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Cross Currents in Trade

Muddled 2019 Outlook

Diane C. Swonk, Chief Economist

Trade tensions flare and recede by the day. Last week the president threatened an additional $267 billion in tariffs on Chinese goods. That is in addition to the $50 billion in tariffs already levied against China and an additional $200 billion in the hopper. Tensions receded a bit this week when China tried to reassure U.S. businesses with facilities there that they would not be subject to retaliation. A day later, Treasury Secretary Steve Mnuchin proposed reopening trade talks with China, which some view as the U.S. blinking.

What people often forget about trade is that trade law is inherently complex. It even makes tax law look like a cake walk. Negotiations take time and need consistency to agree on treaties that do not create new conflicts down the road. Add the unique strategy that the current administration has taken and the road ahead appears littered with potholes.

China represents low-hanging fruit as a target in this election year. Republicans and Democrats alike are enraged by the country's widespread theft of intellectual property including military secrets. Veteran trade negotiators are not convinced the administration's strategy will stop those infractions but it creates a rare, unifying cry all the same.

This issue of **Economic Currents** takes a closer look at where we are on trade policy, the hurdles we face in getting major agreements ratified and what it all means for the economic outlook. Shifts in trade tend to accrue over time. Companies hedge against the initial costs of tariffs by stockpiling what they can. They are often limited by fixed-price contracts, which determine how much of the higher input costs they can pass on to their clients.

Solid Second Half

Our forecast has real GDP slowing slightly from the average 3.1% pace of the first half of the year. The stockpiling stimulated by fears of tariffs is expected to play out, which means the trade deficit will widen significantly. Soybean exports surged in 2Q ahead of retaliatory tariffs by China.

Consumer spending will remain solid as wages gain traction. Housing has stalled. Business investment is expected to slow, but remain a driver of growth. Tax cuts disappointed on the investment front; most went toward stock buybacks and dividend payouts. The incentives to invest will kick in later in the cycle, but then we will also be dealing with higher interest rates. Government spending is the star, with big increases in federal spending adding to smaller gains at the state and local levels. Pension obligations are crimping state and local budgets even among the most fiscally sound.

Hurricane Florence: As of this writing, the hurricane has yet to hit land. The damage from flooding will be greatest; that is the hardest to recover from given limits to flood insurance. Parts of Houston remain devastated.

Fed Hikes in September

A September rate hike by the Federal Reserve is a foregone conclusion. Recent increases in wages and inflation continue to support our call for a fourth rate hike in December. Even the most dovish of Fed Governors, Lael Brainard, now supports more rate hikes.

The uncertainty surrounding the ability to move goods, people and ideas across borders smoothly has a price. Multinational firms need to know what they can and cannot do in a given market before they execute on large bets.

Current Status

Tables 1 and 2 show the status of tariffs and retaliatory tariffs, current on the date of publication. The list has been growing but not yet reached full potential. The hope of most executives I know is that the administration is using strongman tactics as a negotiating tool, rather than a means to an end. What we have seen so far suggests otherwise; there is a clear effort and intent by this administration to curb imports. National Economic Council Chair Lawrence Kudlow is one of the few dissenting voices.

> "The uncertainty alone has a cost that undermines trust..."

Kudlow, known as a free trader, has said the administration's goal is to eliminate all tariffs and subsidies to make trade more free and open. His view, along with his pledge to move forward in such a way, was abruptly vetoed by the president when he left trade meetings with the Group of Seven (G7) nations (Canada, France, Germany, Italy, Japan, the U.K. and U.S.) in June without signing a pledge to do that. That left Kudlow with egg on his face, and quickly escalated into an international incident after one of the administration's most strident protectionists, Peter Navarro, insulted the host of the meeting, Canadian Prime Minister Justin Trudeau. In response, Canada pulled out of NAFTA negotiations, costing valuable time with the clock ticking.

The president sent a loose outline of an agreement with Mexico to Congress on August 31. That gives Congress a 90-day deadline to ratify the agreement. The problem is that NAFTA is a trilateral agreement so it cannot technically be ratified without Canada. Canada has rejoined negotiations but is understandably skittish.

What little we know about the NAFTA outline with Mexico suggests it is more regressive than progressive on trade. Boosting wages in Mexico and increasing North American content to 75%, up from 62.5% for vehicles, would force major changes in the supply chain, boost production costs and prompt some producers to shift production to larger markets with more growth potential such as China. Both BMW, the largest vehicle exporter in the U.S., and Ford have already made such decisions. There appear to be side agreements on quotas for the number of vehicles that can come into the U.S. tariff-free from Mexico (regardless of content). That would further increase costs for consumers and producers.

