

THE VIEW

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US - CHINA TRADE UNCERTAINTY HAS ALREADY COST MORE THAN ACTUAL TARIFFS

- 04 The cost of uncertainty is bigger than the cost of tariffs
- 06 Global trade growth to slow to +3% in 2019, and +2.7% in 2020

EXECUTIVE SUMMARY



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- Trade uncertainty impacted global trade much more than tariffs via three channels: investment (delays in investment plans), consumption (saving rates increased globally) and inventories and prices. We estimate that while US tariffs hampered global trade growth by -0.3pp in 2018, US-led trade uncertainty cost -0.5pp.
- Today the evolution of inventories in the US relative to China, a good advanced indicator of a deterioration in global trade growth, reached a historically high level of 4.5 as per our proprietary indicator. If China and the US fail to find an agreement in Q2, uncertainty would remain and both global trade and global economic growth could slow further. For each two months of trade uncertainty, we estimate the cost to be -0.1pp of global trade growth, and for each four months, -0.1pp of global economic growth.
- Provided that there is an agreement between the US and China in Q2 2019, we expect global trade growth to slow to +3% in 2019, and +2.7% in 2020 as global economic growth decelerates and corporates have little pricing power.



Photo by Unsplash

the cost of US-led trade uncertainty
to global trade

-0.5pp

THE COST OF UNCERTAINTY IS BIGGER THAN THE COST OF TARIFFS

"The biggest issue here is the uncertainty. Uncertainty is causing problems with planning," Sanjeev Gandhi, a member of the board of executive directors at German chemicals firm BASF.

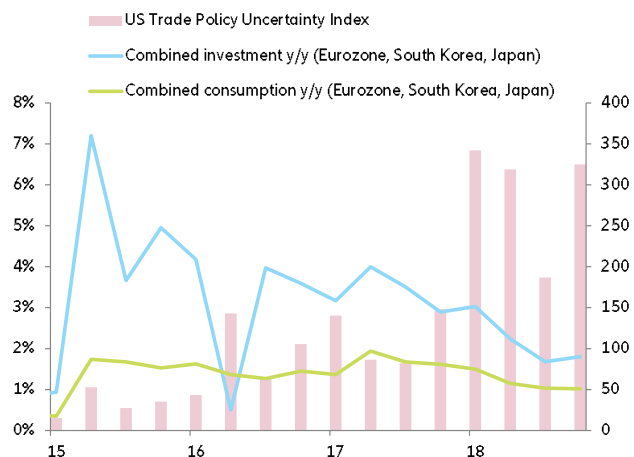
After months of tensions, China and the US reached a trade truce at the end of 2018. While the two countries are working on a way to resolve their disagreements and certain tariffs have been slashed (on cars imported by China from the US for e.g.), global trade growth continues to slow. In 2018, it decelerated to +3.8% (after +5.2% in 2017) and advanced indicators for Q1 suggest more deceleration coming.

This is because remaining tariffs continue to weigh on growth. Secondly, the cost of trade uncertainty is building up. We estimate that while US tariffs hampered global trade growth by 0.3pp, US-led uncertainty cost -0.5pp last year.

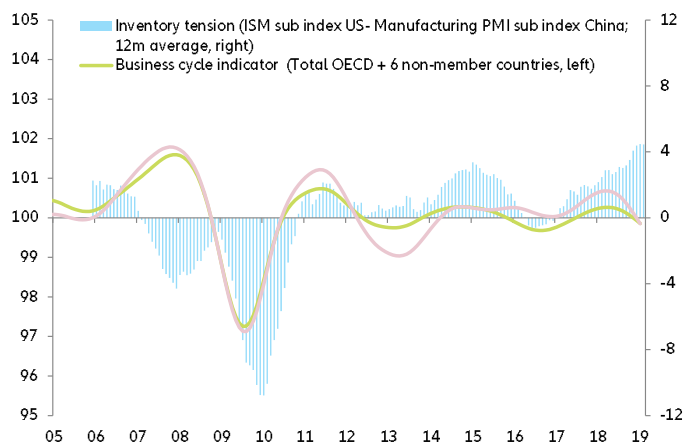
Uncertainty hinders growth through three channels:

