Grant Thornton

The anatomy of a trade war

Implications for the economy

MONTHLY ECONOMIC OUTLOOK

March 15, 2018

Diane C. Swonk, Chief Economist

Trade wars are like family feuds. They often start small, like when someone develops a grudge after feeling slighted by another member. The grudge festers, and other family members intervene. Some people stop talking for years, forgetting what they were really mad about in the first place. Others go to extremes, with tensions escalating into violent clashes.

Some reconcile by erecting boundaries that allow relationships to flourish instead of falter. "Good fences make good neighbors," as they say. Boundaries erected out of rage instead of respect, however, inflict more pain, and often penalize the innocent instead of the guilty.

Most families I know have experienced some version of what I speak, and it is from that familiarity that we need to look at trade wars. The moral of the story is that family feuds break apart families, which means that everyone loses.

This report takes a closer look at the effect of recently announced steel and aluminum tariffs, how they represent the threat of a larger trade war, and what it all means for the outlook for the US economy. As noted in the February report, the administration and Congress were seeding a boom/bust cycle with a late-in-the-cycle surge in fiscal stimulus that would effectively pull growth forward into 2018 at the expense of growth down the road. Tariffs and the threat of a trade war will undermine those gains a bit, via an erosion of purchasing power and increased uncertainty about foreign policy. Relations with our closest allies are becoming particularly contentious, which could make U.S. multinationals targets of protests and more retaliation by our counterparts abroad.

Poised for 2Q snapback

Real GDP growth is expected to slow to a 2.1% pace in the first quarter. Consumer spending is moderating after surging during the holiday season. Tight inventories are holding back home sales, and business investment has slowed despite the enactment of tax cuts. Government spending is constrained, but poised to jump in response to new spending measures approved by Congress. The trade deficit continues to deteriorate.

Prospects for the second quarter are much better. Real GDP growth is expected to rise at a 3.2% pace, more than a third faster than the first quarter. Consumers are swapping spending on vehicles for repairs and upgrades to their homes. Home sales are expected to tread water. Business investment is expected to pick up and spending by the federal government is poised to surge. Trade remains our Achilles' heel, which will only further infuriate protectionists.

Powell raises rates at first meeting

Chairman Powell, and his colleagues appear ready to raise rates in March. Some have moved from expecting four instead of three rate hikes, which is what we have expected for some time now. Those most against an additional hike are not voting this year.

The departure of Gary Cohn, Director of the National Economic Council, has compounded uncertainty about the course of trade policy. Those left with the president's ear on trade policy, Peter Navarro and Commerce Secretary Wilbur Ross, would like to pursue a significantly more protectionist agenda. This also allows the president to make good on the protectionist promises he made during his campaign prior to midterm elections. Larry Kudlow of CNBC, an outspoken free trade ally, was named Cohn's successor. Kudlow is a free-trader but it is unlikely that he will have more firepower than a former Goldman Sachs leader to counter the protectionists at the White House. Many of those who came with Cohn from are also leaving.

Cost of steel and aluminum tariffs

The president used an archaic national security clause from the Cold War to justify the tariffs, which give him unilateral ability to execute them. Republicans in Congress have split with him and some have vowed to use legislative actions to override them; they don't have the votes.

Trade groups and individual companies are also exploring lawsuits as they feel that the tariffs violate the spirit of the national security clause that allowed the tariffs. They are consulting with groups that fought the president on the travel ban to see if they could expedite the process. This may gain some carve-outs within the tariff structure, but trade law is notoriously complex and lawsuits take time. By the time they are settled, much of the damage may have already occurred.

The last time the U.S. imposed steel tariffs was in March 2002 under the Bush administration. The tariffs excluded Canada and Mexico and many developing economies. They were lifted just eighteen months after they were enacted, in part because of the collateral damage imposed on steel consumers. The United States International Trade Commission found that the costs outweighed the benefits by a substantial margin, with losses in both employment and investment. This suggest that the tariffs could undermine the very investment that the president had hoped the corporate tax reforms would stimulate. It also could mean even larger deficits and debt in response to the tax cuts. Lower investment means less productivity growth, which means fewer revenues to offset the cost of tax cuts down the road.