Then there is Congress. Members will likely face backlash from several states and industries on new rules. That would further delay passage of a new NAFTA agreement and up the ante on retaliatory tariffs and supply chain disruptions.

Bilateral Focus

Further complicating matters is the administration's preference for bilateral instead of multilateral agreements. The downsides are numerous with the most obvious being separate negotiations on different sets of rules for each trade partner. That increases costs and the regulatory burden for companies that trade with more than one country and for those that supply multinational firms.

Table 1. Tariffs Enacted by the U.S. Since 2017

Target	Main Items	Date Effective
World	Solar Panels and Washing Machines	10/31/17
Canada	Softwood Lumber	1/3/18
World	Steel and Aluminum	3/23/18
China	Machinery, Mechanical Appliances, Electrical Equipment and Chemicals	7/6/18 ($34B); 8/8/18 ($16B)

(Table 1.) Tariffs on an additional $200B in Chinese imports could be imposed in the near future (mid- to late-September). Tariffs on automobile imports under Section 232 are currently being considered but the scope and timing are in flux. The U.S. has indicated that it would be willing to place tariffs on all Chinese imports not covered by other duties imposed in the last year.

(Table 2.) China is prepared to impose an additional $60B in duties on U.S. exports if the U.S. follows through on its threat of $200B in additional duties on Chinese products.

All tariffs listed are as of 9/12/18.

Table 2. Retaliatory Tariffs Enacted on U.S. Exports

Retaliator	Main Items	Date Effective
China	Steel, Aluminum and Agricultural Products	4/2/2018
China	Sorghum	4/18/2018
Mexico	Steel and Agricultural Products	6/5/18; 7/5/18
Turkey	Agricultural Products, Coal, Machinery and Petrochemical Products	6/21/18
EU	Steel, Aluminum and Agricultural Products	6/22/18
Canada	Steel and Aluminum	7/1/18
China	Steel, Aluminum and Agricultural Products	7/6/18 ($34B); 8/23/18 ($16B)
Russia	Industrial Machinery	7/6/18
India	Agricultural Products	9/18/18

Another problem with bilateral agreements is enforcement. Agreements between two countries are inherently easier to break than multilateral treaties, which can bring the wrath of the crowd rather than the individual into the equation. One of the advantages of the Trans-Pacific Partnership Agreement (TPP) was how it isolated China on intellectual property infringements. TPP included updates to NAFTA to protect intellectual property; we lost those when we abandoned the treaty at the start of 2017.

South Korea

The only trade agreement the administration has successfully negotiated to date is the recently signed treaty with South Korea. Korean producers avoided tariffs on vehicles and parts by accepting quotas on steel and aluminum. Quotas constrain supply at levels below demand for a few well-connected Korean firms, which raises prices for U.S. buyers and ultimately hurts profits. With quotas, we do not receive the tax revenues associated with tariffs.

It is one reason that Japanese quotas on vehicles in the early 1980s were called voluntary. A few of the largest and most influential Japanese producers were able to offset any drop in sales by charging higher prices to U.S. consumers. The results boosted profits per vehicle for those privileged manufacturers and encouraged preferential treatment.

Likely Outcomes

Following trade policy in the current environment is maddening. The terms can literally change by the hour. The uncertainty alone has a cost and undermines trust among the U.S.'s closest allies.

Our forecast assumes a preliminary NAFTA deal by year-end and avoiding additional trade conflicts with the European Union (EU) and Japan. EU negotiators have expressed optimism about achieving an outline by November. The fly in the ointment is the protectionism dominant in the administration, which could lead to another reversal.