- Investment – Companies delay their investments and decisions on hiring while waiting for clarity on the outcome of US-China trade talks.
- Consumption – Consumers increase precautionary savings and delay purchase decisions.
- Inventories and prices - As demand slows and trade barriers increase in the largest economies, the least competitive corporates struggle to sell their goods. This leads to an increase of inventories and a slowdown of production, but also to a vicious circle where corporates start to decrease their prices to be able to sell their goods.



Figure 1 Demand indicators and US Trade Policy Uncertainty Index

Sources: IHS, Euler Hermes, Allianz Research

Figure 2 Inventories and global business cycle

Sources: IHS, Euler Hermes, Allianz Research

Figures 1 and 2 provide an illustration of these three sequences of impact. Figure 1 shows that investment growth in established exports markets (Japan, Germany and South Korea) slowed rapidly, especially in the second half of 2018, as US-led trade policy uncertainty escalated. Consumer spending growth slowed, too, as households envisioned a bleaker future in the wake of rising trade tensions.

Figure 2 shows how the development of inventory imbalances is impacting the global business cycle. To have a proxy of these imbalances, we developed an indicator based on the differential between the inventories built in the US (a less competitive market for merchandise export) and those built

in China (more competitive). This variable is a good marker of global trade disruption, being particularly sensitive to rising economic policy uncertainty.

In a context of weaker growth of global demand and rising trade barriers, less competitive companies (here the US) built up inventories as they could not sell their products, while the most competitive ones (in China) reduced their inventories. Figure 2 shows that the spread between US inventories and Chinese inventories hit its highest level since 2005 in January 2019.

This "inventory glut" has material implications for the global trade outlook. First, it means that corporates will have to scale down their production in the near term and focus on selling

their inventory. It also means that global trade prices will be depressed as corporates will probably use them as a tool to gain competitiveness. China already opened the door on that front. Producer prices have decelerated rapidly since last year and other Asian markets are following suit.



Photo by Unsplash

The size of the inventory glut is a reminder of the need for a US-China agreement as early as Q2 2019

If China and the US fail to sign an agreement in Q2, uncertainty would remain and both global trade and global economic growth could slow further. We estimate that for each two months of trade uncertainty we could lose -0.1pp of global trade growth and for each four months we could lose -0.1pp of global economic growth.

On top of trade-related issues, three factors could further prolong negotiations:

1. Economic and political influence: Both markets are looking for political and economic influence even though they are not at the same stage. And while the US is gradually withdrawing from its role of provider of public goods, China is gradually trying to fill the void with new propositions of multilateralism (Belt and Road Initiative) and a new model of growth.
2. Non-compliance by China to US demands: China will likely make concessions (i) on trade by offering to buy more US goods and (ii) on investment flows by opening its market further. Yet, it is unlikely that these will reverse massively the imbalances that exist between the two countries and solve highly strategic issues (Manufacturing 2025, IP rights, fair treatment).
3. Negotiation fatigue: It has been a year since tensions between China and the US started to escalate. Negotiations have seen several ups and downs and these have led to a strong volatility in global sentiment. The difference of approach (tough stance in the US, more conciliatory tone in China) makes the negotiations difficult. For instance, President Trump's proposition to keep tariffs in place even with a deal in place shows how complicated negotiations could be going forward. It is also hard to believe that China will make concessions without getting anything in return.

GLOBAL TRADE GROWTH TO SLOW TO +3% IN 2019, AND +2.7% IN 2020

We expect global trade growth to slow to +3% and +2.7% in 2019 and 2020. If we break down these numbers in semesters, we see a sharp slowdown in H1 (<2% growth), reflecting continued uncertainties and prevailing tariffs; a normalization in H2 2019, in the 2-4% range, as trade uncertainties wane, and China's stimulus gets tangible impacts and another deceleration in H1 2020 (<3%) as China and the US growth decelerates – we currently forecast a technical recession in the US in Q1 2020.