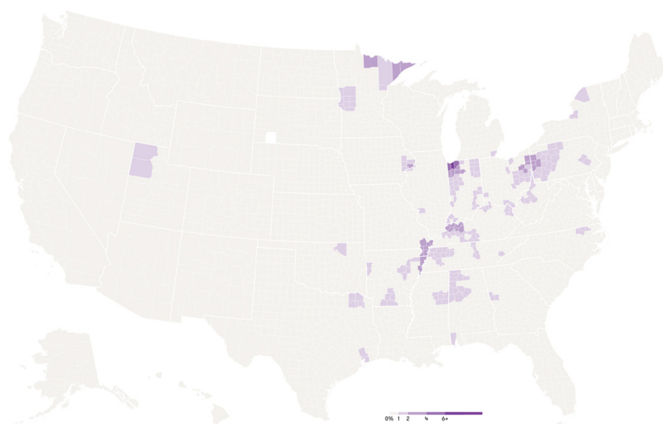
It is still too early to assess the impact of president's recent tariff announcements, given the uncertainty surrounding which countries will actually be affected. Mexico and Canada have been given a 30-day waiver, contingent on their willingness to yield ground on NAFTA negotiations. Australia has also been given wiggle room. The rest of our trading partners still do not know whether they will be affected by the tariffs or not. The clock is ticking; the president allowed 15 days for countries to apply for a waiver on the tariffs announced on March 8.

> "Much like a family torn apart by warring factions, or even one bad player, everyone loses [in a trade war]."

What we can illustrate is how tariffs benefit the few at the expense of many. Chart 1 shows the share of employment in the steel and aluminum producing sectors by country. According to the Bureau of Labor statistics, there are nearly five times as many people employed in the vehicle sector as there are in the steel and aluminum industries combined.

Chart 2[1] maps how exposed different parts of the country are to the higher costs associated with the steel and aluminum tariffs. Our measure of "exposure" does not include the damage done to shipping, trucking, and rail industries. It also fails to capture the larger impact that tariffs are likely to have on overall consumer inflation when price levels are already poised to accelerate. Those initial effects will likely be small but are highly contingent on who is and who is not included in the tariff as well as the extent to which other countries retaliate.

Chart 1: Tariff Industry Employment Shares

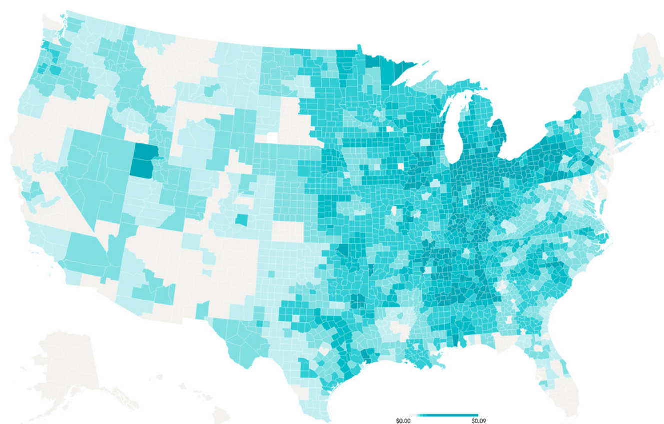


Source: IPUMS/American Community Survey 2012-2016 5-Year Sample.

A rapid escalation

The European Union (EU) has threatened to place tariffs on everything from Harley Davidsons to bourbon and peanut butter. (Most European's I know don't even like peanut butter.) This initial move was designed for maximum political effect - targeting key employers in the home states of Republican leaders - and minimum economic impact. This is at the same time foreign firms, which had plans to invest and expand in the U.S., are threatening to cancel large projects.

