

## 2019: Trade shrinks for the first time since Lehman

The outlook for world trade is moving from bad to worse. Although the direct effects of the trade war are somewhat smaller than previously expected, industrial production has been considerably affected and no longer provides support. Global trade will shrink by 0.2% in 2019 and growth will only be 0.9% in 2020



### Uphill battle

Even before the escalation of the tit-for-tat trade war, we knew that 2019 will be a tough year for world trade in goods.

Trade levels dropped more than 3% in the last two months of 2018, making it an uphill battle to get to trade levels well above the average of 2018 - a battle that is about to be lost. On average, the monthly level of goods traded worldwide during the first half of this year has been 0.5% lower than the monthly level for 2018 as a whole. And there are no signs that the second half of 2019 will show a recovery that lifts trade growth anywhere close to the trade growth of 2018, which was 3.2%.

## Cyclical setback

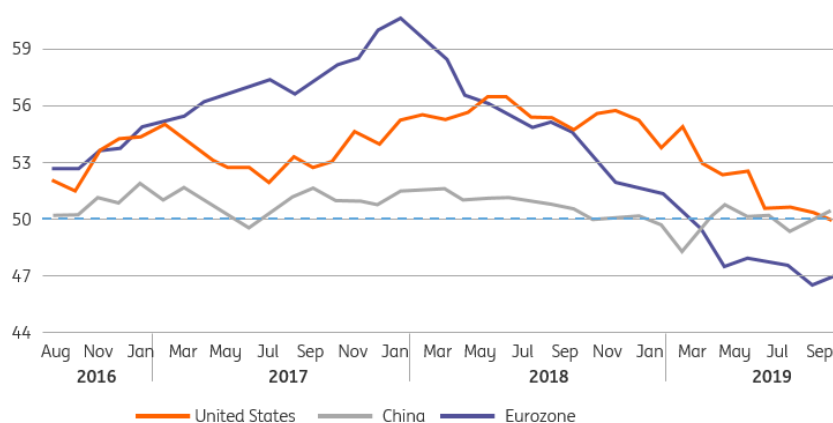
Industrial production, a major driver of world trade in goods, has shown very weak growth during the first half of 2019. The average production level per month has been only 0.7% higher than the average of 2018. Some regions and countries, such as the eurozone and Japan, actually experienced declines in industrial production.

Purchasing managers indices (PMIs) for industrial sectors don't paint an optimistic picture either. Fewer orders for industrial companies are to be expected around the world, as indicated by PMIs converging below 50. The US-China trade war, Brexit, and potential tariffs on US car imports fuel uncertainty, implying no swift recovery of confidence.

Given the negative tendency in manufacturing PMIs worldwide, we assume there will be no growth of industrial production for the remainder of this year implying total industrial production growth will only be 0.5% for 2019. For 2020 we expect the industry to recover somewhat, but the outlook remains bleak with a year on year growth rate of just 0.75%.

According to the relationship between the growth of industrial production and trade growth in 'normal' trade-war-free times, the growth of industrial production would normally result in trade growing around 0.3% for this year and 0.5% for next year. However, these are not normal times. We need to take into account the direct effects of the trade war in 2019 and 2020.

## World Manufacturing PMI's showing decline



Source: Bloomberg

If the trade war develops according to our base case (see below), global goods' trade will shrink 0.2% this year. Due to a deal between the US and China, which we expect to be closed at the start of 2Q next year, 2020 will be characterised by the reversal of half of the tariffs. This will dominate the negative feeding through of the 2019 tariff hikes into the first quarter of 2020 and the net effect will push up traded growth next year by 0.4%, resulting in a 0.9% growth rate for traded goods worldwide in 2020.

## Trade war scenarios

Until now, the trade war has been developing in line with [our forecast](#).

President Trump has been ramping up the pressure on China by hiking tariffs. But China has not conceded to the far-reaching demands of the US. It has made clear that some demands are unacceptable. Moreover, China has taken a tougher tone towards the US. Not only at the negotiation table but also in public. China has left little doubt that it is fed up with President Trump's bullying.