Emerging markets will likely become the largest contributor to global imports growth in both 2019 and 2020. They will account for 55% of global trade, compared to 45% in 2017-18. The first reason relates to the resilience of Emerging Asia (thanks to China's stimulus) and the gradual recovery in Latin America (as new leadership raises the hope of stronger private demand). The second reason is based on the stabilization (or appreciation) of exchange rates as the Fed

signals a more gradual approach to its tightening cycle. The same dovish Fed may help loosen monetary policies in emerging markets, as price and currency pressures are contained. India cut its policy rate by 25bp in February on the back of lower inflation. Going forward, the likelihood of a rate cut has also increased in markets such as Indonesia and Malaysia.

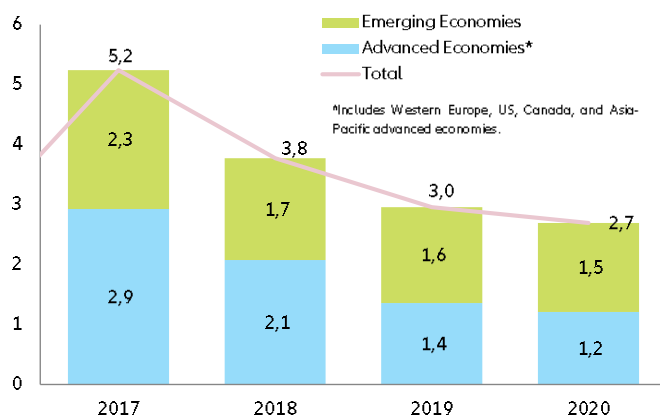
Note that here we assume that China and the US reach an agreement in Q2 2019. This will provide more clarity about the future and help corporates start to reinvest. We also take for granted that China's stimulus will partly offset the cost of uncertainty. Indeed, the equivalent to 5% of GDP in additional fiscal spending, associated with generous monetary conditions will help kick start a mini boom cycle in China and thus boost global trade around +3%.

Though ongoing trade talks could temporarily put an end to fears of a

trade war, it is important to keep in mind that China-US relations have already moved from engagement to rivalry. Hence the need to keep an eye on both: protectionism at-large (beyond trade tariffs, it could be regulatory shocks, for e.g.), and very fragmented (and distended) supply chains, spanning both regions. The car industry is a case in point, cumulating both vulnerabilities.

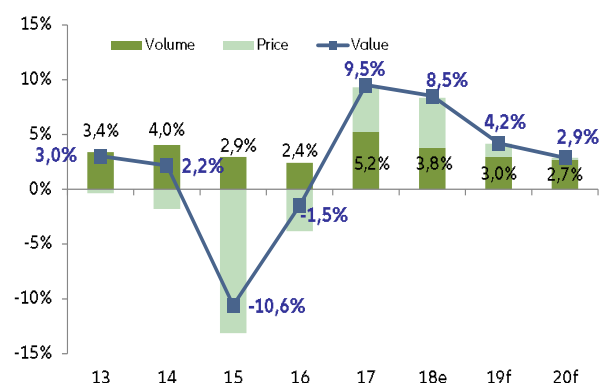
Last, interestingly enough, trade price growth will be limited: we indeed forecast +4.2% growth in value terms in 2019, and +2.9% growth in 2020. Stabilizing commodity prices and a slightly weaker US dollar explains this lack of a price effect in global trade. Microeconomically, we may see stagnating export turnover growth among corporates, as well as a lack of pricing power as they desperately seek to reduce the backlog of inventories that have been built over the past 12 months and re-start a normal production cycle.

Figure 3 Volume of global imports growth (%) with contributors (pp)



Sources: Euler Hermes Calculation

Figure 4 World trade growth (volume and value)



Sources: IHS, Euler Hermes, Allianz Research

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