

Trade Wars: Episode 1 - The Presidential Menace

Four scenarios for how trade wars could unfold and how costly a global trade war would be for major economies - as well as the implications for the US dollar and global risk sentiment

Key Messages

- For global market dynamics to transition from what we see as currently being a Cold Trade Conflict to a real Global Trade War, we need to see one of two things: (1) a broadening of current US protectionist measures to other countries/sectors or (2) the US administration reacting to any initial retaliatory tariffs from Beijing.
- Were an All-Out Trade War to break out, we estimate that the US will lose out most (-2.0% of GDP cumulatively over two years) – as US exporters would face higher tariffs at all borders, while the rest of the world continues trading with each other at prevailing trading arrangements.
- It is the signalling channel of US trade policy that has typically been the key driver for the USD in prior ‘trade war’ episodes. Protectionist measures implicitly signal the US administration's desire for a weaker USD – and such expectations are likely to be entrenched in FX markets until credibly broken

ING's Trade War Scenarios – Transitioning from a Cold Trade Conflict to a Global Trade War

	Scenario Outline US trade policy & response of major trading partners	Economic Impact Implications for US & RoW economic growth	Financial Market Implications	
			Global Risk Sentiment	US Dollar & Global FX markets
Cold Trade Conflict	1 Trump's Lone Trade Attack No retaliation by major trade partners <ul style="list-style-type: none"> • US import tariffs on steel (25%) & aluminium (10%); NAFTA, EU, Brazil, Australia, Korea & Argentina exempt • US impose \$60bn tariff package on China invoking Section 301 by citing alleged theft of intellectual property 	Small economic gain for US (and equivalent loss for trading partners) as no retaliation sees some US import substitution	Nervous Goldilocks Risk sentiment stable but threat of trade war keeps investors cautious	US protectionist policies to address trade deficit implicitly leads to weak USD expectations being embedded into markets
	2 'Tit-for-Tat' Trade Battle Proportional retaliation by trade partners <ul style="list-style-type: none"> • Countries affected by aluminium & steel tariffs retaliate proportionally • China retaliates proportionally to US tariffs (with anti-trade measures) • US does not react to retaliations 	US economic loss given trade partner retaliation. Beijing retaliatory tariffs buffers any damage to the Chinese economy	Stagflation Risks Inflation-linked assets bid, while global equities see knee-jerk dip lower	Asia FX sensitive to US-China trade wars; AUD a proxy self for escalation; CNY stays firm as a way to defuse trade tensions
Escalating Trade Wars	3 US escalates reciprocal tariffs Trump's 'reciprocal' tariff warpath widens <ul style="list-style-type: none"> • US broaden protectionist measures to other countries & sectors (eg, 25% import tax on EU cars); EU retaliate with proportional countermeasures • US reacts to China's retaliation with 20% blanket tax on Chinese imports 	EZ economy hit now as Trump targets EU car imports. Protected US auto sector partly eases US GDP hit in Scenario 2	High Risk Aversion Escalation sees elevated risk aversion & sharper sell-off in risky assets	USD trades lower versus JPY & EUR given large US net foreign liability position & greater scope for dovish Fed re-pricing
	4 All-Out Trade War US adopts a no holds barred policy stance <ul style="list-style-type: none"> • Trump pulls out of WTO and throws world trading system into disorder • US impose 20% tariff on all imports • Trading partners also retaliate with 20% tariff on all imports from the US 	Significant damage to US economy. Loss to RoW is lower as trade between other countries remains at lower tariffs	Global Downturn Sustained move lower in global equities & flight-to-safety in US debt	EM FX underperforms (ZAR, RUB & BRL most sensitive to increases in global risk aversion); FX of SOEs* vulnerable

Source: ING FX Strategy. *SOEs = Small Open Economies

ING's Global Trade War Scenarios: Four Degrees of Escalation

The Trump administration's decision to impose tariffs on US steel and aluminium imports and a \$50-\$60bn tariff package on imported goods from China – means that global trade policy has formally shifted into the realms of a protectionist world.

If countries that are hit do not retaliate to these initial US protectionist measures, the world is 'only' facing a **one-sided contained trade attack** (Scenario 1) - and not a trade war in our view. In this case, the economic effects are limited - with the Chinese economy hit the most (we estimate a cumulative 0.6% GDP loss over two years). If US imports from China, as well as steel and aluminium imports from a range of countries, are partly substituted by domestic production - we estimate that this could lead to a 0.3% increase in US GDP after two years.

Going forward, the immediate risk is whether trade partners seek to retaliate in equal and proportional measures – giving rise to some sort of **'Tit-for-Tat' Trade Battle** (Scenario 2). While reports suggest US and Chinese officials may initially be looking to take a more diplomatic approach, the reality of unsuccessful and challenging trade negotiations means the prospect of significant countervailing measures being imposed by Beijing – beyond the trivial \$3bn retaliatory tariffs on imported goods from the US already announced – is fairly high.

