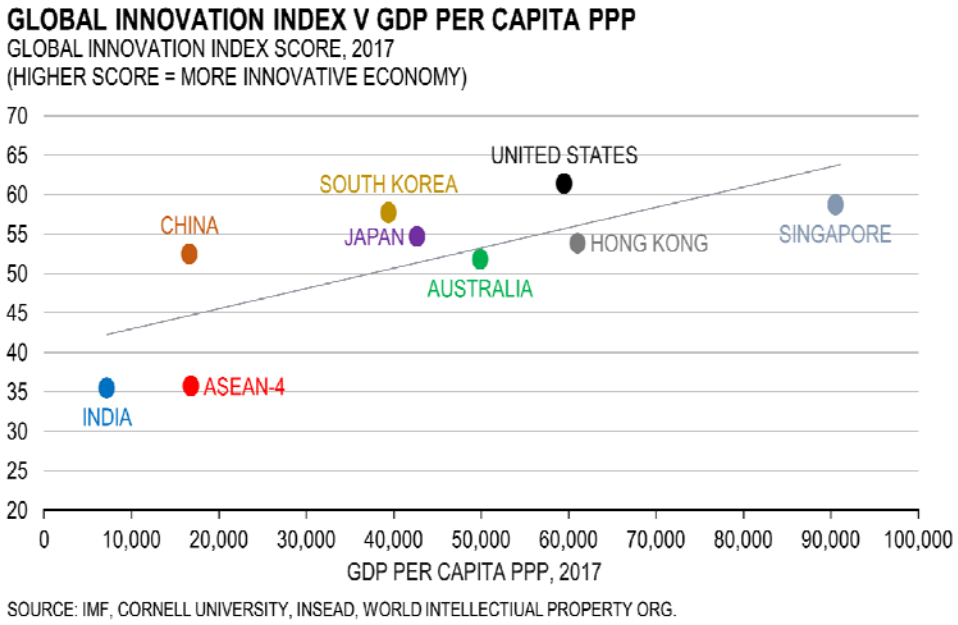
The outcome for China would be a 0.5% drop in GDP by 2020 relative to the baseline of no increase in tariffs. That would be bad news for China but, underlining the self-defeating nature of a trade war, the U.S. would suffer more – with a 0.9% drop in output relative to the baseline. That's because the tariffs affect 100% of U.S. trade, but for China and other countries, only impact bilateral trade with the U.S.

Why is the impact on China under all the scenarios so small? Three reasons stand out:

- In 2007, China's current account surplus was close to 10% of GDP. Now it's less than 2% – trade isn't nearly as important to China's growth as it used to be.
- The U.S. only accounts for about 20% of China's exports. Leaving aside minor second-order effects, China's exports to the rest of the world will be unaffected.
- China's participation in global supply chains means that the impact of tariffs on its exports will be dispersed. To take the familiar example of the iPhone, the impact of tariffs would be spread between South Korean, Japanese and Taiwan suppliers, Chinese assemblers, and the U.S. owners of the brand and intellectual property.

What Ending Technology Transfer Means for China's Development

An important question looking further forward is whether U.S. economic nationalism will put a barrier in the path of China's development. China has a more or less explicit strategy, set out in documents like 'Made in China 2025,' of advancing toward the technology frontier – taking a larger part of the value chain in electronics and building domestic champions that can compete with the likes of Honda and Hyundai, and ultimately Boeing and Airbus.



Technology transfer has been an accelerator of that strategy – allowing China to learn from abroad rather than reinventing the wheel at home. Will Trump's tariffs and the higher bar to Chinese acquisition of strategic assets prevent that from happening? We are doubtful, for three reasons:

- The U.S. does not have a monopoly on technology, and the appeal of China's massive domestic market means it will still be able to tap opportunities for technology transfer from other countries – notably the advanced manufacturing capabilities in South Korea, Taiwan and Japan.
- U.S. business engagement in China is vast and multifaceted. Turning that off in any meaningful way without imposition of draconian measures would not be easy to do. Like South Korean and Japanese firms, U.S. firms will still look for opportunities to tap Chinese demand, and pay a price in technology transfer.
- China's domestic innovation engine is not nearly as advanced as that in the U.S. But relative to China's development level it's not bad, and as China's government continues to pour in vast resources it can only get better.

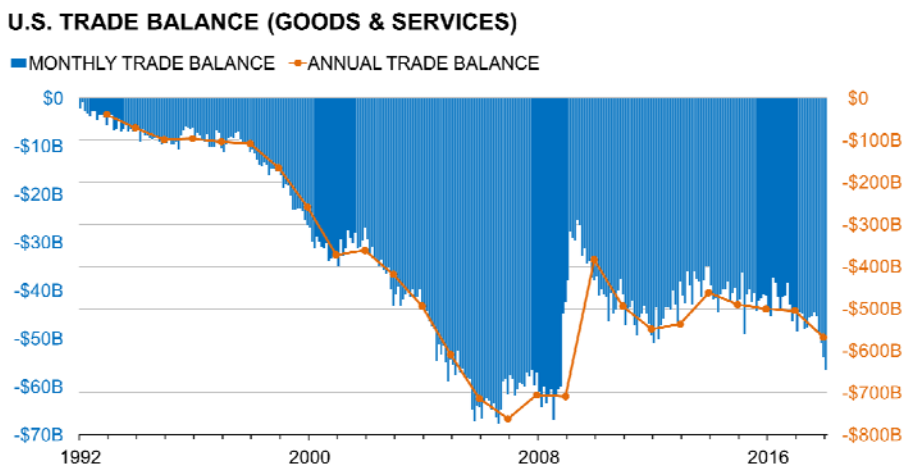
U.S.

Tariffs Yet to Bite, Mind the Slippery Slope

By Carl Riccadonna and Yelena Shulyatyeva

The Trump administration is pursuing a course on trade policy, which, while mostly innocuous at the moment, risks devolving into an economically damaging conflict.

