CHAOTIC TRADE NEGOTIATIONS WILL LIKELY RESULT IN LOWER BARRIERS, BUT AT A COST

- We continue to put a very low probability on a disruptive trade war and consider it to be an overblown risk; we now put a high probability that Trump's disorderly and disruptive negotiating tactics are likely to reduce trade barriers.
- Trump's history as an aggressive New York City real estate mogul and his approach to negotiating captured in his 1987 best-seller The Art of the Deal provide keen insights into his unorthodox tactics, which contrast sharply with the establishment's conventional approach, trade and international diplomacy.
- Trump's initial proposed tariffs on all U.S. imports of steel and aluminum products have been significantly modified and negotiations now focus on China's unfair trade practices. They put major trading nations—China, European Union nations, Japan and others—in a bind, and the most likely outcome will be concessions that lower trade barriers.
- However, these erratic and unpredictable tactics come with a cost: heightened uncertainties and financial market volatility may dampen confidence and weigh on economic performance. Moreover, we believe any progress on reducing trade barriers by these tactics will fall far shy of what would be possible in more conventional multi-national trade agreements.

Putting a positive spin on the trade policy issue sounds crazy and completely contrary to commentary by pundits and the media that focus nearly exclusively on the downside risks of trade wars. However, as negotiations have evolved from President Trump's initial misguided proposed tariffs on all imported steel and aluminum to focus on China's unfair trade practices, we believe the most likely outcome of broader negotiations may even be a reduction in select trade and investment barriers that result in positives for international trade. There are costs: Trump's chaotic deliberations are ruffling many diplomatic feathers and increasing concerns about the U.S.'s reliability add uncertainty to international diplomacy. They are also contributing to financial market turbulence, which may dampen confidence. Unfortunately, the prospects of achieving multi-national agreements are dim: remember, both Trump and Democratic Presidential candidate Clinton aggressively opposed both the TransPacific Partnership (TPP) and NAFTA. Accordingly, trade policy is relegated to trade issues of limited scope, and even if negotiations are successful, their effectiveness is likely to be limited.

Understanding Trump's frame of reference for his trade negotiations and how it is a disruptive and rude confrontation to the conventional, establishment approach to trade provides important insights into current negotiations.

Trump is a deal maker whose frame of reference is New York City's rough-and-tumble real estate market, with little knowledge of the myriad details of international trade or regard for international protocols, and enjoys poking the establishment in the eye. He is not attuned to sensitivities of international diplomacy, and speaks a different language than other international leaders. He holds the media in disdain. And Trump seems to thrive on chaotic negotiations rather than any systematic strategy and juggling many balls at the same time, and does not hesitate to announce initiatives or say things that catch foreigners or even his team off-guard. And he uses leverage to aggressively achieve objectives.

For insights into Trump's behavior with the current trade negotiations (both amusing and irritating) read Trump's The Art of the Deal, a bestseller published in 1987. Apropos

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to the current trade negotiations, the path toward compromise is not straightforward, things aren't always as they seem and literal interpretations are not always appropriate.

Consider Trump's famous statement that “Trade wars are good and we will win”. The establishment and media recoiled in horror with dire prospects of highly disruptive barriers and a collapse in international trade, with frequent references to the Smoot Hawley Tariff Act of 1930 that accentuated the Depression. That response was rational based on a literal interpretation of what Trump said. But Trump's statement—obviously inappropriate and unacceptable in international diplomatic circles—is from the perspective of a dealmaker on his home turf—NYC real estate—in which big deals always involve tough negotiations, brutal confrontations, sometimes nasty public pronouncements and often public lawsuits between peers in the industry.

Global leaders abhor Trump's threat to the trade order—and the way he goes about things. They tout the benefits of international trade and cooperation, even though they quite naturally put their nation's interests first, and strongly defend select trade barriers that protect their coveted industries. There are many examples, too numerous to mention, but France and other EU nations covet barriers that protect their agriculture industries, Canada protects its forestry and dairy industries, China maintains onerous barriers for trade and investment—and the U.S. assesses 25% tariffs on imported light trucks (but not autos).

International leaders also put a high priority on conducting policies through established international organizations like the World Trade Organization (WTO). And above all, they shy away from anything or anybody that may rock the boat or be a threat to commonly-accepted standards of international civility, including orderly debate and dispute resolution through well-established channels.

Trump's tactics are not designed to generate a jarring trade war; although from the establishment's view they are very risky and seemingly threatening a trade war, a consideration of the costs and benefits facing each major trading nation suggest strongly that the actual risks of disrupting trade flows is very low. Most likely, the Trump Administration arrived at this assessment before it started to stir the pot on trade.

While our first instinctive response to Trump's tariff proposal was that higher tariffs are bad policy, we argued that the proposed tariffs on steel and aluminum products would be modified with key exclusions, that retaliation by foreign nations would involve more bark than bite and a damaging trade war would NOT occur, and the economic impact would be modest ("Proposed tariffs, political discord, and markets[berenberg.de]", March 7, 2018). Our biggest economic concern was not major disruptions to trade, rather that trade-related tensions would dampen the elevated levels of confidence that have contributed to solid growth in the U.S., Europe, Japan and globally.