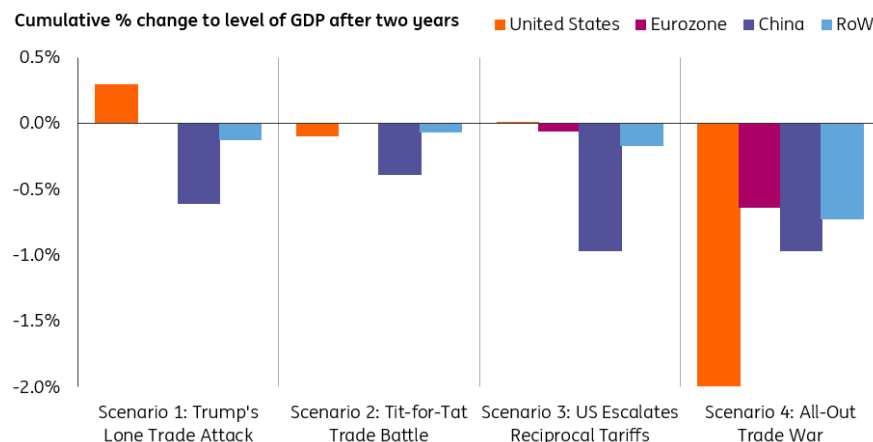
For global market dynamics to transition from what we see as currently being a **Cold Trade Conflict** (Scenario 1 or 2) to a real **Global Trade War** (Scenario 3 or 4), we stipulate that one of two forms of escalation must prevail:

1. President Trump steps up his 'reciprocal' tariff rhetoric by broadening protectionist measures to other countries and sectors (we see US imports of EU cars as the next potential high-level target)
2. The US administration reacts to any significant retaliatory tariffs from Beijing by imposing much harsher protectionist measures (we use the example of a 20% blanket tariff on Chinese imports).

Bold steps like these - which in conjunction we define as a **US Escalation of Reciprocal Tariffs** (Scenario 3) - could ultimately lead to the start of an **All-Out Trade War** (Scenario 4) in which all countries eventually impose a 20% import tax on all imported goods. A trigger for this could be major trading partners giving complete disregard to the international rules that currently govern global trade (and in this tail risk scenario, we assign a non-trivial risk to say the US pulling out of the WTO).

Were an all-out trade war to break out, we estimate that the US will lose out most (-2.0% of GDP cumulatively over two years) – because US exporters would face high tariffs at all borders, while the rest of the world keeps trading with each other at prevailing trading arrangements.

Estimated impact of trade wars on the GDP of major economies (4 scenarios)



Source: ING estimates

Political Economy of the Dollar: Protectionist US policies reinforce weak USD expectations

Mercantilist Trump: Back with a vengeance

US politics - and a narrower focus on what is set to be a close set of midterm congressional elections in November - has been a big element of the policy shift that we've seen in White House in recent months. Add to this the turnover of staff and the departures of globalists (Cohn and Tillerson) - and it's clear to see that the administration's mercantilist and nationalist 'America First' policy agenda is more than just a political show.

For President Trump to truly engage with the core voter base that effectively won him the election, actions may now have to speak louder than campaign rhetoric. As such, one should expect to see trade and foreign policies dominating the White House agenda in the run-up to the November midterm elections.

Political Economy of the Dollar: US protectionism reinforces weak USD expectations

In November 1978, one Paul A. Volcker - then President of the New York Federal Reserve - wrote an op-ed piece titled '[The Political Economy of the Dollar](#)'. In it, he writes "the United States no longer stands astride the world as a kind of economic colossus as it did in the 1940's - nor, quite obviously, is its currency any longer unchallenged".

This seems somewhat fitting in the current environment. It's clear from the President's tweets alone - which have seen mentions of 'trade deficits' increase almost four-fold over the last quarter - that the US administration has narrowed its economic focus on reconciling the balance-of-payments deficit. However, recent trade policy announcements - and the imposition of tactical import tariffs on selected sectors and countries - shows that the White House is now willing to take a more proactive approach to address the US external trade position.

Protectionist measures implicitly signal the US administration's desire for a weaker USD - and such expectations are likely to be entrenched in currency markets until credibly broken

The negative consequences for the US dollar are two-fold:

1. The willingness to impose actual protectionist policies - and the ongoing threat from the White House that more may be yet to come - means that US policy uncertainty remains high (and hence USD assets may trade with a discount in the near-term to compensate for this uncertainty)
2. The adoption of protectionist measures implicitly signal the US administration's desire for a weaker USD - and such expectations are likely to be entrenched in currency markets until credibly broken

Indeed, investors are probably finding it difficult to reconcile the case for a stronger US dollar with the Trump's administrations adamant focus to tackle the US trade deficit - especially in a 'gung-ho' manner that demands instant success. Equally, if it is the expectations channel that drives currency markets, current USD weakness is a sign that global investors are not convinced that US protectionist measures will be successful in tackling the US trade deficit (and therefore boosting US economic activity). Our empirical analysis shows that there is evidence justifying such expectations (the US economy loses out under a All-Out Trade War scenario). Equally, structural trade deficits do not get resolved overnight (or even over a Presidential term).

So, despite what standard textbooks may tell us about tariffs and exchange rates, we expect unilateral protectionist measures by the US to weigh on the dollar - with global investors loss of confidence in the US economic regime expressed through a diversification away from US assets. Were global trade war dynamics to escalate, we note the US dollar would face two additional channels of downside: (1) a repricing of US monetary policy expectations - where the 80bp of Fed tightening by end-2019 looks inconsistent with an environment where a global trade war is being played out and (2) a large US net foreign liability position (around \$8 trillion) making the USD vulnerable any deterioration in the investment environment.

In such an environment, one would expect the dollar to underperform its relatively low-yielding, safe-haven currency peers like the JPY and EUR - both of which command a better net external foreign asset position and have relatively limited scope for any monetary policy re-pricing.