While the initial rumors of trade restrictions prompted a mild market reaction, the formal announcement on March 8 – a 25% tariff on steel imports and 10% on aluminum – was taken in stride. After all, steel and aluminum imports totaled about $75 billion in 2017, or less than 3% of total imports of goods and services. A 25% price increase in steel prices, if carried out completely, would push prices back to mid–2008 levels, a period when core producer prices were accelerating toward a peak of just north of 4.5% compared to almost 2% at the start of this year.



Source: U.S. Census Bureau

A price spike would not be anywhere near this magnitude for two primary reasons: First, higher domestic production would mute some, but not all, of the price increase. Second, special exemptions for strategic allies (currently Canada and Mexico, but likely to be expanded to others) would similarly minimize supply–chain disruptions.

If the current tariffs – which include solar panels, washing machines, aluminum and steel – remain constrained, then adverse economic consequences will be small and manageable. A look back to 2002–2003 provides an example. President George W. Bush imposed temporary tariffs on steel imports in the first quarter of 2002 in response to allegations of foreign dumping.

Exemptions for Canada and Mexico were extended to a few other steel–producing countries. The European Union threatened retaliatory tariffs on products from key states of political importance to the Bush administration. Following a harsh ruling from the World Trade Organization, the tariffs were withdrawn in late 2003.

An investigation by the United States International Trade Commission noted some industry–specific impacts for certain sectors, such as manufacturers of auto parts and railroad rolling stock, but only minor consequences at an aggregate, economy–wide level. According to the study, prices initially rose for the safeguarded products, but in many cases the increases were neither sustained nor successfully passed along the supply chain. The study noted that roughly half of steel–consuming firms shifted some of their sourcing to domestic producers. Fears of substantial job losses in related industries and sharply rising input costs in the supply chain proved overblown.

The economic effects were negligible in terms of both GDP (estimated at –$30 million) and employment. A trade association of steel–consuming industries claimed that 200,000 jobs were lost due to the tariffs, but the International Trade Commission later argued that employment actually rose. A majority of businesses surveyed in the study indicated that the tariffs had little impact on employment levels.

If the current trade skirmish plays out in a similar fashion – countries are already lining up for exemptions and foreign threats of retaliatory tactics are being bandied about – the economic consequences will similarly be

minor. The economy's resilience toward retaliatory measures should be sturdier, given that growth prospects are on much sounder footing in 2018 compared to 2002, when the U.S. was emerging from a recession. The prospect of losing as many as 200,000 jobs hardly registers against a labor backdrop in which nonfarm payrolls exceed that amount in a single month and unemployment is poised to fall below 4%. Sadly, a firmer starting point may diminish the Trump administration's willingness to compromise before repercussions intensify.

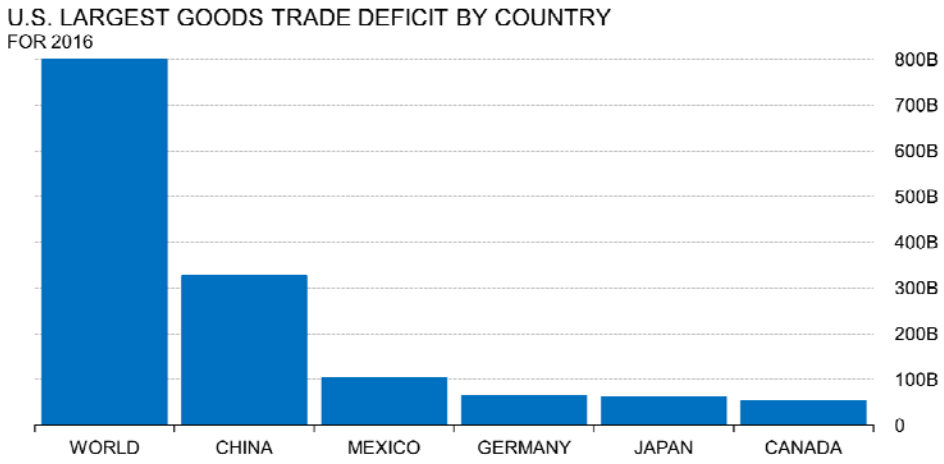
To be sure, parallels to the Smoot–Hawley tariffs of the 1930s, which are credited with both deepening and lengthening the Great Depression, are an extreme dramatization of the present situation. The Tariff Act of 1930 impacted more than 20,000 imported goods, whereas the tally at present is four product areas. While currently of "mole hill" status, the threats of escalating retaliation have already begun to emerge on both sides.

Once again, U.S. trade counterparts are searching for pressure points by targeting products from key congressional districts, including motorcycles (House Speaker Paul Ryan), bourbon (Senate Majority Leader Mitch McConnell) and peanut butter (Agricultural Secretary Sonny Perdue). Meanwhile, Trump has stated that the U.S. may pursue "a reciprocal tax program at some point." In such a scenario, the U.S. would match taxes imposed on U.S.–produced goods on the countries applying them – instituting a so–called "mirror tax."

Trump's tariff target list to date also serves a political agenda. Domestically, it musters support in the Rust Belt states of Wisconsin, Michigan, Indiana, Ohio, West Virginia and Pennsylvania, which were critical to winning the presidency. This will prove essential to securing a second term, not to mention securing congressional seats in November's midterm elections. Internationally, it provides greater leverage in NAFTA negotiations.

Ultimately, rising trade barriers result in a suboptimal deployment of labor and capital, making goods and services more expensive to bring to market and diminishing overall economic output. Furthermore, the "onshoring" of production is unlikely to materialize to a meaningful degree if producers expect barriers to exist only temporarily, or at least not survive beyond the Trump administration. Reshaping supply chains requires intensive, costly capital investment. Producers may simply choose to wait out the storm if there is an end in sight. Fiscal and monetary policy can offset some of the economic consequences in the short run, but not indefinitely.

Tax reform was the hallmark accomplishment of Trump's first year in office. Tax cuts provide an immediate fiscal stimulus, while structural reform is designed to promote investment and ultimately improve the longer run growth potential of the economy. A major infrastructure initiative could provide a similar, dual boost to growth, and become the economic centerpiece of year two. The economic implications of trade restrictions are generally understood to result in the costs being widely distributed, while the benefits are narrowly targeted. However, in the current environment there are some compelling positive elements, which should not be ignored.