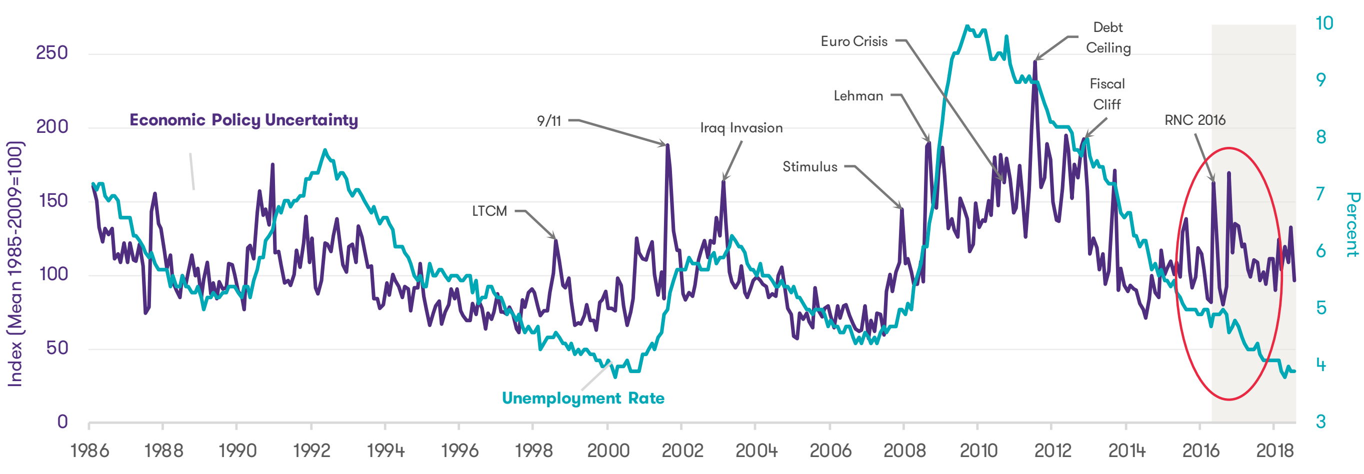
China is another story. The result is hitting U.S. farmers the hardest. Most of the initial tariffs hit specific inputs in the supply chain, including chemicals used to prevent mold on wall board. That will further bid up construction costs at a critical time with another hurricane bearing down on the East Coast. Moreover, many of those inputs subject to tariffs are no longer produced in the U.S., which is squeezing margins in the manufacturing sector.

An additional $200 billion in tariffs is in the pipeline, which will raise prices on consumer goods. They have already triggered backlash and warnings from electronics producers and major retailers.

Our forecast assumes $250 billion in tariffs on Chinese imports by the fourth quarter but the effects should not last long. The question is whether we see retaliation. The situation is extremely fluid but China appears to be softening its stance on how far it will go to target U.S. firms operating in China.

The bet is that we avoid the additional $267 billion in tariffs that the president has threatened, given the cost to both economies. The backlash from U.S. businesses has already been swift and significant. A new coalition spanning nearly every sector of the economy is protesting existing and pending tariffs. That said, nothing can be fully discounted given the personalities involved in trade policy.

Chart 1. Unprecedented Uncertainty
Economic Policy Uncertainty and Unemployment, 1985-2018



Source: BLS and Baker, Bloom, and Davis (2012)

Uncertainty

The chart plots the Economic Policy Uncertainty **Index** against the unemployment rate. Uncertainty is at an unprecedented high given how low unemployment has fallen. This is typically a stage in the cycle when firms feel more certain and reassured by prospects for growth. The only period that comes close was the late 1990s when crises rocked financial markets but were quickly resolved. That marks a sharp contrast to what we are facing today.

Escalating trade tensions are driving the recent surge in uncertainty. The greatest toll will be on investment. A recent **survey** by the Federal Reserve Bank of Atlanta revealed that roughly 20% of all firms were revising down their plans to invest in response to escalating trade tensions in July; nearly one-third of respondents in manufacturing, retail and transportation were cutting investment plans. Moreover, that survey was taken before additional threats of tariffs in August and early September.

We expect the blow to investment to occur in 2019 as firms have already made plans for this year. That parallels what we saw following the Brexit vote. It took time, more than a year, before uncertainty stemming from the vote showed up in limits on investment.

Now losses are compounding as firms hedge their bets by shifting operations and investment to the eurozone from the U.K. to ensure rules on the flow of goods, people and ideas. The ways that countries retaliate, by targeting specific companies with tariffs and business disruptions, are among the hardest to capture in an economic model. The initial effects are small but compound over time.

It is unclear what emerging trade pacts will look like, even if a major trade war is averted. Preliminary results on Korea and the current negotiations with our NAFTA partners suggest that any new treaties will include more limits on imports, which will add to, instead of reducing, trade frictions.

Bottom Line

Trade is one of the greatest threats to the near-term economic outlook. It is also one of the most fluid and difficult shifts to predict. What we do know is that protectionists appear to be winning over the few free traders left in the administration. Any agreements reached over the next year or so are likely to include more curbs on imports than in the past. That ups the ante on retaliation and uncertainty surrounding trade policy for some time to come. Uncertainty alone has a price. Ask British businesses.

