



Focal Point

US trade policy: More barking than biting

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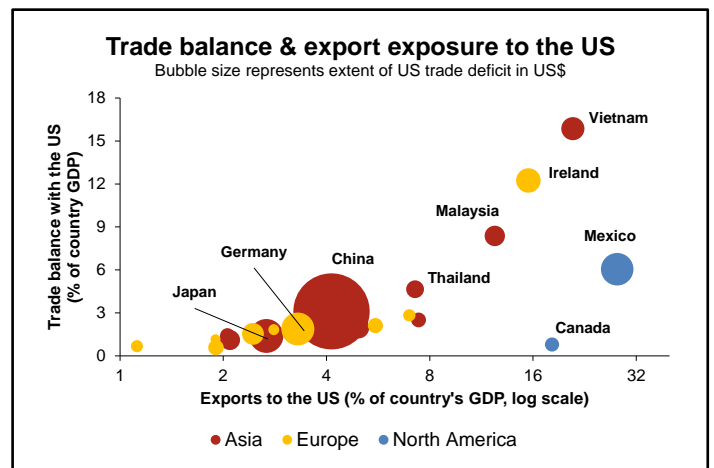
- President Trump has pledged in his America first campaign to end “stealing American jobs” by rebalancing the large US trade deficit. Measures discussed comprise punitive tariffs, a border tax and renegotiations of trade agreements.
- China, Japan, Germany and Mexico are the most important contributors to the US trade deficit in absolute terms. The NAFTA countries Canada and Mexico have a very high export exposure to the US in terms of GDP.
- Car exports are the major reason behind the Japanese, German and Mexican trade surpluses, while in China electronics and labor-intensive consumption goods play the dominant role.
- US firms and consumers also have much to lose from a disruption of global supply chains.
- However, trade talks with China and Japan have already begun and are due for NAFTA. First results show that compromises could be possible with countries and firms ready to invest more in the US as a safeguard against trade sanctions. Ultimately, we expect more barking than biting from US trade policy.

After four months in office, trade policies of the new US President Trump are still very much unclear. During his election campaign, Trump had adopted a tough rhetoric regarding countries having a trade surplus with the US on “stealing American jobs”. In office, he withdrew from the Trans-Pacific Partnership (TPP) and announced renegotiations of the North American Free Trade Agreement (NAFTA) with Mexico and Canada. He also ordered the Commerce Department and the US trade representative to conduct a 90-day review of the causes of the massive trade deficit, launched a trade probe against China and other exporters of cheap steel, and forced German steel producers alleged for dumping to pay an import tax to the US. At the same time, the US Department of Treasury refrained from labelling any country as currency manipulator while maintaining six countries (China, Japan, Korea, Taiwan, Germany and Switzerland) on a list for close monitoring. Additionally, he held summits with Japan’s PM Abe and China’s president Xi, agreeing with both on trade talks and suggesting possible ways out of a trade conflict by investing more in the US (in case of Japan) or possibly political support (China regarding North Korea).

Almost 50% of the 2016 US trade deficit (of US\$ 734 bn) originates from trade with China, followed by Japan (9.4%), Germany (8.8%) and Mexico (8.6%). In terms of GDP exposure, trade with the US is highest for Mexico while China, Germany and Japan are less exposed.

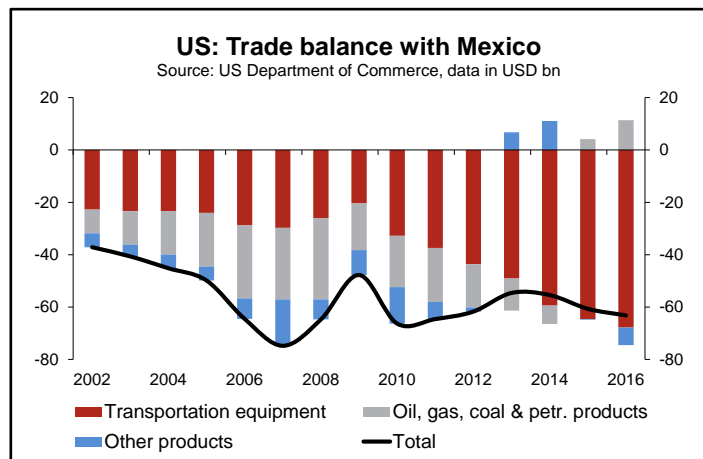
Mexico to lose most from tough NAFTA talks