Chart 2: Downstream Exposure To Tariff Industries



Source: IPUMS/American Community Survey 2012-2016 5-Year Sample and 2007 BEA Detailed Input-Output Tables.

Canada and Mexico are not likely to sit idle if their temporary waivers are not extended. Much depends on whether the administration yields on their requests for concessions on NAFTA negotiations. There are no NAFTA negotiations scheduled during the waiver period, and it is unclear whether Canada and Mexico would bow to the administration on NAFTA even if there were. Both countries have begun bilateral negotiations with each other as a hedge if (when?) NAFTA fails. Mexico also faces elections in July, where backlash to the U.S. will play a central role.

Work done by Oxford Economics suggests that a repeal of NAFTA would shave 0.5% from growth in the U.S., 0.6% from growth in Canada, and 0.9% from growth in Mexico its first year. Fiscal stimulus would initially cushion the overall blow to the US economy, but leave us with less growth and even more debt when we are done.

[1] In chart 2 we ask, "What areas are most exposed to steel and aluminum?" To answer this question we took the mean of industry exposure to steel and aluminum for each county and weighted it by the mean share of workers in each industry in that county.

China, which was the original target of tariffs, will not be hurt much by the actual tariffs. Chinese firms affected by anti-dumping tariffs have already curbed their exports of steel and aluminum to the U.S. fairly dramatically. China isn't even among the U.S.'s top ten sources of foreign steel. While China has the capacity to produce at least half of the world's demand for steel and aluminum, it sells the vast majority in non-U.S. markets.

That won't stop the country from retaliating. Agriculture will be China's first target, as they can easily get what they need from farmers in other countries.

A more protectionist agenda

Peter Navarro has seized the president's agenda on trade now that Gary Cohn has departed. He is a protectionist who has a reputation for discarding data and facts. In one interview following the tariff announcements on Bloomberg, he said "This [protectionism] is the president's vision. My function, really, as an economist is to try to provide the underlying analytics that confirm his intuition. And his intuition is always right in these matters."

No. The job of an economist is to provide context to better inform the president, not twist the data to fit preconceived biases.

What's next? The administration is not finished with China. They are reportedly assembling a full package of tariffs, sanctions, and limits on investments and visas. Those moves would disrupt everything from retail to real estate. They will also hit higher education, where Chinese students make up a large share of those applying and pay full tuition to attend.

Greg Valliere, Chief Strategist at Horizon Investments warned in a note on March 14 regarding the pending trade war with China that "...there's virtually no chance that Trump will relent - and Congress will not thwart him." China has made many an enemy over the years, especially with its piracy of intellectual property.

Valliere also warned in a tweet that same day that a "Trade war with China looks imminent." He expects China to retaliate this spring.

Tech is most at risk. Next up is the U.S. vehicle industry, which made investments in China well ahead of their foreign competitors. This is all in addition to China's size - it is the world's second largest economy - which means changes there will have ripple effects elsewhere.

Finally, but by no means last, is the fact that China holds about $1.2 trillion in our Treasury debt. Any slowdown in purchases of that debt by China could have a disproportionate effect on interest rates in the U.S. The only deterrent is that any rise in U.S. rate also hits the value of their portfolio. (E.g. They would also pay a price if Treasury yields spiked and the value of those bonds fell.)

Implications for the fed

The Federal Reserve's holding of Treasury bonds are roughly twice that of China. That could provide a cushion against any slowdown in purchases by China. That said, the Fed has worked hard to broadcast to financial markets that its balance sheet will be shrinking in predictable increments. Any deviation from that policy risks roiling financial markets.

Given the loss of Cohn at the White House, it is unclear who will control appointments to the Fed's Board of Governors going forward. Cohn kept the administration from appointing extreme critics to the Fed's Board of Governors; four of the seven seats on the Board are still open. Whoever fills those seats could have a profound impact on the course of monetary policy for years to come.