Source: International Monetary Fund

Access to the largest economy in the world will provide the Trump administration with leverage to halt unfair trade practices, including currency manipulation, product dumping, intellectual property theft and economic espionage. Furthermore, if economic leverage helps bring parties to the table and diffuses critical geopolitical tensions, a contained and temporary tariff skirmish could prove worthy of the economic cost.

Treasury Secretary Steven Mnuchin responded to the recent tariffs by stating, "let's be very clear. We're not looking to get into trade wars." Let's hope he's right.

This article was first published on the Bloomberg Terminal on March 13.

After Defeating Cohn, Trump's Trade Warrior Is Rising Again

By Peter Coy, Bloomberg News

President Donald Trump's nationalist trade adviser Peter Navarro has staged a startling comeback.

Last year he nearly disappeared from view when his small operation was subsumed under the White House's National Economic Council, which was headed by his rival, Gary Cohn, the free-trader who was president of Goldman Sachs. Now, Cohn's on his way out while the steel and aluminum tariffs that Navarro advocates are on the verge of becoming national policy.

Navarro's surprising resurrection is that Trump has taken renewed interest this year in trade and national security – Navarro's issues – after having focused in 2017 on health care and tax cuts. The second factor is that Navarro is as relentless as a honey badger. He's been in front of television cameras repeatedly over the past week championing the tariffs. Trump signed an order establishing the tariffs on March 8.

Peter Navarro

After losing to Cohn in the White House turf wars, someone else might have packed up and gone home to California. Instead, Navarro kept working the issues and building the case for stronger action. Even now he's not letting up, according to Michael Wessel, a steelworkers representative who speaks with him regularly.

"He is certainly excited about where he is and what's going on because he has worked a long time to get here," said Wessel. "But he's running at warp speed and probably doesn't have much time to think about it."

Free-traders are elbowing each other aside to express their dismay about Navarro's ascendancy – and Navarro welcomes their disdain. Although he holds a Ph.D. in economics from Harvard and taught the subject at the University of California-Irvine Paul Merage School of Business, Navarro accuses his fellow economists of blindly adhering to free-trade principles at the expense of national security.

"The president said very clearly that we can't have a country without steel and aluminum industries, and I totally agree with him," Navarro told Bloomberg TV on March 7. Echoing Trump, he added, "All the countries that trade with us are getting the better part of the deal."

Today's Navarro has a monkish demeanor. He's wiry, almost gaunt. Running shoes by the door of his office attests to his habit of running to work. He works such long hours that he stifled a laugh when a Bloomberg TV interviewer asked him about his "day" job. His closest administration ally is Commerce Secretary Wilbur Ross, a fellow trade nationalist.

Navarro's not-so-secret weapon in the White House turf wars is that he has a lot in common with the president. They're about the same age: Navarro is 68 and Trump 71. Also, neither backs down from a fight. "Peter has always been a contrarian, someone who's never been afraid to defend his views vociferously," said Scott Paul, president of the Alliance for American Manufacturing.

Most important, both Navarro and Trump are former Democrats who feel no compunction to stick to Republican orthodoxy on trade. Navarro was actually kind of a liberal once. He served in the Peace Corps, surfed, and later campaigned against uncontrolled real-estate development in the race for mayor of San Diego in 1992 – ironic now that he's working for the world's most famous developer. One poster for his 1996 congressional race read, "Peter Navarro. The Democrat Newt Gingrich fears most!"

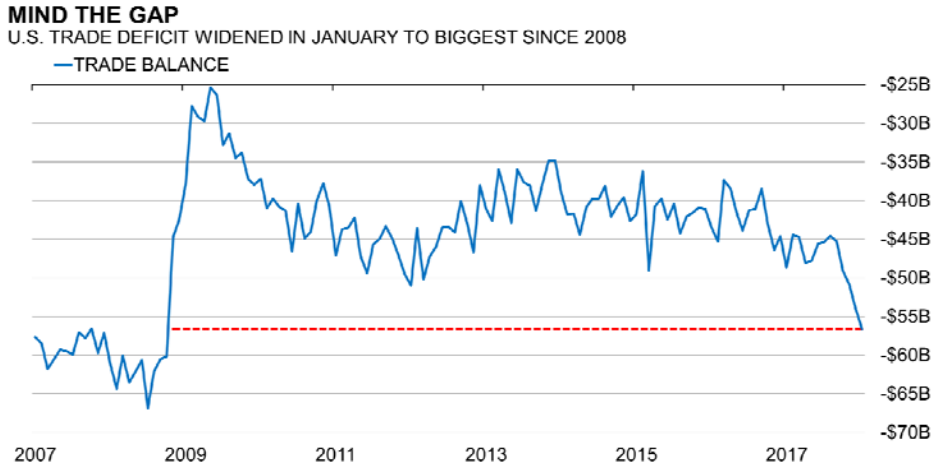
Speaking to Bloomberg on March 7, Navarro heaped praise on his boss and described his own role as that of an enabler. "This is the president's vision. My function, really, as an economist is to try to provide the underlying analytics that confirm his intuition. And his intuition is always right in these matters," Navarro said. He compared the White House to the successful New England Patriots football team. "The owner, the coach, and the quarterback are all the president. The rest of us are all interchangeable parts."

The interchangeable part labeled Peter Navarro got off to a strong start last year when Trump pulled the U.S. out of negotiations on the 12-nation Trans-Pacific Partnership trade deal, one of his first acts in office. Navarro also spearheaded the president's "Buy American, Hire American" initiative, which tightens enforcement of federal procurement rules and cracks down on alleged abuse of H-1B visas and other foreign-hiring programs. In April, Trump called Navarro "one of the greats at trying to protect our jobs."

Then Navarro started to fade from view. Trump turned his attention to the unsuccessful effort to repeal Obamacare and after that raced to get tax cuts passed by the end of the year. John Kelly arrived as chief of staff at the end of July and restricted access to the Oval Office. In September, Kelly folded Navarro's office into the National Economic Council. Navarro was required to copy his new boss, Cohn, on emails. He wasn't invited on Trump's state visit to China in November.

