Trade Wars and their impact on the markets

"What generates war is the economic philosophy of nationalism: embargoes, trade and foreign exchange controls, monetary devaluation, etc.
The philosophy or protectionism is a philosophy of war."
- Ludwig Von Moses, American Economist, 1881

"When a country (USA) is losing many billions of dollars on trade with virtually every country it does business with, trade wars are good, and easy to win. Example, when we are down $100 billion with a certain country and they get cute, don't trade anymore-we win big. It's easy!"
- Donald J. Trump, President, USA, 2018

130 years later, the statement has a distinct resonance. In the background of these statements, let us examine what trade wars are, the recent trade wars happening around the globe and their impact on the markets.

What is a Trade War?

A trade war takes place when a nation imposes tariffs on imports and foreign countries retaliate with similar forms of trade protectionism. As it escalates, a trade war reduces international trade.

HOW MUCH LONGER WILL THEY CARRY HIM?
Montreal Weekly Witness, 7 October 1925

How does it start?

A trade war starts when a nation attempts to protect its own domestic industry and create jobs. In the short run, it may work since the domestic industry is protected from external competition. But in the long run, a trade war costs jobs and depresses economic growth for all the countries involved. The domestic industry stops innovating and as a result, growth slows down.

The US Trade War with China – Sequence of events

Jan 22, 2018
- President Trump imposed tariffs and quotas on imported Chinese solar panels and washing machines
- The World Trade Organization ruled that the United States didn't have a case in levying the tariff.

Mar 08, 2018
- Trump asked China to develop a plan to reduce the $375 billion U.S. trade deficit by $100 billion

Mar 26, 2018
- The US levied tariffs on $60 billion of imports from China. It also said it would limit U.S. technology transfers to Chinese companies.
- China responded by announcing tariffs on $3 billion in U.S. fruit, pork, recycled aluminum, and steel pipes.

Apr 03, 2018
- The US announced 25% tariffs on $50 billion in Chinese imported electronics, aerospace, and machinery.
- China retaliated by announcing 25% tariffs on $50 billion of U.S. exports to China within hours. China also cancelled all U.S. soybean import contracts

May 04, 2018
- The Trump administration presented a list of demands to China. It asked China to end subsidies to tech companies, open China to more US investment and to reduce the trade deficit by $200 billion by 2020.

May 15, 2018
- China agreed to import more US goods and remove tariffs on pork imports

May 29, 2018
- The US said it would announce a final list of products to receive tariffs and also announce investment restrictions on Chinese acquisition of U.S. technology

Causes of the US Trade War with China

1. **Trade deficit of the US**
   In 2017, the US exported $130 billion to China and imported $ 506 billion. However, most of the imports were from U.S. manufacturers who sent raw materials to China for low-cost assembly. Once shipped back to the United States, these were considered imports. Thus, the tariffs hurt both U.S. corporations as well as foreign ones.

2. **Unwillingness to pay more for “Made in America”**
   China is the world's No.1 exporter. Its comparative advantage is that it can produce consumer goods for lower costs than other countries can. China has a lower standard of living, which allows Chinese companies to pay lower wages. American companies can't compete with these low costs. This causes a loss of manufacturing jobs for them. However, Americans want these goods for the lowest possible prices. Most are not willing to pay more for "Made in America."

Why the trade war might just be short-lived?

1. **Legal requirements**
   The federal law that President Trump has used to issue a notice seeking public comments for the imposition of 25% customs duty on over 1,300 Chinese items requires his administration to seek “consultations” with China before imposing the levies. The US Commerce Secretary Wilbur Ross said that he expected trade actions between the US and China to lead to a “negotiated deal”.

2. **China to appeal to the WTO**
   The Chinese government said that it would appeal to the World Trade Organisation’s Dispute Settlement Body (DSB) for adjudication. Going by past records, plaintiffs almost always end up on the winning side. This could favour China. The WTO has been majorly ignored by the US so far.

3. **Pressure from within the Republican Party**
   The retaliatory tariffs by China are targeted to hit the US where it hurts, potentially sparking dissent and pressure from domestic lobbies. Agrarian states such as Iowa which had voted for Trump are likely to be hit by the tariffs. Indications are that the build-up of pressure within the Republican Party itself could force Trump’s hand on this issue.