Economic forecast — September 2018

	2017(A)	2018	2019	2017:4(A)	2018:1(A)	2018:2(A)	2018:3	2018:4	2019:1	2019:2	2019:3	2019:4
National Outlook												
Chain-Weight GDP*	2.2	2.8	2.4	2.3	2.2	4.2	2.9	2.6	2.0	2.1	2.0	2.0
Personal Consumption	2.5	2.5	2.3	3.9	0.5	3.8	2.7	2.2	2.1	2.1	2.1	2.1
Business Fixed Investment	5.3	7.1	3.9	4.9	11.5	8.5	3.7	6.4	2.8	2.7	2.6	2.5
Residential Investment	3.3	0.0	0.6	11.1	-3.4	-1.6	-3.1	0.5	0.3	1.2	3.5	4.4
Inventory Investment	19.1	22.3	61.3	13.7	25.8	-22.9	40.4	46.1	54.3	64.7	64.1	62.0
Net Exports	-713.7	-751.7	-825.3	-748.6	-751.0	-698.4	-765.2	-792.2	-808.3	-821.8	-831.4	-839.9
Exports	3.0	4.4	3.9	6.6	3.6	9.1	-1.9	3.3	4.1	4.6	5.4	6.9
Imports	4.6	4.6	5.4	11.8	3.0	-0.4	7.6	6.1	5.2	5.2	5.2	6.2
Government Expenditures	-0.1	1.8	2.2	2.4	1.5	2.4	3.4	3.5	2.0	1.4	1.1	0.8
Federal	0.7	3.6	4.4	4.1	2.6	3.7	8.1	8.0	4.7	2.2	1.1	0.1
State and Local	-0.5	0.7	0.8	1.4	0.9	1.6	0.7	0.9	0.3	1.0	1.2	1.3
Final Sales	2.2	2.8	2.2	3.2	2.0	5.3	1.4	2.5	1.9	1.9	2.0	2.0
Inflation												
GDP Deflator	1.9	2.3	2.4	2.5	2.0	3.0	2.1	2.6	2.4	2.2	2.3	2.2
CPI	2.1	2.6	2.4	3.3	3.5	1.7	2.3	3.1	3.2	2.0	1.4	1.8
Core CPI	1.8	2.2	2.4	2.2	3.0	1.8	2.5	2.5	2.6	2.5	2.3	2.0
Special Indicators												
Corporate Profits**	3.3	6.8	3.5	3.3	5.9	7.7	7.0	6.8	6.6	4.0	4.9	3.5
Disposable Personal Income	2.6	2.8	2.3	2.3	4.5	2.5	2.3	1.2	2.6	2.4	2.8	2.8
Housing Starts (mil.)	1.2	1.3	1.3	1.3	1.3	1.3	1.2	1.3	1.3	1.3	1.3	1.3
Civilian Unemployment Rate	4.4	3.9	3.6	4.1	4.1	3.9	3.8	3.6	3.6	3.6	3.6	3.7
Total Nonfarm Payrolls (thous.)***	2176.7	2509.6	1433.3	556.3	632.3	647.7	624.6	605.0	457.4	383.5	319.6	272.8
Vehicle Sales												
Automobile Sales (mil.)	6.3	5.4	5.0	6.2	5.7	5.5	5.2	5.2	5.1	4.9	4.9	4.9
Domestic	4.6	3.9	3.6	4.5	4.1	3.9	3.8	3.8	3.7	3.6	3.6	3.6
Imports	1.7	1.5	1.3	1.7	1.6	1.5	1.4	1.4	1.4	1.3	1.3	1.3
Lt. Trucks (mil.)	10.9	11.6	11.2	11.5	11.5	11.8	11.5	11.5	11.3	11.2	11.0	11.1
Domestic	9.0	9.4	9.1	9.4	9.3	9.5	9.3	9.3	9.2	9.1	9.0	9.1
Imports	1.9	2.2	2.1	2.1	2.2	2.3	2.2	2.2	2.1	2.1	2.0	2.0
Combined Auto/Lt.Truck	17.2	17.0	16.1	17.7	17.2	17.3	16.7	16.7	16.4	16.1	15.9	16.0
Heavy Truck Sales	0.4	0.5	0.4	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.4
Total Vehicles (mil.)	17.6	17.4	16.5	18.1	17.6	17.8	17.2	17.2	16.9	16.6	16.3	16.4
Interest Rate/Yields												
Federal Funds	1.0	1.8	2.8	1.2	1.5	1.7	1.9	2.3	2.4	2.7	3.0	3.1
10-Year Treasury Note	2.3	2.9	3.2	2.4	2.8	2.9	2.9	3.0	3.2	3.2	3.3	3.3
Corporate Bond BAA	4.4	4.8	5.1	4.3	4.5	4.8	4.9	5.0	5.1	5.1	5.2	5.2
Exchange Rates												
Euro/Dollar	1.1	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Dollar/Yen	112.1	110.1	109.1	112.9	108.3	109.1	111.5	111.6	110.5	109.3	108.7	107.8

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.