But Navarro never stopped pushing his agenda, which intertwines economics and military readiness and puts China at the heart of U.S. policy. He pressed the Pentagon to seek increased funding for Abrams tanks and Bradley Fighting Vehicles, in part to keep open the factories in Ohio and Pennsylvania that make them, according to Wessel, who represents United Steelworkers President Leo Gerard and is a congressional appointee on the U.S.-China Economic and Security Review Commission.

He also argued successfully for the Pentagon to seek funding for another Littoral Combat Ship, again to keep the shipyards where they're made afloat. And, according to Wessel, Navarro was behind Trump's executive order requiring a broad review of the nation's defense industrial base. It's due in April.



Source: Commerce Department

Navarro has come a long way from his roots as a mainstream economist. He supported free trade in a 1984 book, "The Policy Game: How Special Interests and Ideologues Are Stealing America," arguing that tariffs "protected the profits of a small core of domestic industries" while harming consumers. (He explains that because "the globalist erosion of the American economy" was just getting started, he hadn't recognized it then.)

By 1993 he was expressing some misgivings, referring to the North American Free Trade Agreement, or Nafta, as "Shafta." By the 2000s, China was on his radar.

He concluded that it owed its success to unfair trading practices. In 2006 he published "The Coming China Wars: Where They Will Be Fought, How They Will Be Won." In 2011 he wrote "Death by China: Confronting the Dragon – A Global Call to Action" (co-authored with Greg Autry), which argued that the U.S. and China are on a trajectory for armed conflict.

Navarro essentially barged into the China-watcher community without an invitation. "Navarro is not known in any China circles," James McGregor, a former chairman of the American Chamber of Commerce in China, told Foreign Policy magazine last year.

But it was "Death by China" that caught Trump's attention. Trump provided a blurb for a 2012 documentary film based on the book: "Right on. ... I urge you to see it." The trailer features a knife, representing China, that's plunged into a red, white, and blue map of the U.S. Blood leaks from the tricolor corpse. "He gets criticized for the 'Death by China' meme but he's been way more correct about China than almost any other observer," says Paul, the Alliance for American Manufacturing chief.

Plenty of observers wouldn't agree with Paul that Navarro is correct on China, or much of anything else. That's unlikely to bother someone who's followed a convoluted path to power, and who revels in his outsider role: the economist and self–made China expert who's regarded with suspicion by other economists and China experts. And in Trump's White House, none of that hurts him a bit.

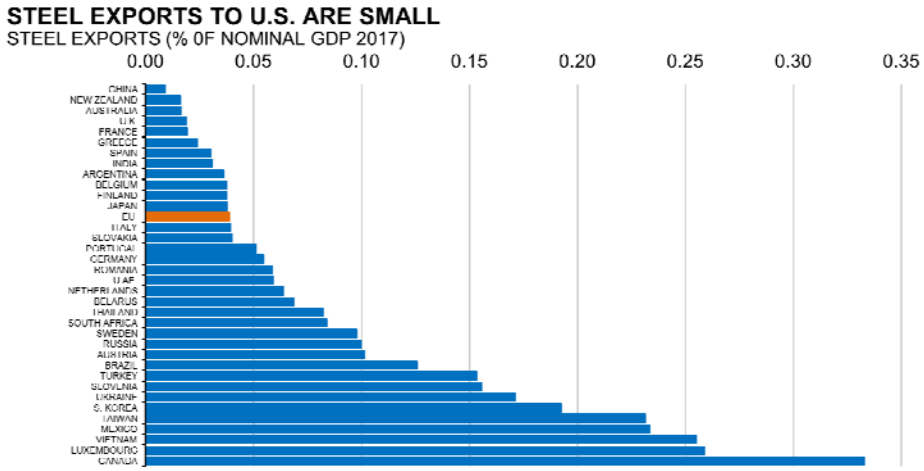
Europe

Botched Brexit as Costly as Trump Trade War

By Jamie Murray and Dan Hanson

Jean–Claude Juncker is busy. As leader of the European Commission he's handling twin threats to trade – Brexit and U.S. protectionism. So how should he divide his time? Equally. We estimate that averting a global trade war is just as important for economic growth as smoothing Britain's departure from Europe's single market.

European steel and aluminum producers will see the cost of their exports rise by 25% and 10% respectively in American markets if the EU's exemption isn't extended after May 1. That's not a big problem. EU steel destined for the U.S. accounts for less than 0.1% of the trading bloc's GDP and no economy within the EU has an exposure of more than 0.3%. Lower exports to the U.S. also won't affect GDP one–for–one. Imports of iron will be lower, alternative markets may be found and some products are highly–specialized, meaning a portion of U.S. buyers may have to pay the higher price. Exports of aluminium account for less than 0.01% of the region's GDP.



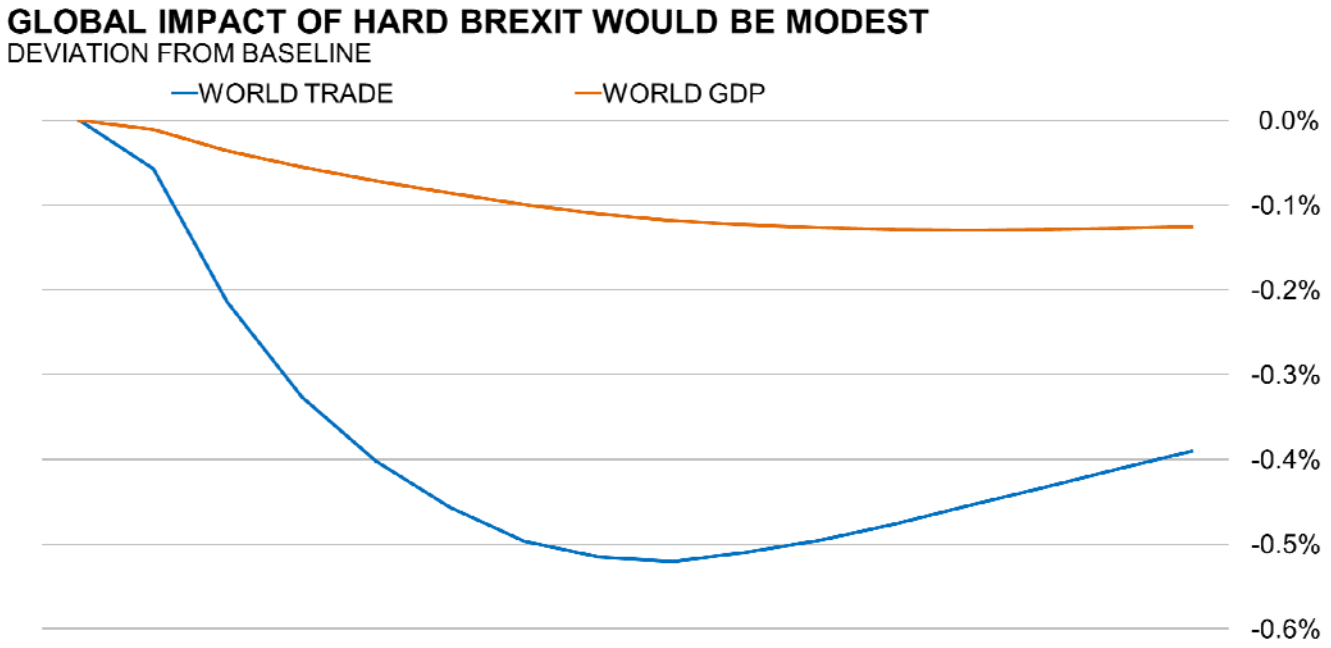
Source: U.S. Department of Commerce, IMF, Bloomberg Economics

