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GLOBAL TRADE: TWO STEPS FORWARD, ONE STEP BACK

Berenberg Macro Flash

Good news at last: the outlines of a surprisingly ambitious US-Chinese trade deal announced last Friday and the reduced uncertainty about the outcome of the Brexit saga in the wake of Thursday's UK election brighten the outlook for global trade and manufacturing next year. For now, these two steps forward more than offset the damage done by the forced removal of the ultimate umpire, the World Trade Organization's appellate body, from the playing field of global trade last Wednesday.

Since September, we have argued that global trade and manufacturing output should bottom out in early 2020 and start to recover gradually thereafter. On balance, last week's events strengthen our conviction that the worst for global trade and the economies most exposed to it could soon be over. If the US-Chinese deal is indeed finalised and implemented, the risks to some of our growth forecasts for 2020 could soon be tilted slightly to the upside.

US-CHINA: MUCH MORE THAN A MERE „PHASE ONE" DEAL

The trade deal which US and Chinese negotiators have drafted is quite ambitious - see Mickey Levy's report The US-China trade agreement – significant structural changes. In two respects, it goes well beyond a mere „phase one" arrangement:

First, the US has not only put the threat to impose new tariffs on imports from China worth an annual $160billion on 15 December on hold. In return for a Chinese promise to buy significantly more agricultural goods as well as energy products, industrial goods and financial services from the US, the US will cut the earlier 15% levy on $120bn of imports from China to 7.5%.

Second, the deal addresses some of the thorny issues of intellectual property, forced technology transfer and transparency. It also contains clear mechanisms to monitor how China complies with its commitments.

Before Trump coined the term „phase one", we would have described such an agreement as a **substantial deal** rather than a mere truce. According to media reports, the legal text to formalize the agreement still needs to be finalised and translated. Both sides have reserved the right to re-impose sanctions if the other side does not comply with the terms of the deal. Still, as we have argued before, both sides should have a political and economic interest to come to and abide by such an arrangement.

The US and China are and will remain geostrategic rivals. But even in the old cold war between the US and the Soviet Union, the two rivals had sometimes struck and then largely complied with deals of mutual interest. After an ambitious deal now, it will be less important whether or not the US and China manage to negotiate a „phase two" deal next year that could cover further difficult issues such as cyber-security.

US-EU trade relations will probably hit occasional snags next year, for instance over the Airbus-Boeing dispute. But as there is much less political support in the US for a trade war against the EU than for taking a tough line against China, we do not expect US-EU trade tensions to escalate to such an extent as to depress business confidence, investment and trade flows.

CONTAINING THE BREXIT DAMAGE

The near-certainty that the UK will formally leave the EU on 31 January does not resolve any of the economic issues between the UK and the EU27. The UK may still drop out of the EU single market and customs union the hard way without a follow-up trade deal at the end of the transition period on 31 December 2020. Nonetheless, the end of the political paralysis in the UK and the clear margin of victory for Boris Johnson should help to mitigate the economic risks.

First, the political clarity will allow both sides to move on. That the key political question, Brexit or no Brexit, has now been settled unequivocally takes some of the venom out of the debate within the UK and between the UK and the EU27. That will leave more room for pragmatic compromises, especially on the UK side.

Second, as Kallum Pickering has argued, Johnson's solid majority in parliament will allow him to sideline the Brexit hardliners in his Conservative Party and conclude a sensible free-trade deal with the EU and/or extend the transition period during which the UK stays in the single market and customs union beyond the end of 2020 if need be.

Third, companies and markets get used to risks over time. They have repeatedly faced the risk of a no-deal Brexit in the last twelve months and guarded themselves against it at least to some extent. The prospect that it might still happen at the end of 2020 will be less disruptive than a hard Brexit would have been the first or second time around.

US DEALS SEVERE BLOW TO RULES-BASED GLOBAL TRADE

With its veto against new appointees for the WTO appellate body, the US has paralyzed the key dispute settlement mechanism for global trade. Since Wednesday, this body has only one rather than the required minimum of three judges.

Of course, global trade will go on almost as normal for the time being. But like in a competitive game of sports, the absence of a neutral referee with the power to enforce mutually agreed rules will matter. The negative effects will be felt over time. A crucial mechanism to restrain protectionist impulses of countries will be missing. This makes it more likely that countries will impose more import restrictions than before. Trump's transactional approach to global trade and his assault on trade rules also adds to the uncertainty which companies face in their decisions about cross-border supply chains.

In the end, the damage to the system of rules-based trade and to global trend growth could be severe unless the dispute is resolved. However, the damage will probably unfold only slowly over time, restraining trade growth in the long- rather than the short run. It hence does not (yet) affect our calls for economic growth in 2020 and 2021 significantly. For now, a measure of calm between the US and China and the extra clarity on Brexit matter more.

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