The Bull in the China Shop?

The markets have reacted sharply to the recent news on the trade wars. It's up. It's down. It's flat. It's hard to make any sense of what is taking place. Here's a recap of the recent spat: The Trump administration published a list of about 1,300 Chinese exports worth approximately $50 billion annually to be charged with a 25% tariff. China's Ministry of Commerce responded by announcing plans to impose its own tariff of 25% on $50 billion worth of U.S. exports. Among the affected products are aircrafts, cars and soybeans. It's important to note that these tariffs have not yet taken effect and remain open for debate. Nevertheless, this exchange of tariffs has the markets fearing the uncertainty of whether this could escalate into a full-blown trade war.

What is Trump's plan for engaging China in a tariff battle?

The idea is to get China to improve its trade practices that harm the U.S., specifically taking aim at China's alleged theft of U.S. intellectual property. Intellectual property (IP) refers to inventions, designs and symbols used in commerce according to the World Intellectual Property Organization. IP is protected by patents, copyright and trademarks, enabling people to earn recognition or financial benefit from what they invent or create. According to the U.S. Trade Representative, which led the seven-month investigation into China's intellectual property theft, the estimated "annual cost to the U.S. economy continues to exceed $225 billion in counterfeit goods, pirated software, and theft of trade secrets and could be as high as $600 billion." Chinese officials have said that protecting foreign companies' intellectual property rights is important to China, but many Chinese companies appear to have missed that memo. In general, the plan is to better negotiate terms that would be mutually beneficial to both countries.

What is the current U.S. trade position?

To understand the potential impact of a trade war, let's start by looking at the trade deficit. A trade deficit occurs when a country imports more than it exports, and the balance of goods and services is negative as shown in the chart to the right. For a long time, the U.S. has run a trade deficit. Last year, the trade imbalance came in at -$568 billion or roughly 2.9% of GDP, an increase of 12.5% from $504.8 billion in 2016. Typically, the U.S. runs a deficit with countries that can either produce things more cheaply, or that trade a lot of everything with the United States, but the U.S. imports more than it exports.

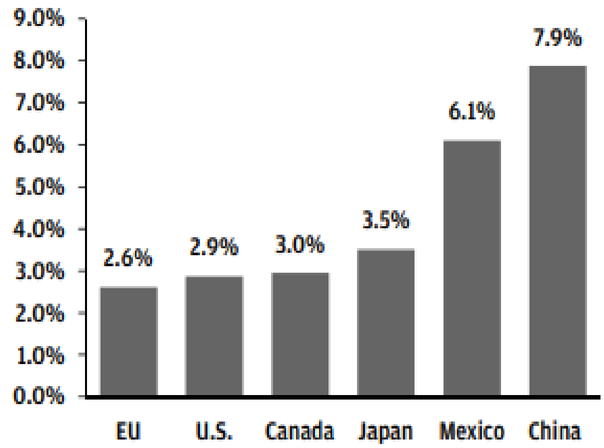
Is a trade deficit bad for the economy?

The answer is no. Trade deficits on their own are not a sign of unfair trade practices or a lack of American "competitiveness." When Americans buy imports, foreigners must do something with the dollars they earn. They can use the dollars to buy American exports or invest in American assets such as Treasury bills, stocks, real estate and factories. Because of China's cheap currency (a topic to be discussed further another time), the country has been able to produce goods cheaper, and in return buy U.S. government bonds. In doing so, China supplies credit to the U.S. to buy more of their cheap goods. And so, the cycle goes on. Trade deficits also expand during times of prosperity and contract during times of recession. Intuitively, the U.S., which is a consumer-led economy, tends to buy more goods when consumer confidence is high. This is one of the reasons the trade deficit has increased over the last few years. Economic theory suggests that persistent trade deficits will be harmful to a nation's economy by negatively impacting employment, growth, and devaluing its currency. The U.S. has defied these principles, possibly due to its size and the fact that the dollar is the de facto global currency (also known as reserve currency), meaning it is accepted for trade throughout the world. Large trade deficits may simply reflect our preferences for buying cheaper goods and may not matter much at all in the long run.

What's driving the trade deficit?

One of the reasons for the trade deficit has been an imbalance in the application of the tariffs. According to Dr. David Kelly, Chief Global Strategist at JPMorgan, "the U.S. currently charges lower tariffs on its imports than some of its major trading partners do on theirs." The U.S. on average charges 2.9% import tariffs, compared to China, which charges 7.9% import tariffs. The E.U. has the lowest tariffs globally, as it primarily trades within the European Union.

EXHIBIT 2: AVERAGE TARIFF IMPOSED ON TRADING PARTNERS
Simple average, all products, AHS basis



Source: WITS, WTO, World Bank, United Nations, J.P. Morgan Asset Management. Data are as of 2016 or most recently available. Data are as of March 9, 2018.

There are certainly a host of other reasons driving the trade deficit, such as a stronger dollar relative to other currencies, higher labor costs, and fiscal deficit. However, given the size of the U.S. economy on the world stage, one can certainly argue that we may have better leverage in negotiating favorable terms.

Bottom Line: Neither China nor the U.S. wants to engage in an all-out trade war. The stated terms of the tariff are not yet final. Larry Kudlow, President Trump's top economic adviser and a proponent of free trade, stated: "Bear in mind, these are just the first proposals. In the United States at least, we're putting it out for comment, it's going to take a couple months, I doubt if there will be any concrete action for several months, we'll see how that plays out." In addition, according to Commerce Secretary Wilbur Ross, China's tariffs "amount to about 0.3% of U.S. GDP. So, it's hardly a life threating activity." While the negotiations on the public stage are certainly analogous to a bull in a china shop, they are not entirely without merit either. The U.S. could benefit from protecting our intellectual property and having a level playing field relative to our peers. However, we hope the current administration fully vets the idea of tariffs before implementing any lasting changes. Meanwhile, markets hate uncertainty and will likely remain volatile until the details are ironed out. Ultimately, we hope that tariffs will lead to negotiation and not trade wars.