## The scenarios in numbers

Fig 1: GDP growth (%YoY)

	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17
GDP	3.8	3.3	3.6	4.6	3.0	3.2	2.6	2.7	4.1	4.0	4.9	5.1
Private consumption	3.0	3.1	3.2	2.9	3.4	3.4	4.1	4.7	4.7	4.9	4.8	4.9
Public consumption	1.4	0.0	-0.1	7.2	3.5	3.1	2.8	-1.4	0.5	2.1	1.9	5.4
Fixed Investments	12.7	6.4	4.3	4.5	-9.7	-4.6	-6.9	-9.7	-0.5	0.9	3.3	11.3

Source: GUS

Fig 2: Contributions to GDP growth (%YoY)

	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17
GDP	3.8	3.3	3.6	4.6	3.0	3.2	2.6	2.7	4.1	4.0	4.9	5.1
Private consumption	2.0	1.9	1.9	1.5	2.2	2.0	2.5	2.3	3.0	2.9	2.9	2.4
Public consumption	0.2	0.0	0.0	1.4	0.6	0.5	0.5	-0.3	0.1	0.4	0.3	1.0
Fixed Investments	1.7	1.1	0.8	1.3	-1.4	-0.8	-1.3	-2.7	-0.1	0.2	0.6	2.8
Inventories	-1.1	-0.1	0.2	0.1	1.8	-0.1	0.8	2.2	0.7	1.9	0.0	-0.3
Net exports	1.0	0.4	0.7	0.4	-0.2	1.6	0.2	1.2	0.4	-1.3	1.2	-0.8

Source: GUS

Source: GUS, ING

## The base case: US-China deal at the end of the winter

We think China will continue to stand firm and will not accept any deals that limit its autonomy in making its own laws regarding intellectual property protection. Neither will it accept interference in setting goals, such as the intention to become a world leader in certain high tech markets. Furthermore, China is demanding the US reverses all tariff hikes once a deal is done.

President Trump will increasingly become aware that his high-pressure strategy is not working. To be able to claim that he is delivering on his election promises to improve the terms of trade for the US, Mr Trump needs to show voters that he is capable of striking trade deals. For this to happen, he needs to compromise. However, for now, we don't see enough signs that the President is prepared to scale down his ambitious list of demands for a deal.

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However, this is likely to change. We forecast the US economy will deteriorate in the coming two quarters and believe the trade war will partly be blamed for this. This would translate into polls moving against President Trump, which will prepare him to water down some of the demands and refrain from 'bullying' China in public enhancing more fruitful negotiations with a deal at the start of 2Q20.

We expect this deal will encompass a commitment by China to import at least \$70 billion per year more from the US to lower import tariffs and open its markets for foreign (majority) investing. On the issue of intellectual property, we expect China to commit to taking additional steps to prevent the theft of intellectual property or forced IP- transfers. But there won't be any agreement if it's only the US which has a stick to beat China if there's not a satisfactory implementation of the deal. Further, we expect that half of the tariff hikes from both sides will be reversed immediately

after the deal and the remainder will be phased out gradually during 2020 and 2021 conditional on positive evaluation of both sides that the other side is complying with the deal.

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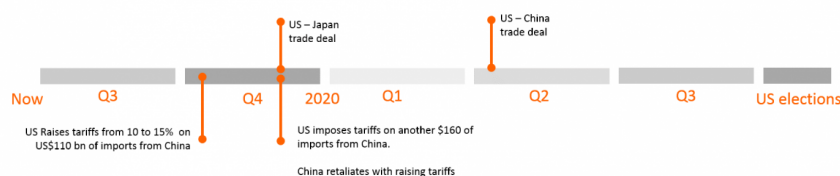
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In this scenario, we assume that Mr Trump will not start a trade war with the EU, despite our belief that an improvement in the terms of trade for the US in doing business with the EU is definitely high on his wish list. We don't doubt the President would like to impose tariffs on the imports of European cars as this would create leverage for negotiations and negotiating with leverage is simply the way President Trump likes to operate.