President Trump has repeatedly blamed NAFTA for the job losses suffered by the US manufacturing sector. While the



US trade deficit with Canada stood at a negligible US\$ 12.1 bn at end-2016, the one with Mexico (US\$ 63.2 bn) has received a much closer scrutiny. Undoubtedly, Mexico has massively benefitted of the NAFTA as its bilateral trade balance with the US has moved from a deficit of 2.0% of GDP in 1994 to a surplus of 10.7% in 2016. This is mostly explained by the widening Mexican surplus in transportation equipment (which includes car exports), up to US\$ 67.8 bn in 2016. On the other hand, the shale revolution has allowed the US to reverse a deficit on oil, gas, coal and petroleum products into a small surplus.

Last Thursday, the US Trade Representative, Mr. Lighthizer, sent a formal letter to Congress party leaders in order to start the negotiations over the overhaul of the 23-year-old NAFTA. Any substantial adverse revision of the



agreement would severely hit the Mexican economy, as exports to the US amount to 81% of the total and 29% in GDP terms. In addition, the relocation of future investment plans back to the US, as already announced by a few car makers, could impact foreign direct investment over the longer term, lowering Mexico’s potential growth.

That said, Mexico has a few negotiation tools to limit the losses. Firstly, the two countries have a highly integrated supply chain, with related-party trade – trade between a parent company and its subsidiaries – being particularly large in the auto industry (up to 60%). Secondly, outsourcing allows US firms to reduce their input costs thus benefitting US consumers. Finally, the Mexican peso would play a key role as shock absorber over the longer-run, making production repatriation less convenient.

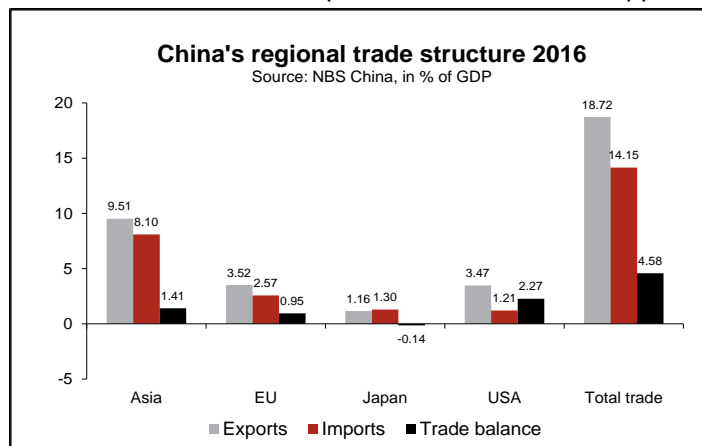
China: asymmetrical trade structure with the US

In 2016, China’s trade with the US was responsible for almost a half of the total US trade deficit in 2016. China was the largest exporter to the US (21% of total US imports), while exports to China added up to 8% of total US exports. From a Chinese perspective, the US is an important export market (18.5% of total exports), but Asian countries remain by far the largest trade hub (51%). However, as China accounted for about half of the US trade deficit, this bilateral trade also accounted for half of the Chinese trade surplus of a total of 4.6% of GDP. China’s total (global) trade surplus was mitigated by a service and income deficit to a current account surplus of just 1.7% of GDP in 2016.

The trade structure is very asymmetrical. Half of China’s exports are dominated by machinery, encompassing computers, office machines and telecommunication. Another third are labor intensive manufacturing goods like clothing, footwear and furniture. Top imports from the US comprised agricultural products (China is the US 2nd largest agricultural market) and crude minerals, air-crafts, cars and specialized electrical machinery. Accordingly, aircrafts (Boeing) and soybeans are typically mentioned among the top possible targets of retaliation.