Since then, amid the flood of alarming warnings by commentators on the evils of protectionism and the dire risks of trade wars (fueled by some purposely inflammatory public comments by Trump), Trump's trade proposals have been modified in two critical ways: exemptions have been granted to Canada, Mexico and other nations if they take steps to reduce their own trade barriers to U.S. goods and services or are otherwise supportive of U.S. diplomatic objectives, and the focus of the trade negotiations has shifted to China's unfair trade practices.

The U.S. imports approximately $29 billion of steel products, and under current and proposed exclusions, only $10 billion would be affected by the 25% tariff. The U.S. imports $17 billion of aluminum products and under the exclusions, only $9 billion would be subject to the 10% tariff. These are dwarfed by total U.S. goods imports of $2.4 trillion.

While we absolutely agree with the short-sightedness of protectionism, the evolving thrust of the trade negotiations support this view that the probability of disruptive trade wars is very low. The skeptics view recent positive steps as reducing the potential risks. But instead of considering them as reducing downside risks, is it possible the trade negotiations will result in outright positives?

Despite financial market turmoil, tactical retaliations and widespread fear of trade
disruptions, we now take that positive view, with a decidedly unconventional assessment: while Trump’s approach to negotiating trade policy is incorrectly based on concerns about the U.S.’s bilateral trade deficits with select nations and is extremely unorthodox, the most likely outcome is that:

* China will be forced to tone back some of its unfair trade practices regarding intellectual property and will lower tariffs on select imports, and maybe loosen some of its investment policies, benefitting the U.S., Europe and Japan and others,
* The European Union will agree to lower select barriers to trade in order to exempt its businesses from Trump’s tariffs on steel and aluminum products, and, more broadly,
* What began as “protectionist” tariffs will actually end up reducing some tariffs and barriers, and facilitate continued, if not enhanced, global trade.
* Resulting ruffled diplomatic feathers and heightened uncertainties will impose costs that mitigate any benefits to trade.

The basis for this assessment rests on the importance of international trade for the well-being of the major national trading partners.

**Factors driving compromise.** International trade is extremely important to economic performance and higher standards of living as well as political stability, and global leaders involved in the current negotiations, including China, the European Union and the UK, Japan and emerging nations, fully understand the necessity of maintaining healthy trade relations. The Trump Administration perceives that the U.S. is in a strong position with significant leverage. While it has misguided notions about the importance of bilateral trade imbalances, it is aware of the complex web of trade barriers and anti-competitive constraints imposed by different nations that provide all nations room to negotiate on trade—and ultimately they will be willing to do so.

As such, Trump’s tactical strategy is to put key international trading partners in the awkward situation of negotiating—and be willing to tone down select trade barriers in order to maintain open channels of trade that are necessary for their economic performance.

The objective of China’s leaders, like all effective dictators, is to maintain control over its citizens, and that is facilitated by rising standards of living, which hinges critically on trade. China’s export-related manufacturing sector has been its vital engine of growth and source of tens of millions of jobs and huge gains in income that have lifted 100s of millions of citizens from poverty. China has become the world’s largest exporter of goods. As its overall economy has benefited and grown, China’s goods exports have diminished as a percent of GDP to 18%, but nevertheless remain essential. China relies heavily on advanced nations’ export markets: 19% of its goods exports go to the U.S., 19% to Europe and 6% to Japan. China is also a leading importer of goods and services: its businesses rely heavily on imports of durable goods used in its production processes from Japan, Germany and the U.S., and consumer goods (including autos, foodstuffs) required by an increasingly consumer-oriented society.

In a nutshell, China is very aware of its barriers to trade and investment, understands its unfair treatment of foreigners’ intellectual property, and knows that if pressured, it would tone down some of its more blatant trade practices in order to maintain functioning trade relations with the U.S., Europe and Japan. As an indicator of this, China’s retaliatory threats to the steel and aluminum tariffs are modest—affecting $3 billion of goods that China imports from the U.S.

Overall, for EU nations, the U.S. is their largest export market outside of their member nations (13% share), while its exports to China as well as other Asian nations that rely on China’s growth and trade have increased dramatically. This is particularly true for Germany.

Germany’s exports are 50% of GDP, more than three times higher than the U.S. ratio. Roughly 9% of these exports go to the U.S. and a sizable (7%) but rapidly rising share goes to China. Germany is the world’s third largest exporter of goods (China is the first
and the U.S. is the second largest; the U.S. is the largest exporter of goods and services combined; Charts 1 and 2). Germany is by far the world’s largest exporter of automobiles, and its auto industry is its largest in terms of output and employment. China’s auto sales have soared above U.S. sales—27 million per year versus 17 million—and China’s market is increasingly important to Germany and its manufacturing industries.

In recent decades, as China has grown into an economic powerhouse, it has imposed onerous tariffs on various imports, including a 25% tariff on imported autos. It has required all foreign automakers and other manufacturers in China to operate in joint ventures with Chinese companies (typically government-owned). These joint ventures have funneled large profits to Chinese companies (including State Owned Enterprises) and provided the opportunity for Chinese producers to learn how to manufacture efficiently (through fair practices as well as through copyright infringement and illegally obtaining foreigners’ intellectual property). Germany would love to ease some of these barriers and requirements that impinge on trade and investment.

