

Article | 4 July 2018

UNITED STATES

Trade war: Trump will flex muscle until US elections

The world is about to enter into a real trade war. In our view, only significant protests among Trump voters or a quick surrender of US trade partners can prevent this. There are few signs this will happen anytime soon



Trade: the war is on

Things have changed. In our [analysis](#) at the end of March, there was a real possibility that various trade partners would be permanently exempted from higher US tariffs and that others would give in to Trump's demands under the threat of elevated tariffs, thereby avoiding a broad trade war. At first, this seemed to be the case. South Korea, Brazil, Argentina and especially China made considerable concessions.

But in the run-up to the G7 summit, Trump decided that his allies in Europe and his Nafta partners Mexico and Canada would no longer be exempt from steel and aluminium tariffs. He also decided that the concessions offered by the Chinese were not enough to put the trade conflict between the US and China on hold. Trump ruled that a 25% tariff on \$50 billion worth of imports from China- as a punishment for alleged theft of US intellectual property- would be implemented on 6 July. As a consequence, China, the EU, Canada and Mexico are hitting back.

And we fear there is more to come. China has threatened to impose its own tariffs on US products on Friday, which the US has warned will lead to tariffs on an additional \$200 billion of Chinese export goods at a rate of 10%. Trump has already warned that if the Chinese retaliate again, another package of goods worth \$200 billion will be subject to higher tariffs as well.

In addition, the EU could see its car exports to the US hampered due to an import tax of 20% if the US Commerce Department's investigation concludes that imports of cars are a threat to national security. This measure could well be applied to other countries given that the current investigation encompasses imported cars from all countries (not just the EU). According to the Financial Times, the EU is considering a special deal with the US on cars, but many hurdles need to be overcome for this to become reality.

Trump overplays his hand

It is impossible to know how the trade war will evolve precisely from Friday onwards, so we consider three scenarios. One of the most important points to make here is that if President Trump steps up his protectionist measures afterwards, the US economy will join the rest of the world in suffering negative GDP effects (see figure 1). This is due to the fact that the positive effects of import substitution will no longer outweigh the negative effects that retaliation will have on US exports.

Figure 1

GDP impacts of trade war escalation, %					
	US	EU	China	World	
				GDP	Trade
6 July	0.06	-0.02	-0.18	-0.03	-0.35
Scenario 1	-0.05	-0.08	-0.27	-0.10	-0.67
Scenario 2	-0.16	-0.12	-0.36	-0.17	-0.90
Scenario 3	-1.99	-0.64	-0.97	-0.82	-2.60

Source: ING estimates
6 July: US steel and aluminium tariffs, plus 25 percentage point (pp) tariff increases on imports from China worth \$50bn. Both measures are retaliated against by trade partners.
Scenario 1: US increases tariffs on imports from China worth \$200bn by 10pp and on European cars by 20pp. China and the EU retaliate.
Scenario 2: US increases tariffs on a further \$200bn of imports from China by 10pp, and \$100bn of imports from the EU by 10pp. China and the EU retaliate.
Scenario 3: US increases tariffs by 20pp on all imports and all trade partners retaliate.

In the extreme third scenario, where the US charges an import tariff of 20% on imports from all countries and these countries do the same regarding their imports from the US, the American economy suffers a cumulative GDP loss that's three times as big as the rest of the world's within just 24 months. This is a consequence of the fact that US exporters would face a 20% tariff at the borders of all destination countries, while the rest of the world only face this tariff at the American border and trade among each other at prevailing tariffs.

The US economy and its trade balance would have been much better off if Trump had

accepted the concessions that China offered during the negotiations. In particular, the offer to increase imports from the US by \$70 billion would have been a much better result. The tariffs on Chinese imports in, for example scenario 3, are probably not even high enough to reduce imports by more than \$70 billion and because American exports to China will decline due to Chinese retaliation, the net result in the bilateral trade balance will not even come close to \$70 billion.

The scenarios also show that China will be hurt more than the EU because the US exports more to the EU than to China. So in the EU, retaliation leads to more GDP growth caused by import substitution than in China.

The table also shows that world trade will suffer more than world GDP. An all-out trade war would drive down world trade growth by 2.6 percentage points in two years while the effect on world GDP would be -0.8 percentage points.

The most worrying aspect within this dispute is that Trump views his trade restricting measures as necessary to level the playing field for trade and he considers a response to retaliatory measures as unavoidable. This could mean a trade war escalates quickly.

When will this end?

When will Trump stop firing at his trade partners? To answer that question we need to know what his overall objective is. How many concessions from trade partners are needed for Trump to stop his war on trade? We don't know but Trump's attitude towards China indicates that he is aiming very high. He wants the bilateral trade deficit with China to be cut by more than half in two years. And the president seems reluctant to compromise, as seen by his refusal to accept China's offer to increase imports from the US by \$70 billion.

Trump's ambition reduces the chance that further negotiations with China will lead to a result any time soon. And his recent remark that the EU may be "as bad as China" when it comes to trading fairly with the US, signals a lack of flexibility in the emerging negotiations with the EU on bilateral trade in cars.

In our view, there are only two events that could bring this trade war to an end. First, trade partners give in to Trump's demands. Secondly, internal resistance in the US against trade policy becomes too much, especially if Trump voters start to protest on a large scale (see figure 2).

Figure 2

Trade war scenario	Trade partner's behaviour	+	Attitude of Trump voters	=	Result
1. Trump's gamble succeeds	Trade partners give in soon		Support for Trump continues		Short trade war
2. Trump's gamble fails	Trade partners keep retaliating		Support for Trump continues		Long trade war
3. Trump loses face	Trade partners keep retaliating		Voters oppose trade policy		Short trade war
4. trump gets lucky	Trade partners give in soon		Voters oppose trade policy		Short trade war

Right now, there is little reason to be optimistic about any of this happening soon. First of all, we don't see a lot of domestic resistance from Trump voters against his policy. Ratings on Trump's economic policies are actually improving. Recent events also teach us that Trump is unmoved by objections from business leaders. He criticised Harley Davidson for shifting some operations out of the US while the American steel association's plea to exempt Canada from tariffs fell on deaf ears. Maybe Congress can stop Trump, but that remains to be seen.

Second, US trade partners could decide to give in to Trump's demands, but the concessions from China thus far are already quite generous and it seems unlikely that they'll meet Trump's demand to lower the trade deficit by \$200 billion. And the EU? Well thus far, the bloc has been playing hardball with the US. The EU seems to be standing pretty firm in its defence of WTO rules.

Canada and Mexico are most dependent on demand from the US for their exports, making them the first likely candidates to acquiesce. But equally, it wouldn't make sense for an offshore El Dorado like Mexico to accept Trump's request for a sunset clause, which would scare away investors.

The world has to be prepared for an escalation of the trade conflict in the months to come. For now, Trump's voters back his stance on trade, suggesting he's unlikely to back down, particularly ahead of the mid-term elections, where the Republicans will be fighting to hold onto a majority in the Senate. By the end of the year, the effect of the trade war on the US economy will become more visible, which might spark a rethink of his trade policy.

Author

Raoul Leering

Senior Macro Economist

raoul.leering@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the

THINK economic and financial analysis

Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.