> "Relations with our closest allies are becoming particularly contentious, which could make U.S. multinationals targets of protests and more retaliation by our counterparts abroad."

“...the tariffs could undermine the very investment that the president had hoped the corporate tax reforms would stimulate.”

Many within the White House remain extremely critical of the Fed’s actions during the crisis. In the interim, the regional Fed presidents who have just rotated onto the voting arm of the Fed - the Federal Open Market Committee (FOMC) - favor more rate hikes than their predecessors last year.

Chairman Powell is widely expected to raise rates at his first policy meeting March 20-21. That hike is prompted by a more bullish forecast on the overall economy and the prospects for inflation. All members of the Federal Reserve System, including more dovish presidents, have upped their forecasts for the 2018. Tax cuts and a surge in federal spending are the primary reasons for these upward revisions.

The Fed’s most recent Beige Book, which provides the Fed with real-time color on the economy, showed the strongest reports on wage gains since before the crisis. This, coupled with anecdotal reports from our clients and across industries, suggest that we are close to a tipping point on wages.

The larger issue is how the White House reacts as rate hikes have more of a bite. One would be hard-pressed to find a president who welcomed rate hikes as the economy was accelerating. There is no reason to expect this administration will be any different. To the contrary, the president actually ran on an anti-Fed platform, which could easily reemerge as the Fed gets more aggressive.

This, coupled with the incredible control the administration has over Fed appointments, could actually change the course of policy. Nixon was the last president to intervene on monetary policy; he wanted to stimulate to ensure his chances at a second term in 1972. The result helped to seed the stagflation of the 1970s.

Bottom line

We are in a tinderbox of tensions with regard to trade, making a full-blown trade war more likely. Fiscal stimulus should offset some of the near-term drag associated with tariffs and escalating trade tensions. It will not compensate, however, for the blow to the economy should a full-fledged trade war break out. Worse yet, the loss in growth associated with a trade war would further up the costs and the rise in federal deficits and debt associated with recent fiscal stimulus. Much like a family torn apart by warring factions, or even one bad player, everyone loses.