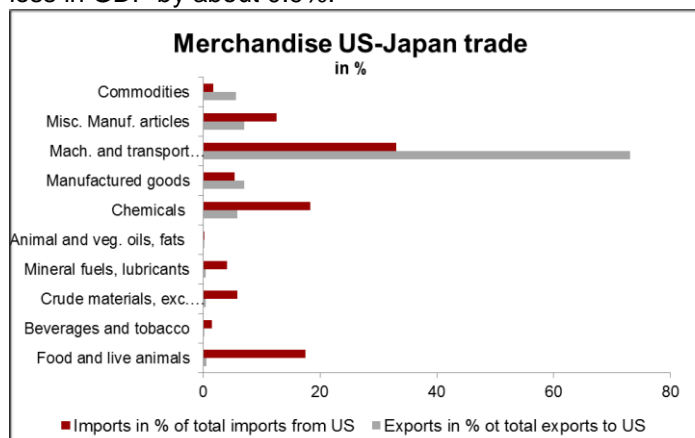
According to these numbers, China stands to lose a lot in a trade conflict. During his election campaign, Trump has threatened China with a 45% across-the-board import tariff. Given a long-term adjusted export elasticity of about 1.1 (IMF paper estimate), this would imply an export loss of about 50%. In 2016, exports to the US amounted to 3.5% of GDP. Thus the direct export effect (1.75 pp) would be substantial. However, China’s processing imports amount to about 20% of total exports. These imports, largely computer parts, mainly come from neighboring Asia and would

additionally spread the negative impact into the region, while mitigating the GDP effect slightly by 0.3 pp. In case of a 20% BAT, the GDP impact would be about -0.7 pp.



Car exports key for Japan, Germany and Mexico

After China, Japan caused the second largest deficit in the US trade balance with US\$ 68 bn. It resulted from US imports worth US\$ 132 bn (6% of total US imports) and exports to Japan of US\$ 63 bn (4.3% of total US exports). Conversely, Japanese goods exports to the US amounted to 2.6% of 2016’s GDP (or 20.2% of exports), while imports from the US summed up to 1.4%. Looking at the sector breakdown, exports were dominated by machinery and transport equipment, 35% alone were cars and other road vehicle. Imports from the US were dominated by agricultural products (17.5%), chemicals (18.3%) and machinery. Japan was the 4th largest US export market for agricultural goods. Similar to China, the most important trading partner for Japan is neighboring Asia, but the US is a major source of surplus. Overall, the bilateral merchandise trade surplus added up to 1.2% of GDP in 2016, almost a third of Japan’s current account surplus of 3.8%. That said, while Japan’s dependency on exports to the US in terms of GDP is smaller than in China, the elasticity is estimated to be much higher with 1.7. Thus a 20% BAT would lead to a loss in GDP by about 0.9%.

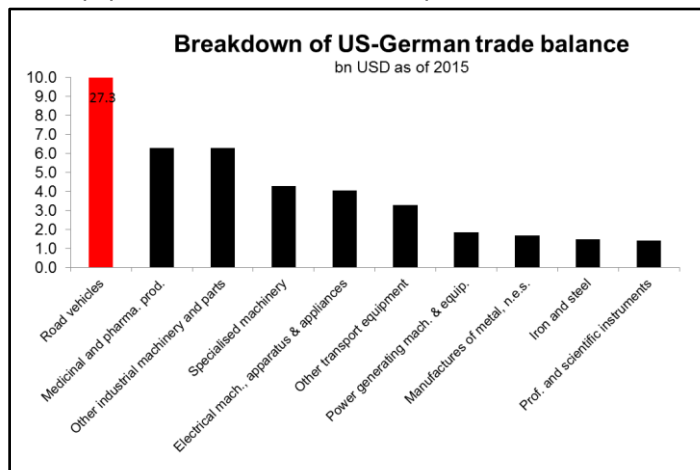


Taxes on cars Achilles heel of German exports

Germany’s current account surplus with the US has been driven by goods trade. This trade surplus amounted to a peak of 1.8% of German nominal GDP in 2015 (or € 55.4 bn) and has slightly moderated to 1.5% (or € 47.5 bn) in 2016. In 2015, almost half of this surplus (47%) was due to car exports, medical and pharmaceutical products (11%) and industrial machineries (11%). Quite interestingly, iron and steel exports – on which the US government focuses

at the moment – contributed only 3%. Hence, US sanctions against German steel producers will have only a small direct effect on GDP. What would be really biting are sanctions also covering the German car industry. For instance, if a BAT were introduced on Germany’s most important export market, estimates suggest a reduction of German GDP by about 1% with the car industry being harmed the most.

Being a EU member, Germany has delegated trade policy issues to the European Commission. In 2016, the EU held a trade surplus with the US (of € 115 bn) limiting the scope for retaliation. But there are some products, e.g. telecommunication equipment, electronic data processing and office equipment, with a US trade surplus.



How protectionist will the US become?

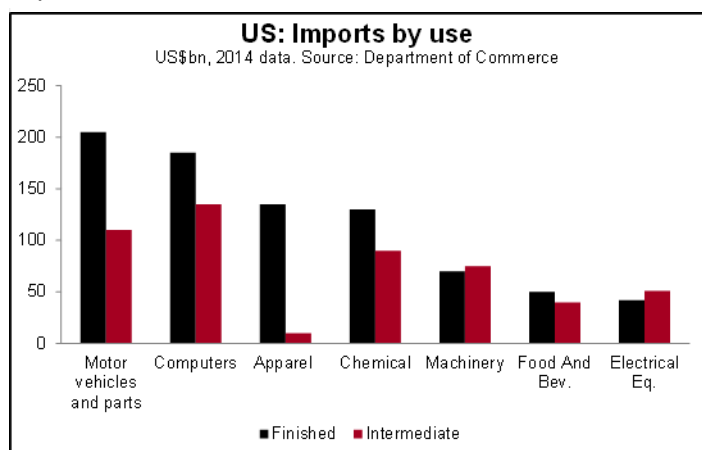
During the first months in office President Trump issued several harsh statements towards trade partners. However, no substantial measures have been taken yet. There is an inherent conflict between the electoral pledges and reality. On the one hand, he needs to serve his election base by bringing back industrial jobs. On the other hand, strong trade measures would run into conflicts: International conflicts with possible retaliation measures and risks of a trade war, domestic conflicts with producers, fearing disruptions in their production chains, and political conflicts with his own party and the Congress.

With regard to the last point, lasting decisions on external trade cannot solely be taken by the President alone, but have to be agreed on by the Congress as well. Far reaching protectionist reforms would face big political hurdles also within the Republican majority. In contrast, labelling a country an unfair currency manipulator can lead to temporary tariffs decided unilaterally by the President.

Moreover, we expect that the BAT, aimed at scrapping deductions for imports, will not be implemented, as the opposition from key industries relying on imports (like apparel and retailers) would be very strong. Higher prices for cars would also harm consumers and could hence weaken Trump’s popularity. By the same token, unwinding NAFTA appears to be nearly impossible, given the strong international connections in the production process in key industries like automotive. We expect limited changes to NAFTA, not to different from those advocated by the Obama administration. However, Trump’s tough rhetoric may encourage foreign firms to move production capacities to the US, thereby allowing the President to claim success.

With regard to China and Japan, we expect Trump to use the trade lever to induce these countries to also invest more in the US. Moreover, the US will press to open up these markets for US products. The recent US-China trade agreement of mid-May (while quantitatively unimportant) points in this direction.

Given these considerations we rather expect the Trump administration to bark but not to bite on broad-based trade sanctions. We deem it more likely that the US follows a strategy of moral suasion and bilateral negotiations. However, whether this will reduce the US trade deficit remains unclear. According to the latest IMF economic projections, the US current account deficit will widen from 2.6% of GDP in 2016 to 3.6% in 2020, partly as a consequence of the expected fiscal stimulus.



Imprint

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