So far it's a skirmish, not a war. And, at first, Europe looked simply to have been caught in the crossfire between the U.S. and China. The EU response has been to threaten tariffs on politically–sensitive products. Now the rhetoric from President Donald Trump's administration has turned to autos. The risk, of course, is that the imposition of tariffs escalates. Bloomberg Economics has already considered the global impact of U.S. protectionism. We estimate that if the U.S. takes action to lift import costs by 10% and the rest of the world responds in kind, world GDP could be half a percent lower by 2020, than it could have been.

For the euro area, the impact is smaller, at 0.2% of GDP. The U.K. escapes largely unscathed, reflecting the composition of its trade and the sensitivity of exports and imports to price changes. That's just as well – the U.K. economy is already taking a hit from its decision to leave the EU. Some economies in developing Europe could even gain a little, reflecting spillovers from changing trading patterns in response to the shock.

We've already run the rule over what crashing out of the EU might mean for the U.K. economy – higher inflation and slower growth. To understand the spillovers to the rest of Europe and the world, we've mapped the broad features of that scenario through the same global model of the economy used for our tariffs analysis. We assume the cost of imports between the U.K. and the rest of the EU rises by about 5%; that monetary policy balances the influence of higher inflation against weaker demand and that a failure to reach a trade deal comes as a surprise.

What we find is that U.K. GDP is about 0.7% lower after two years, roughly in line with our earlier estimates. The global impact is tiny – shaving just 0.1% from world GDP after two years and 0.5% from trade. For the euro area, the impact is roughly the same as that of the introduction of tariffs on trade with the U.S. – 0.2% of GDP.



Source: Bloomberg Economics

In both scenarios, the damage is limited, but the conclusions are clear. For what will be left of the EU, the escalation of global trade rhetoric could be worthy of as much attention as the Brexit negotiations. Juncker and his team will have to keep on juggling.

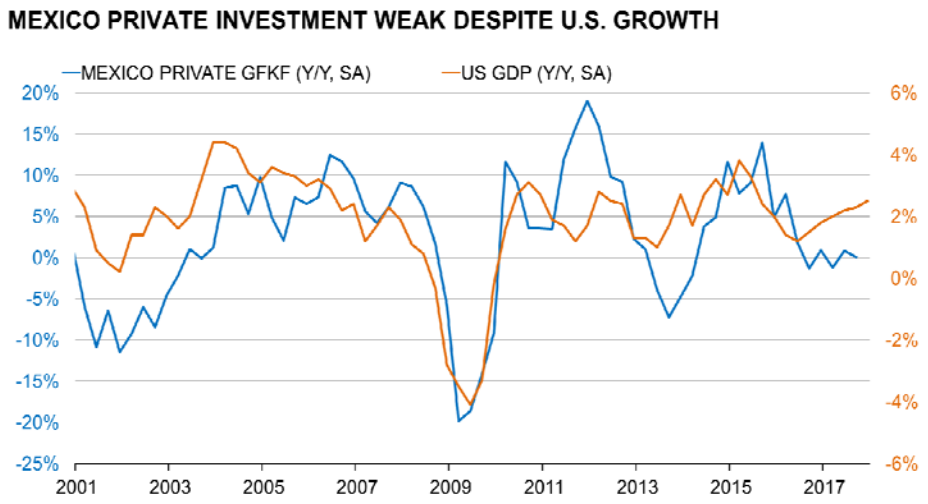
Mexico

Tariffs Are Weighing on Investment

By Felipe Hernandez

U.S. protectionist rhetoric and tariffs have had little impact on Mexican exports, which continue to benefit from strong U.S. demand and the weak peso. What they have done is raise uncertainty about the future of bilateral relations, and that is already weighing on investment and growth.

Bloomberg Economics estimates uncertainty shaved close to $4.3 billion, or 0.4% of GDP, from private investment in machinery and transport equipment in 2017. The cost would be higher were it to account for headwinds on broad investment and domestic demand.



Source: Bloomberg Economics

The result is consistent with evidence that some local and foreign companies have decided to reduce, delay or cancel their investment plans while the future of U.S.–Mexico bilateral relations is determined. It is also in–line with the tighter monetary and fiscal policies implemented by the central bank and the government to limit the risks and volatility from potential changes. Seven months into negotiations, Nafta's outlook is still unclear and lingering uncertainty is poised to remain a drag on investment and economic growth.

Private investment in Mexico has historically benefited from stronger U.S. economic growth. This has been particularly true for investment in machinery and transport equipment, where a significant share is done by local and foreign manufacturing firms with a strong U.S.–export–oriented bias.

The positive correlation has weakened since 2016, when U.S. protectionism and uncertainty about the future of U.S.–Mexico bilateral relations began escalating. Private investment in machinery and transport equipment growth fell to 2% in 2017 from 3% in the previous year, while U.S. economic growth rose to 2.3% from 1.5% over the same period.

A simple linear regression suggests that private investment in machinery and transport equipment should have increased by close to 7% in 2017. The 5–percentage–point difference accounts for around $4.3 billion, or 0.4% of GDP, providing a estimate of the cost of uncertainty caused by increasing U.S. protectionism since the election of President Donald Trump.

Our estimate does not include the potential impact on private investment in construction or overall public investment, both of which have a much lower correlation with U.S. economic growth, and should prove more

resilient. These are still likely to see some headwinds as companies adjust their investment plans, though tight monetary and fiscal policies should be larger drags than protectionism worries.

Capital inflows from foreign direct investment into manufacturing dropped to $13.4 billion in 2017 – the lowest since 2012 – from $17.3 billion in the previous year. The sharp drop is in–line with other evidence of weaker private investment in Mexico. Central bank analysis last year found a negative correlation between foreign direct investment and uncertainty about Nafta's future. The central bank estimated that, between the second half of 2016 and the third quarter of 2017, uncertainty reduced capital inflows from foreign direct investment by close to $4.4 billion.

These results provide a partial estimate of the impact that uncertainty raised by increasing U.S. protectionism in the Trump era has had on investment and economic growth in Mexico. They also point to a strong rebound, if the Nafta renegotiation is successful.

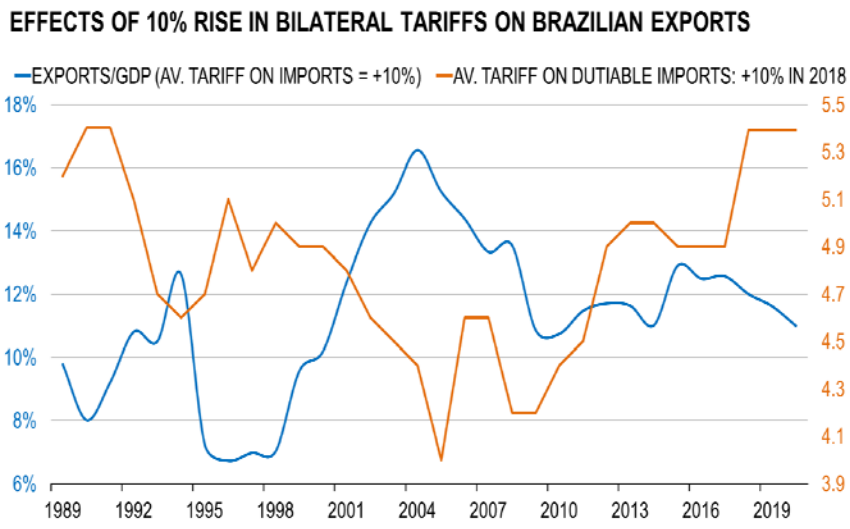
Brazil

U.S. Policy Threatens Brazil's Economy

By Marco Maciel

If the U.S. raise tariffs by 10% and the rest of the world retaliates in the same manner, Brazil's exports would fall, dragging GDP growth and lifting inflation amid lower international commodity prices and intensifying currency volatility.

This would prompt Brazil's central bank to hike interest rates at a faster pace. Taking into account the effects of declining exports on gross investment and personal consumption, given the decrease in government expenses relative to GDP targeted for the next 20 years, economic growth would slow this year and in 2019. By 2020, a trade war would reduce GDP growth by as much as 0.3 percentage points relative to the baseline forecast of 3.5% growth with no change in tariffs.



Source: Bloomberg Economics

The real could weaken to 3.7 per dollar, and inflation would climb to 4.8%, above the target center of 4% but below the upper bound of 5.5% for 2020. This outcome would drive the central bank to set the policy rate at 8.25% instead of 7.0%–7.50% currently projected for 2020.

The fall in net exports relative to GDP from 1% in 2017 to –1.5% in 2020 would bring the current account deficit to 2.6% of GDP in 2020. That compares with a projected deficit of 0.37% in 2018. The deterioration of Brazil's current account deficit is more significant compared to GDP deceleration due to decreasing commodity prices.

A decline in commodity prices would be stronger this year because relatively efficient and forward–looking markets would anticipate the expected decrease in prices through 2019 and 2020. This also explains why the real would devalue mostly in 2018 ahead of decreasing commodity prices through the next three years.

We are cautious on the results of our simulations. First, the minor drag on GDP's annual growth between 2018 and 2020 relative to our base scenario is explained by the modest rise in interest rates in Brazil and by the drop in exports. The eventual devaluation of the real would take unregulated inflation – which includes prices not monitored by government agencies – to a month on month average of 0.4% in the medium term. In the long run, unregulated year–on–year inflation would remain between 4.3% to 5%. If regulated inflation stays at 4.25% to 4.5%, overall CPI would reach 4.7% to 5%.

As inflation would remain above the center of the central bank's target range, but below the upper bound between 2018 and 2020, the bank would probably seek to raise the policy rate to 7.75%–8.75% from 6.75%. The central bank would manage to maintain an economic recovery as real interest rates would stay below the neutral rate, while higher nominal rates would help anchor CPI inflation near the center of the target range.

Resulting real rates before and after a trade war would be very close to each other. Those levels would be sufficiently high to maintain inflation below 5% in the long run.

