Good MornING Asia - 8 March 2018

ECB takes centre stage today and we may get further clarification on exemptions to Trump's trade policies.

In this bundle

A switch of focus

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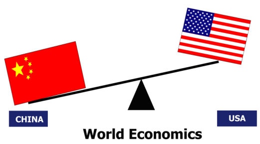

China

China: Patient on US trade tantrum

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Opinion | 7 March 2018

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Rose

Bored of Trump and Trade? Try ECB instead

For a change, today, we can focus on something other than Trump and trade. Today, the European Central Bank decides whether to amend their statement on monetary policy. Sounds dull? Well, you're probably right, but in the world of economics and central banks, this is racy stuff. In the introductory statement to the ECB's monthly policy decisions, ECB president, Mario Draghi, offers a summary. This contains a number of key sentences. Right now, the main one to watch is this: "If the outlook becomes less favourable, or if financial conditions become inconsistent with further progress towards a sustained adjustment in the path of inflation, we stand ready to increase the asset purchase programme (APP) in terms of size and/or duration".

The point of this is to suggest that the ECB policy, although clearly moving towards an end to asset purchases, still has an inherent easing bias. This, to anyone who has been watching Eurozone economic data flows over the last couple of years, is complete and utter nonsense.

Yes, the Eurozone has low inflation, so does everyone else. Growth data are strong, and the labour market is improving continuously. You would have to have lost touch with reason to believe that the ECB is doing anything other than slowly gearing up for an end to asset purchases and negative interest rates. Yet still, the market hangs on these words uttered by Draghi as if they had some sort of meaning. Markets can move, and move substantially on this sort of stuff.

Let's suppose, as an analogy, a child breaks its mother's prized vase. It waits until it sees its mother in a good mood before telling her. This in no way alters the state of the vase or the timing of when it got broken. But the resulting backlash in terms of punishment could be less. However, in this case, we are all fully aware of the state of the vase, or in this case the economy and financial markets. Draghi owning up should be no more than a statement of the obvious, which it is. The reality, however, it that markets will seize on this as highly meaningful and the Euro could well rally, and Eurozone government bonds sell off significantly in response.

For the record, we don't expect Draghi to "fess-up" today. But the direction of markets in the coming months is as obvious as if Draghi were standing in shards of broken pottery and dead flowers.

In case you were missing the Trump / trade story...

In case you were missing the Trump/trade story since Gary Cohn's departure yesterday, a number of Trump's remaining economic advisers have been trying to patch up the damage of this latest incident. Most notably, remarking that other countries might also gain exemptions from his steel and aluminium tariffs, not just Canada and Mexico (in the event that they sign up to an amended NAFTA agreement).

This may go some way to restoring market calm, though remains a Damocles sword hanging over the NAFTA negotiators. A sort of "Give me what I want on trade or the puppy gets it" approach.

Newswires are touting the possibility of a statement on this today, so you won't have to go Trump-less after all if so.

Day ahead

It is a fairly quiet day today in both the G-7 (ex-ECB) and Asia, though we have US non-farm payrolls to look forward to tomorrow.

Yesterday, we had a strong US ADP employment report, though it contains no wages data, so is a bit tangential to the market's focus right now. But we did get the US Fed's Beige-book overnight. Amongst the uninteresting stuff, it did note that wages growth picked up moderately in many districts, which could indicate a further rise from last month's 2.9%YoY average hourly earnings growth. That would push up both the USD and US Treasury yields.

Data out already today include a solid upward revision to Japan's 4Q17 GDP from 0.5% to 1.6% - further reason to imagine that the Bank of Japan will go the same way with monetary policy as the ECB this year, though perhaps not as quickly.

Australia's January trade balance rebounded far more than had been expected, recording a AUD1055m surplus, delivering some lift to the currency.

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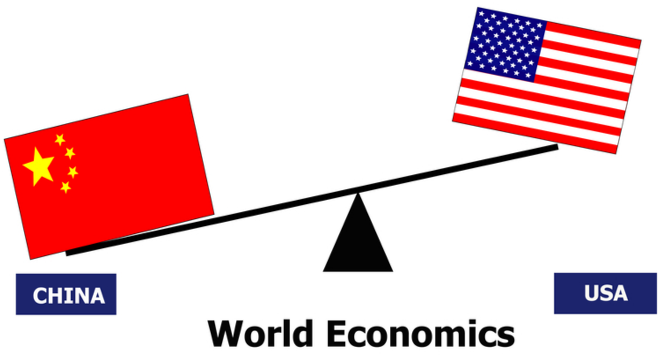
China: Patient on US trade tantrum

The direct impact on China from US steel and aluminium tariffs is likely to be minimal



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The first round: Little impact on China

The direct impact on China from this first round of US trade tariffs is likely to be small because China has reduced its steel exports significantly, and is not even among the top 10 steel exporters to the US. While China's aluminium exports to the US constitute around 10% of total aluminium exports, the number is still small compared to China's total exports.

To understand why China is not one of the top steel exporters to the US, we need to emphasise that the country has been cutting steel production capacity since 2015. Exports of steel came down from a peak of 11.2 million tonnes in September 2015 to less than five million tonnes in January 2018. In addition, the government has announced further iron and steel production capacity cuts in 2018. That means China would have exported less steel even without US import tariffs.

To this extent, US import tariffs don't hurt China's steel producers

As for aluminium, China's exports to the US are likely to go somewhere else in the world. As other countries' aluminium exporters would also need to find other buyers, China may end up having more supply domestically, which could mean either Chinese aluminium producers produce less or sell at a lower price or both. So the tariff may hurt some Chinese aluminium exporters but the scale of aluminium exports is small compared to China's total exports.

All in all, the direct impact on China is minimal.

The second round: Complicated but China may not be the loser

Some countries will feel the heat from US import tariffs and Europe has already talked about retaliation. Assuming that more countries join Europe, there will be fewer trade flows between the US and the rest of the world.

Would that hurt China? Maybe. When trade flows shrink, US trading partners earn smaller profits, workers earn lower salaries and consumption declines. China's products would also face shrinking export demand. That's likely to be the short-term negative impact on China. But the process may not end there.

Worries about falling profits will lead non-US steel producers to find alternative solutions to boost sales. Producers of final goods that use steel and aluminium in the US would also find other business solutions to avoid the higher cost of steel and aluminium.

These final goods producers could move production from the US to other locations around the world where they could produce at a lower cost, whilst also being closer to their customers, thus allowing them to avoid falling profits. Of course, this would not happen overnight because moving production lines to other countries requires investment and takes time. But this could be an alternative if the US trade wars continue, especially for multinational companies that already have factories outside the US. China, which has a growing consumer market for everything from automobiles to aircraft, could be one such location.

The Chinese government repeated in the 'Two Sessions' (annual meetings for members of the National People's Congress) that China is deregulating its foreign direct investment policies, suggesting that foreigners setting up businesses and factories in China would face fewer hurdles than before.

If there is a third round...

If the US insists on imposing more trade restrictions on the rest of the world, it is inevitable that world growth will slow. That would hurt China as explained. But we don't think China will just take that as given. We believe that the country will see this as a valuable opportunity to try to bring back world growth.

The Belt and Road Initiative (BRI) could be one of the solutions, or even an expanded version of the BRI, including more countries, which facilitates a trade and investment alliance. By that time, there would likely be even more countries willing to join the BRI.

US trade war? Easy for China.

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