However, given our expectation that public sentiment about the trade war will deteriorate over the next couple of months, we think that the President won't want to risk starting another trade war, in this case with an old ally, as this would hurt his chances of being re-elected. Therefore, we expect Mr Trump to continue to threaten the EU, but to hold his fire until after the election. His threats will continue to weigh on business sentiment around the globe which is one of the reasons why we don't expect industrial production to show a strong rebound from the current slump.

The automobile tariffs were not only a threat to the EU but also to Japan as it is a big exporter of cars to the US. Against the trade-war backdrop, negotiations have been silently progressing with Japan. A headline agreement has already been achieved and we expect that a full trade deal will be rounded up before the end of this year.

## Base scenario



Source: ING

## The downward risk scenario: Further escalation on all fronts

Given the tougher stance of China and the fact that President Trump has so far shown no signs that he is willing to water down his demands, the risks are tilted to the downside.

Instead of giving in to China's demands, Mr Trump could choose to keep on increasing the economic pressure on China with additional protectionist measures, thereby listening to stakeholders in the US that expect him to stay tough. For this scenario, we assume that the President will raise the current average tariff on Chinese goods from 24% (currently planned) at the end of this year to 35% on the eve of elections. This might seem bold, but let's not forget that President Trump in his election campaign in 2016 already threatened China with a tariff of 45%. And given recent events, there is little doubt about his willingness to follow up on his threats. In

this scenario, China will retaliate proportionally lifting average import tariff on US goods to 30% (currently planned to rise to 25.9% by 15 December).

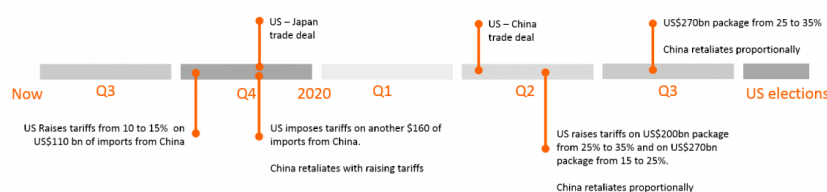
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President Trump is more likely to implement this downward risk scenario, the less his voter base seems to be concerned and if the US economy doesn't deteriorate substantially. This is likely to result in a long fight and no resolution before the 2020 presidential elections.

In a downside risk scenario, President Trump escalates the trade war with the EU as well. In this case, he is likely to follow up on his threat and announce a 20% increase of import tariffs on EU-cars, to be imposed two weeks after the current reprieve period which ends in mid-November 2019.

This scenario would hardly change the outlook for trade growth in 2019 but it would have a significant negative effect on trade figures for 2020. Instead of a bounce-back of trade growth, more hikes will take the damage to new highs of 1%, leading world trade to not only shrink in 2019 by 0.2% but instead decline by 0.3% in 2020.

## Down scenario



Source: ING

## Upside risk scenario: A quick resolution

An upside risk is that a deal between the US and China is cut before the end of 2019. In this scenario, Mr Trump's preparedness to compromise comes faster than we currently expect.

Quick deterioration of support among his voter base and a substantial slowdown of the economy could help this positive scenario. In this case there will be no tariffs on EU cars.

The damage of the trade war in 2019 would be 0.3% which would result in world trade just escaping a decline this year and would lead to a decent recovery in 2020. This is higher than our base case due to the earlier undoing of tariffs of 2018 and 2019.

The negotiation climate between the US and China deteriorated significantly at the beginning of May 2019, nevertheless we still expect a deal as both sides will benefit.

But the downside risk of no deal has definitely increased since our last Trade Outlook in June. 'Saving face' has become an important factor, now that China has made clear it is fed up with President Trump's 'bullying' tactics and because China has publically put some demands of its own on the table.

It all depends on Mr Trump's evaluation of his chances to get what he wants without watering down his demands. We think he will take a step back to make a deal possible so that he can show his voters he is delivering on his promise to improve the terms of trade for the US. But it'll be a very close call.

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