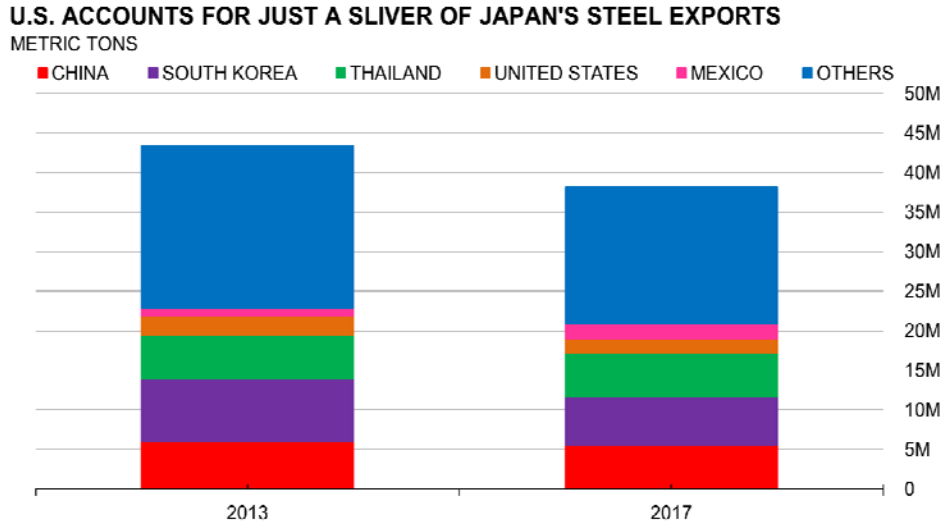
Japan

Pain But No Disaster for Japan

By Yuki Masujima

A trade war would hurt, but probably wouldn't spell disaster for Japan's economy. U.S. President Donald Trump's tariffs on steel and aluminum imports will barely register on growth. A worse scenario though – where the U.S. raises import costs by 10% and the rest of the world responds in kind – would be more painful, especially given Japan's low growth.

That would shave 0.2 percentage point from growth this year and 0.3 ppt in 2019, mainly through the impact on global supply chains. But there is an offset over the medium term – freer trade within the Trans–Pacific Partnership, and this support would strengthen as TPP membership expands. A caveat – this analysis doesn't take into account moves in the yen, which could rise on safe–haven demand in a risk–off environment, denting Japan's exports.



Source: Ministry of Finance, Bloomberg Economics

A U.S. tariff on Japanese steel – Prime Minister Shinzo Abe hasn't been successful in winning an exemption – may affect individual companies but the effect at the macro level would likely be negligible. Japan's steel exports amounted to just 0.6% of GDP in 2017. The U.S. share of the Japan's steel shipments was just 5%, virtually unchanged from 2013.

Over that period, Japan's steel exports to Thailand and Mexico increased substantially – the share going to Mexico doubled to the 5% in 2017 from 2.5% in 2013. That suggests the risk to Japan's steel industry from U.S. tariffs centers on supply–chain demand, more than on demand from the U.S. itself.

A global trade war would be more damaging. A scenario where the U.S. raises import costs by 10% and the rest of the world retaliates would reduce Japan's growth by 0.2 ppts in 2018 and 0.3 ppts in 2019, with a total impact of 0.6% of GDP by 2020, based on estimates by Bloomberg Economics. The simulation assumes no policy response by central banks, and therefore limited change in exchange rates. It's likely though, that a trade war would hurt market sentiment, pushing up the safe–haven yen. One implication – the Bank of Japan would need to keep up its extreme monetary easing for longer.

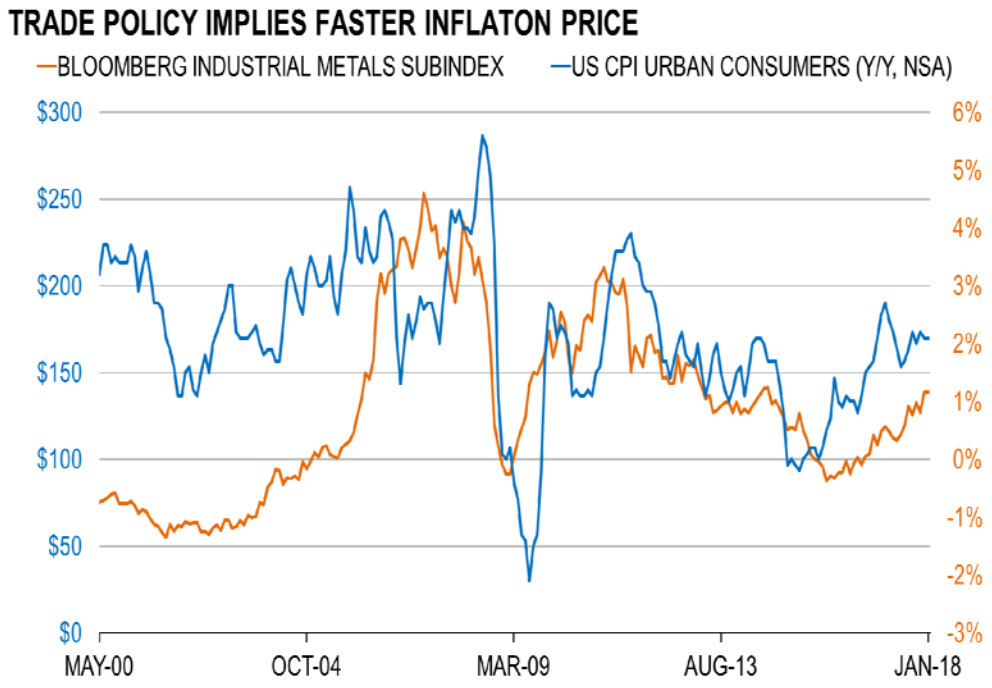
Amid all the talk about U.S. protectionism though, it's important to keep in mind that trade policy in many other parts of the world is going the other direction – and the lower barriers should help to buttress growth. Japan and 10 others on March 8 signed the Comprehensive and Progressive Agreement for Trans–Pacific Partnership (Trump pulled the U.S. out of the talks early last year). For Japan, participation could increase its real national income by 0.9% by 2030 relative to an absence of a deal, according to research by Brandeis University Professor Peter Petri and others, and the prospect of others joining the pact is an added positive over the medium term.

Strategy

U.S. Stocks Look Vulnerable as Trump Turns to China

By Gina Martin Adams , Bloomberg Intelligence

A possible trade war is front-and-center for equity investors as uncertainty builds regarding the size and extent of the Trump administration's protectionist decisions.



Trade and fiscal policy may result in a faster pace of inflation for stocks to contend with in the year ahead.

Import prices have already started to rise from their early-2016 low, reflecting deterioration in the dollar relative to most major currencies. Protectionist trade policies seem likely to accelerate the trend, and could have significant consequences for stocks, pressuring equity valuations, compressing margins for U.S. corporations or increasing prices for consumers – or some combination of all three.