Trump and the EU

In March 2018, Trump announced a 25 percent tariff on steel imports and a 10 percent tariff on aluminium. The tariff was in effect against China, Japan and Russia. Subsequently, Trump exempted South Korea from the steel tariff. In May, the tariff was extended to Canada, Mexico and the EU. Canada is the largest source of U.S. steel imports and Mexico is the fourth largest. In June, the EU retaliated by imposing tariffs on $3.2 billion of American products. It targeted imports like bourbon, motorcycles, and orange juice.

Trump and India

The increased duty on steel and aluminium products have a tariff implication of $241 million against India (effective from August 2018). In June 2018, India said that it would retaliate back by increasing duties on 29 products including American walnuts, apples, motorcycles and some stainless-steel products. The collection from this is expected to be around $239 million.

How did the markets react to the trade war?

The Chinese Markets: Every major Chinese EFT is underperforming the S&P 500. MSCI China (MCHI) is down 6.74%, FTSE China (FXI) is down 10.45%. As against this, the S&P 500 is up 1.6% year-to-date. The Chinese currency depreciated to 6.60 against the dollar. The previous period of depreciation was in 2016 when the exchange rate reached 6.96. This mainly reflected capital outflows from China. Equity markets reacted negatively then to the weaker Yuan in the past and are likely to do so again.

The US Markets: In April the US markets reacted negatively, with the Dow Jones industrial average closing 572 points down. However, the markets soon corrected. NASDAQ has gone up by nearly 9% this year. One possible explanation is that Trump's trade agenda is cooling an economy that was on the verge of overheating from Trump's tax cuts. That in turn has eased fears of runaway inflation that would force the Federal Reserve to aggressively raise interest rates.

The map below shows how equity markets from around the world have responded to 29 seperate "trade-war events" dating back to the beginning of 2016. The lower panel shows the maximum peak-to-trough impact for each event, while the color indicates the size of the impact from bright green (the anticipated market move didn't materialize) to bright red (the maximum move).

		Directly exposed to threatened tariff hikes			At risk from escalation		At risk from trade and financial spillovers					
		US	China (% fall)	Mexico	S. Korea	Taiwan (% fall)	Japan	Hong Kong	Australia	Germany (% fall)	France	UK
	AVERAGE IMPACT	0.9	1.0	0.6	0.8	0.9	1.4	1.3	0.7	1.1	1.0	0.8
	MAX IMPACT	4.6	6.1	3.4	3.2	6.5	7.2	6.2	4.8	4.2	3.8	4.0
2016	7 Jan	3.4	6.1	3.4	1.1	1.7	2.7	3.1	2.5	3.6	3.3	2.5
	26 Sep	0.9	1.5	1.1	0.3	1.0	1.3	1.6	0.5	2.5	2.0	1.5
2017	23 Jan	0.3	0.0	0.0	0.0	0.0	1.8	0.0	0.7	0.7	0.6	0.6
	31 Mar	0.4	0.0	0.7	0.2	0.4	0.8	0.8	0.5	0.0	0.1	1.0
	29 Apr	0.2	0.7	0.4	0.2	0.0	0.3	0.3	0.0	0.0	0.1	0.4
	14 Aug	0.0	0.0	0.0	0.0	1.0	1.0	0.0	0.0	0.0	0.0	0.0
	18 Aug	0.2	0.0	0.0	0.3	0.5	1.6	1.1	0.8	1.1	1.2	0.9
	31 Oct	0.0	0.6	1.1	0.0	0.0	0.0	0.3	0.1	0.0	0.0	0.0
	9 Nov	0.5	0.0	1.7	0.4	0.8	1.0	0.0	0.0	1.9	1.7	1.3
	10 Nov	0.1	0.0	1.5	0.8	0.6	2.1	0.1	0.4	0.8	1.2	1.0
2018	22 Jan	0.0	0.0	0.0	0.7	0.0	0.0	0.0	0.2	0.0	0.0	0.2
	5 Feb	4.1	2.1	2.2	2.9	6.5	7.2	6.2	4.8	3.1	3.8	4.0
	16 Feb	0.5	0.0	0.0	0.0	0.0	0.0	0.8	0.1	0.0	0.0	0.0
	17 Feb	0.5	0.0	0.0	0.0	0.0	0.0	0.8	0.1	0.0	0.0	0.0
	1 Mar	1.3	0.4	0.0	1.0	1.1	4.0	0.8	1.5	4.2	3.5	2.1
	3 Mar	0.0	0.9	0.1	2.2	1.3	3.1	3.7	1.3	2.3	2.4	1.4
	4 Mar	0.0	0.9	0.1	2.2	1.3	3.1	3.7	1.3	2.3	2.4	1.4
	7 Mar	0.0	0.5	0.5	0.4	0.4	0.8	1.0	0.9	0.0	0.0	0.0
	8 Mar	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	22 Mar	4.6	3.8	2.1	2.7	1.7	3.6	3.5	2.0	3.4	2.8	1.7
	23 Mar	2.1	4.1	1.8	3.2	1.7	4.5	2.5	2.3	2.6	2.0	0.9
	26 Mar	0.0	1.3	0.0	0.0	0.0	0.0	0.0	0.5	0.8	0.6	0.5
	2 Apr	2.2	1.0	0.6	0.1	0.8	0.8	0.0	0.2	0.8	0.3	0.3
	3 Apr	0.0	0.6	0.0	1.5	0.6	0.5	1.9	0.2	1.1	0.5	0.5
	4 Apr	0.0	0.1	0.0	1.4	0.0	0.0	2.2	0.0	0.4	0.2	0.1
	5 Apr	1.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	6 Apr	2.2	0.0	0.1	0.3	0.0	0.4	0.0	0.0	0.5	0.3	0.2
	16 Apr	0.0	3.5	0.7	0.1	1.4	0.0	2.4	0.0	0.4	0.0	0.8
	20 Apr	0.9	1.2	0.6	0.5	2.5	0.5	1.5	0.2	0.2	0.0	0.0

Source: Oxford Economics/Haver Analytics

Note: Peak falls between business day before trade war event and the day after. Colour-coding signifies size of fall - ranging from bright green (no fall) to yellow (50th percentile) and dark red (maximum fall) - and is based on all countries in the sample. Dates in red constitute the top 10 events based on average falls across countries.

Impact on currencies worldwide:

According to the WTO, the escalation of tariffs could remove 9% of global trade flows which is identical to the drop seen during the 2008-09 financial crisis. The hardest hit areas will be emerging markets and developing economies. Sectors such as agriculture and food processing will witness the maximum impact.

Emerging markets are already under pressure from the Fed interest rate hiking cycle. The tightening policy has favoured the dollar which has appreciated by around 5.5% this year on an index benchmarked against a basket of currencies. This increases inflation in emerging markets and is likely to lead to growth-dampening interest rate hikes. In addition to this, the cost of the foreign currency denominated debt increases, making less money available for government spending.

In the third week of June, most emerging markets currencies were hit. The MSCI Emerging Markets ETF declined by 6%, witnessing a net outflow of $5.39bn.

Potential impact on India

In the short term: A diminished US-China trade engagement could benefit India from a trade perspective. For example, in the case of Soybeans which is one of the key items on the list, there could be a cascading impact in terms of openings for India to enter other markets, according to the Soybean Processors Association of India.

In the long run: A full-fledged trade war will negatively affect India as it will lead to slower growth and higher inflation. The currency as well as certain sectors in the equity market will be negatively impacted.

Impact on interest rates: Within the US, a higher tariff escalates the threat of higher consumer prices which could in turn force the Federal Reserve to raise rates faster than it would have otherwise. The Fed is also slated to pursue its scheduled reversal of the easy monetary policy of the last decade. Even a minor disruption in US financial markets can have major implications for India. The three external risk factors - higher tariffs, rising interest rates, and elevated bond sales come at a time when the domestic banking system is grappling with a renewed stress of bad loans. The Indian economy, especially financial markets, will need to brace for significant volatility and stress from the combined effects of global and domestic challenges.

Impact on equity markets: Higher US rates will lead to outflows from emerging market bonds and equities as American investors will look to chase higher returns in their home. While a surge in domestic inflows is a reassuring factor for Indian equities, higher interest rates do make the option of investors borrowing cheap money in the US and investing in Indian equities significantly less attractive.