**Chart 1: Total Value of Goods Exports by Country (in USD)**

![Chart 1: Total Value of Goods Exports by Country (in USD)](chart1.png)

*Source: China Customs, Deutsche Bundesbank, Japan Tariff Association, Japan Ministry of Finance, Census Bureau, Haver Analytics and Berenberg Capital Markets*

**Chart 2: Total Value of Goods Exports by Country (Index, 2000=100)**

![Chart 2: Total Value of Goods Exports by Country (Index, 2000=100)](chart2.png)

*Source: China Customs, Deutsche Bundesbank, Japan Tariff Association, Japan Ministry of Finance, Census Bureau, Haver Analytics and Berenberg Capital Markets*
China has been the international poster boy for unfair trade practices by international standards. Trade representatives of the U.S. and other leading nations have actively tried for decades to open up China's markets and end unfair trade practices. The history of the World Trade Organization, which sets international standards of fairness, is replete with disputes about Chinese violations of intellectual property rights, patent infringements, etc. China was officially admitted as a member of the WTO in 2001, and this has only partially curtailed some of China's most egregious trade practices. Foreign businesses and trade representatives—the U.S.'s and others—have tolerated a certain amount of unfair trade practices because they are perceived to be a necessary cost of access to China's extraordinarily large and growing market. But when pushed, complaints are officially registered with the WTO and by other means.

The Obama Administration's Trade Representative Michael Froman was active and effective, working through the WTO to end some of China's violations of intellectual property and patent laws and other unfair trade practices. To its credit, the Obama Administration added important transparency to the issue. Its initiatives were considered positive because they were conducted through conventional establishment channels. Trump's approach to China, not surprisingly, is more visible, confrontational and outside normal diplomatic channels, and somewhat broader in intent—and certainly less predictable—than the pursuits of the Obama Administration.

The effectiveness of Trump's disruptive negotiations likely will stem from its ability to have stirred the pot on trade policy on many dimensions, and the willingness of other nations to selectively modify their current trade practices—while maintaining their most coveted barriers—in order to maintain open trade channels.

European nations face several dimensions in this challenge. Germany and other EU manufacturing businesses support the U.S.'s efforts to break down trade barriers with China—they could be significant beneficiaries. But European leaders recoil at Trump's aggressive tactics—although they are willing to negotiate trade policy with the U.S. “in good faith”—and they are understandably weary of his unpredictable behavior. But keep in mind that while governments negotiate the rules on trade, it is businesses and households that actually produce and consume the goods and services that are traded, and Europe's leading manufacturers work together with their elected officials and have significant power.

Europe's heavy reliance on international trade will likely lead it to propose select reductions in its tariffs and other trade barriers sufficient to be permanently exempt from the U.S.'s tariffs on steel and aluminum, especially if it is associated with better terms in conducting business with China. Germany, Europe's engine of growth, is a powerful weight in negotiations. But other strong European nations must agree, and they want to protect their own agendas and favorite industries. These differences must be ironed out.

Highest probability outcomes. Disruptive trade wars are highly unlikely, in our view; they would be too costly to all nations and inconsistent with their self-interests. We believe ultimately, some trade barriers will actually be reduced and global trade channels will remain open, and some may be enhanced. On net, what started as a seeming disaster—with Trump's proposed tariffs on all U.S. imports of steel and aluminum—will likely result in modest positives for international trade. Again, gains will be minor compared to what potentially could be accomplished through a broad, multi-national trade agreement, and they are unlikely to generate net new manufacturing jobs in the U.S. As with any big negotiation, there will be winners and losers. Trade policies rely heavily on their details—nuanced definitions of products, volumes and practices—and the effectiveness of any negotiated pact, as well as the winners and losers at the industry level, are determined in the detail.

Moreover, Trump's tactics and behavior come at a cost. When NYC real estate deals are concluded, aggressive buyers can claim victory, without much regard for the also-rans. But things are different for policy leaders. International leaders (with few exceptions) are expected to act diplomatically. International leaders will question the U.S.'s reliability as a friend, and make them tentative in future relations with Trump. The heightened uncertainties are contributing to volatility in financial markets. Whether all
of this jars confidence is uncertain. But a negative impact on spending and investment patterns of private businesses and customers would be a negative.

The biggest downside risk to this outcome is China. If it takes a hard stance against Trump's aggressive negotiating tactics, there could be moderate disruptions to trade. But we believe the probability of this is low, insofar as China's economy would suffer and undercut the enhanced leadership power of Premier Li. Moreover, European leaders quietly support Trump's aggressive efforts to curtail China's unfair trade practices, and China cannot afford any disruption of trade with both the U.S. and Europe.

Another possible outcome would be if the correction in the stock market leads Trump to back off from his trade initiatives. But his history and negotiating strategies—and his pattern of behavior during the unpredictable path toward enactment of the Tax Cuts and Jobs Act—suggest that this is a low probability, in our view.
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