At a time when fiscal and monetary policy shifts have already elevated equity-market volatility, trade policy is entering the fray, and stocks appear vulnerable. Concerns about Nafta negotiations specifically are likely to resurface with the U.S administration's announced tariffs on steel and aluminum.

Stocks sensitive to Mexico have faltered recently, but earnings estimates for major Nafta-dependent industries indicate trade disruptions aren't priced into expectations. Earnings estimates for S&P 500 stocks with the greatest sensitivity to changes in the Mexican peso fail to reflect potential trade risks, as groups most exposed to Nafta – machinery, food products, autos, energy – are still posting strong estimate revision momentum this spring.

Souring U.S.-China trade relations also threaten stocks. If the Trump administration's protectionist trade measures turn to China, then technology, industrial and consumer stocks may be among the first to suffer.

The largest categories of U.S. exports to China – agriculture (specifically soybeans), aircraft and automobiles – have already struggled under the weight of a possible renegotiation of Nafta and could be hurt further if the U.S. targets Chinese trade. More than half of U.S. soybean exports go to China and though prices are already depressed, tariffs would undoubtedly hurt grain producers.

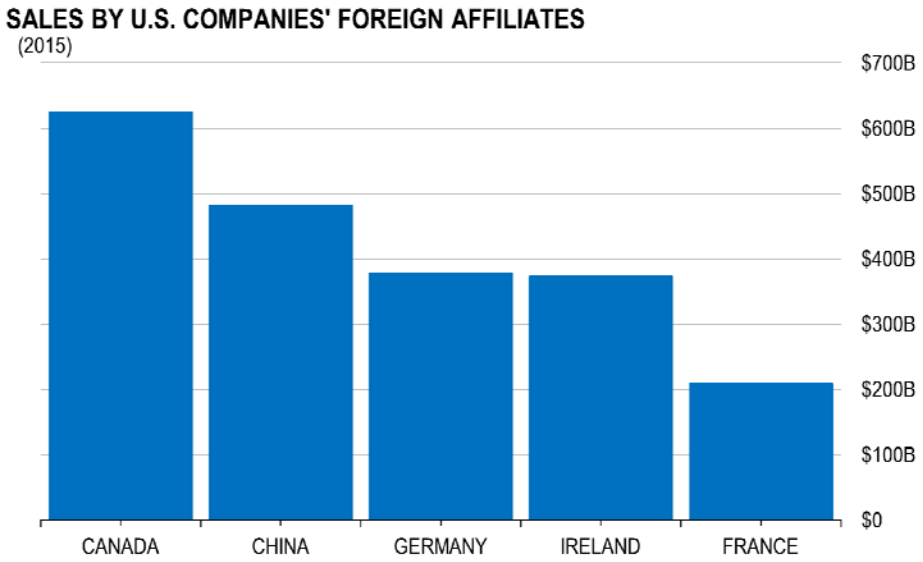
Auto exports to the country have been stagnant since their peak in 2014 and trade tensions are only likely to exacerbate this trend. Finally, U.S. trade and current-account deficits have suffered as transactions have risen with China, yet U.S. consumers have benefited greatly through decades of slowing price hikes – and even declines – for the goods they buy.

Congress Is Unlikely to Offer Relief From Tariffs

By Caitlin Webber, Bloomberg Intelligence

Retailers, automakers and a myriad of U.S. industries critical of President Donald Trump's tariff strategy shouldn't look to Congress for relief from higher import costs.

Even though most of Trump's fellow Republicans oppose the tariffs, lawmakers are unlikely to prioritize legislation limiting the president's ability to restrict trade and risk exacerbating an intraparty feud in a crucial U.S. election year. Republicans had a chilly reaction to Trump's steel and aluminum tariffs announced March 8 and they warned strenuously against Trump applying additional tariffs on Chinese imports that could erode the economic benefits of tax reform passed in late 2017. Congress has only a few legislative options to roll back tariffs set to be imposed by Trump anyway. Congress could hypothetically pass legislation that changes the tariffs or even repeals the president's underlying authority to impose the tariffs under Sections 232 and 301 of U.S. trade law. Such an action would undoubtedly face a presidential veto. Congressional Republicans lack the two–thirds vote required to override the president's veto pen as many Democrats support the tariffs and other Trump initiatives to constrain free–trade.



Legislation to nullify import tariffs is highly unlikely to advance to a vote in Congress, even though it could garner headlines as leading Republicans take on the president. Arizona Senator Jeff Flake is among those to propose laws to clip the tariffs. The Republican congressional leadership that controls which legislation reaches the floor for a vote is unlikely to prioritize those measures and highlight the party's split on tariffs.

Another possible, but unlikely scenario, would be for Republicans to use the tariffs to threaten another federal government shutdown in 2018. Under such a strategy, Republicans could pass a spending bill prohibiting federal funds from being used to implement tariffs. Still, it's unlikely even a shutdown would prompt Trump to back down. Trump has spoken positively of government shutdowns in the past and has already shown a willingness to side with Democrats in spending battles.

Short of legislative action, Republican lawmakers could have some success lobbying Trump to further narrow metal tariffs. Their strongest argument could be pointing out how U.S. stocks weakened in reaction to news of his tariff plan. Trump frequently cites gains in the Dow Jones index as the outgrowth of his economic policies. It's likely congressional Republicans already had some success with this strategy in convincing Trump to exclude Canada and Mexico from the initial application of those tariffs. The Trump administration has opened the process for additional countries and individual companies to apply for exemptions to tariffs on March 19.

House Speaker Paul Ryan and House Ways and Means Committee Kevin Brady have blasted the tariffs for risking higher consumer prices and reprisals against U.S. exporters or sales of U.S. companies abroad. Proposed tariffs would cause costs to surge for automakers including Ford, General Motors, Fiat Chrysler, Toyota Motors and Hyundai. Tariffs could raise U.S. steel and aluminum prices, increasing revenue for steelmakers including AK Steel, ArcelorMittal, Nucor, U.S. Steel and Steel Dynamics and aluminum producers including Alcoa, Kaiser Aluminum and Century Aluminum.

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