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### TRADE WAR RISK: THE LITMUS TEST AHEAD

#### Berenberg Macro Flash

A transatlantic trade war stoked by US President Donald Trump poses the biggest threat to our modestly positive outlook for global growth and financial markets. His disdain for rules, allies and multilateral institutions sows uncertainty that is bad for business. Beyond their direct costs for consumers and businesses, trade barriers can disrupt supply chains, stifle innovation and lock resources into less productive uses, impairing short-term demand and the long-term supply potential of the economies concerned.

Why are we nonetheless cautiously optimistic that Eurozone growth can rebound to annualised rates around 2% after a modest dent now? In essence, we do not expect Trump to follow up on the worst of his threats and look for businesses to get used to a somewhat elevated level of noise over time. If so, equity markets, bond yields and the euro could rise over time, reflecting positive economic fundamentals. However, if these assumptions are wrong, escalating trade wars could push financial markets into risk-off mode, resulting in a more subdued outlook for equities, lower bond yields and further safe haven flows into the US dollar.

#### THE LITMUS TEST STARTS TODAY

The litmus test could be potential US tariffs on car imports. Today, the US Department of Commerce will host its public hearing on car and car parts imports at which roughly 45 US manufacturers, suppliers and car dealers as well as foreign diplomats will testify. Some time thereafter, the Department of Commerce will rule whether imports of cars and car parts threaten US national security and decide whether to recommend tariffs to the president. Although the Department of Commerce may possibly propose such tariffs, we assume for our base case that Trump would use the threat as a bargaining chip but will not actually implement the levies. However, if the US indeed imposes new tariffs on its annual \$62bn of such imports from the EU, a transatlantic trade war would have started. The EU would retaliate in kind. In such a case we would probably have to delay the projected rebound in Eurozone growth to an above-trend pace of around 2% from late 2018 into 2019, with risks of a temporary dip to a pace below the 1.5% trend beforehand and potentially more lasting damage.

For now, the direct damage from Trumpian protectionism remains very limited. At unchanged import values, the punitive tariffs the US has levied so far on imports from China (a broad range of products worth an annual \$37bn) and the EU (steel and aluminium worth \$7.7bn) would yield US tariff revenues of roughly \$11bn, equivalent to merely 0.05% of US GDP. Trade diversion effects could reduce the total costs, which will be borne largely by US consumers, US importers and by companies along the supply chain of the affected products. What counts more than the direct damage is the outlook and, most importantly, the perception as to how it may all end.

#### PLACING A BET ON WHAT TRUMP MAY BE UP TO

To make economic forecasts in the age of Trump, we have to place bets on what he may do. Judging by his public pronouncements over the decades and his behaviour in office so far, Trump does not understand the most fundamental concept of international economics, comparative advantage. He mistakes bilateral “imbalances” in goods trade as proof of “unfair” trading practices and rails against multilateral institutions such as the EU, NATO and the World Trade Organization (WTO). He seems to have a penchant for “strong men” with whom he can strike bilateral “deals” instead of going through the laborious procedures of forging compromises in complex settings with various partners.



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However, Trump also seems to crave the admiration of others, wanting to present himself as a winner and “master of the deal”. More prosaically, he needs Congress to get a lot of things done. The cross-party resolutions in support of NATO which the two chambers of the US Congress passed in immediate reaction to Trump’s irritating comments at last week’s NATO summit show that he cannot count on full Republican support for all of his disruptive behaviour. More importantly, the verbal turnaround he had to make within a day of his overly cosy meeting with Russian president Vladimir Putin in Helsinki suggests that he reacts to heavy criticism if it comes from the right quarters.

Throwing tariffs at foreign companies who are selling more goods in the US than Trump may be popular with his base. The costs that these tariffs impose on US consumers and businesses are probably too widespread to cause noticeable pain and thus make a major difference to his support. But the targeted retaliation of other countries may hurt more.

This spring, Trump made a major mistake. Taking his “America first” rhetoric as a licence for an “America alone” approach, he apparently rejected a tentative EU proposal to settle any US-EU dispute amicably and jointly take on China over Beijing’s discriminatory practices and its penchant for forced technology transfers. Instead, he is lashing out against China and the EU at the same time, by far the most important trading blocs of the world beyond the US. Their tit-for-tat retaliation against new US tariffs can have visible effects in the US:

- The 20% drop in US soybean prices from their March-to-May 2018 average may have at least as much to do with a general softness in commodity prices than with the 25% retaliatory tariff which China has imposed on soybean imports from the US. Still, it hurts in the heavily Republican US farmbelt. And right or wrong, it can be portrayed as a consequence of Trump.
- A producer of iconic US motorcycles made waves with its announcement to shift production of bikes destined for the EU out of the US to avoid an EU retaliatory tariff. The economic impact would be miniscule. Nevertheless, it has raised awareness that a trade war would hurt identifiable interests in the US.

### **OUR BASE CASE: NO NEW CAR TARIFFS**

For our base case, we assume that actual and potential retaliation by the EU and China will eventually stay Trump’s hand. Today’s Department of Commerce hearing will likely reveal that many US companies involved in the automotive business are against the disruption of supply chains which US tariffs on car and car imports would cause. Opposition in US Congress against the abuse of a “national security” clause to levy US tariffs on car imports from the EU could also help. Instead of imposing these tariffs, we expect Trump to either conclude a deal with China and/or the EU ahead of the US mid-term elections in November to impress his base (25% probability) or at least engage in more serious negotiations while keeping his car tariff threat on hold in the meantime (55% probability).

In both cases, the pervasive fear of escalating trade wars could gradually fade. That would allow Eurozone business confidence and investment intentions to rebound from, say, September onwards on the back of strong underlying fundamentals: In turn, this would pave the way for Eurozone growth to return to an above trend-rate of roughly 2% in late 2018 from the current pace close to the 1.5% trend. Eurozone exports to the US and China look set to rise further this year due to strong US final domestic demand and – to a lesser extent – a modestly undervalued euro exchange rate. Unless mounting trade tensions were to stoke the fear factor again and again, the rise in exports should serve to soothe nerves. We put the risk of a trans-



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atlantic trade war at 20%. With luck, the meeting between Trump and European Commission President Jean-Claude Juncker on 25 July could be the start of a new round of US-EU negotiations.

Of course, predicting US trade policies under Trump is not an exact science. The purpose of the discussion above is more to spell out the assumptions and the rationale underlying our base case than to justify precise probabilities. As political risks encounter solid economic fundamentals, we still look for the fundamentals to prevail in the end.

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