Economic forecast — March 2018

	2017	2018	2019	2017:4	2018:1	2018:2	2018:3	2018:4	2019:1	2019:2	2019:3	2019:4
National outlook												
Chain-weight GDP[1]	2.3	2.8	2.7	2.5	2.1	3.2	3.3	3.4	2.8	2.4	2.08	1.15
Personal consumption	2.7	2.8	2.5	3.8	2.2	3.0	2.7	2.7	2.5	2.4	2.33	2.12
Business fixed investment	4.7	5.2	6.5	6.6	2.4	4.9	7.3	7.8	7.2	5.9	5.34	3.37
Residential investment	1.8	1.5	1.8	13.0	-5.6	7.1	2.5	2.3	1.1	0.0	2.02	2.02
Inventory investment	13.3	64.3	77.5	8.0	54.2	57.2	68.5	77.1	81.1	81.6	76.45	70.95
Net exports	-621.4	-713.2	-778.6	-652.2	-688.8	-705.6	-721.2	-737.2	-754.3	-770.7	-789.08	-800.13
Exports	3.4	4.1	6.3	7.1	1.4	3.8	6.2	6.7	6.3	6.5	6.44	6.19
Imports	3.9	6.4	7.0	14.0	6.3	5.3	6.9	7.3	7.1	7.1	7.27	6.07
Government expenditures	0.1	1.9	1.8	2.9	1.0	2.8	2.8	3.0	2.2	1.4	0.78	-3.12
Federal	0.2	3.3	2.5	3.3	0.6	6.6	5.4	5.2	3.1	1.6	0.2	-9.38
State and local	0.1	1.1	1.3	2.7	1.3	0.6	1.2	1.6	1.6	1.3	1.14	0.9
Final sales	2.4	2.5	2.7	3.3	1.0	3.1	3.1	3.2	2.7	2.4	2.2	1.27
Inflation												
GDP deflator	1.8	2.0	2.3	2.3	2.5	1.2	2.1	2.2	2.5	2.5	2.53	2.66
CPI	2.1	2.2	1.5	3.3	3.4	0.9	2.0	0.9	1.0	2.0	2.08	3.01
Core CPI	1.8	2.3	2.2	2.2	3.0	2.3	2.0	2.1	2.2	2.3	2.34	2.45
Special indicators												
Corporate profits[2]	7.6	5.2	0.8	7.6	10.7	11.9	9.0	5.2	4.8	3.5	2.35	0.79
Disposable personal income	1.2	3.0	4.1	1.1	5.2	2.9	3.8	4.3	5.9	3.4	3.02	2.12
Housing starts (mil.)	1.2	1.3	1.3	1.3	1.3	1.3	1.3	1.4	1.4	1.3	1.35	1.34
Civilian unemployment rate	4.4	3.9	3.4	4.1	4.1	4.0	3.9	3.6	3.3	3.4	3.38	3.56
Total nonfarm payrolls (thous.)[3]	2171.7	2705.7	2069.1	551.3	593.5	621.4	751.6	739.2	750.7	616.5	368.74	333.19
Vehicle sales												
Automobile sales (mil.)	6.3	5.8	5.6	6.3	5.9	5.9	5.7	5.7	5.7	5.6	5.5	5.5
Domestic	4.5	4.2	4.0	4.6	4.2	4.2	4.1	4.1	4.1	4.0	4	4
Imports	1.7	1.6	1.6	1.7	1.7	1.7	1.6	1.6	1.6	1.6	1.5	1.5
Lt. trucks (mil.)	10.9	11.1	10.4	11.5	11.5	11.2	11.0	10.9	10.6	10.5	10.4	10
Domestic	9.0	9.1	8.6	9.4	9.3	9.1	9.0	8.9	8.7	8.6	8.6	8.3
Imports	1.9	2.1	1.8	2.1	2.2	2.1	2.0	2.0	1.9	1.9	1.8	1.7
Combined auto/Lt.truck	17.1	16.9	16.7	17.8	17.3	17.1	16.7	16.6	16.3	16.1	15.9	15.5
Heavy truck sales	0.4	0.5	0.5	0.4	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.4
Total vehicles (mil.)	17.5	17.4	16.4	18.2	17.7	17.6	17.2	17.1	16.8	16.6	16.4	15.9
Interest rate/yields												
Federal funds	1.0	1.9	3.2	1.2	1.4	1.7	2.0	2.5	2.8	3.1	3.38	3.38
10-year treasury note	2.3	3.1	3.8	2.4	2.8	2.9	3.1	3.4	3.6	3.7	3.8	3.9
Corporate bond BAA	4.4	4.8	5.5	4.3	4.4	4.6	4.8	5.1	5.3	5.5	5.61	5.8
Exchange rates												
Euro/Dollar	1.1	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.21	1.21
Dollar/Yen	112.1	108.5	104.5	112.9	109.7	109.1	108.1	107.2	106.2	105.0	103.96	102.94

1. In 2016, GDP was $16716.164 billion in chain-weighted 2009 dollars.
2. Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.
3. Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding

Grant Thornton

GT.COM

"Grant Thornton" refers to Grant Thornton LLP, the U.S. member firm of Grant Thornton International Ltd (GTIL), and/or refers to the brand under which the GTIL member firms provide audit, tax and advisory services to their clients, as the context requires. GTIL and each of its member firms are separate legal entities and are not a worldwide partnership. GTIL does not provide services to clients. Services are delivered by the member firms in their respective countries. GTIL and its member firms are not agents of, and do not obligate, one another and are not liable for one another's acts or omissions. In the United States, visit grantthornton.com for details.

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd