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RBC WEALTH MANAGEMENT

Global Insight

Focus Article

The year of the tariff

Protectionism is back in play, and we assess the potential outcomes—good, bad, and ugly.

Eric Lascelles

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All values in U.S. dollars and priced as of April 30, 2018, market close, unless otherwise noted.

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Focus article

The year of the tariff

Financial markets are in a state of high alert, responding spasmodically to an onslaught of macro- and company-level shocks. Among them, protectionism has been a particularly central and recurring villain. Just how bad might the "year of the tariff" turn out to be? RBC Global Asset Management's chief economist tallies up the good, the bad, and the ugly.

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The good

There are two sides to every ledger, and—believe it or not—some countries are still trying to deepen international trade rather than undermine it. The recently announced 11-nation Trans-Pacific Partnership (TPP) trade pact is a major step forward. The EU has also entered into important deals with Canada and Japan.

China, the world's other superpower, is opportunistically seeking to fill the void left by a retreating U.S. Doing so includes a gradual tempering of Chinese capital controls and a vision of China as the benefactor of a refreshed Marshall Plan, connecting (and enriching) central Asia and eventually much of the developing world via large-scale infrastructure projects.

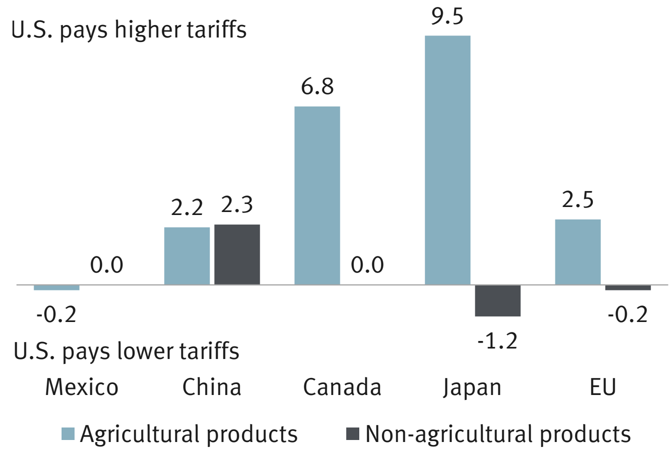
NAFTA negotiations, so far a long, grim affair, have suddenly bounded forward after the U.S. surprisingly eased its demands on the minimum domestic share of auto production. No less importantly, the comments from all three countries have suddenly become much more constructive, with each appearing to target a high-level deal this month.

Granted, there is more NAFTA work to be done. Key sticking points include a proposed sunset clause, the nature of the pact's dispute resolution system, and government procurement rules. It remains unclear what concessions Canada and Mexico have made. Furthermore, there could yet be a last-minute hitch (whether premeditated by U.S. negotiators or via a wrench thrown by the executive branch). But suffice it to say that whereas we rated the risk of NAFTA's destruction as high as 40% at one point, in our assessment it has fallen to just 15%. That doesn't guarantee the final deal is economically positive or even benign, but it does limit the potential for damage.

Let us also recognize that the U.S. is not entirely incorrect in its trade grievances. American exporters do, on average, pay higher tariffs than foreign firms do when entering the U.S. market. If the recent barrage of U.S. tariffs is instead viewed as being a temporary wedge designed to pry open foreign markets, globalization could actually be advanced rather than impeded by these unorthodox tactics. This is unquestionably a best-case interpretation, but not an impossible one based on White House comments. In fact, there is some evidence of the U.S. succeeding with this approach in the past:

U.S. gets bad tariff deal versus partners

Tariff rate differential between U.S. and partner countries, 2017 (ppt)



Note: Difference between tariff rates U.S. pays on its exports to partner countries and rates partner countries pay on exports to U.S.
Source - WTO/ITC/UNCTAD World Tariff Profiles 2017, RBC Global Asset Management, RBC Wealth Management

U.S. trade complaints not without some foundation.

- President Nixon imposed a blanket 10% tariff on imports in 1971, removing it four months later when other countries agreed to depreciate their exchange rates against the U.S.
- The Plaza Accord of 1985 was not technically a protectionist action, but the currency negotiations therein were motivated in part by U.S. firms agitating for trade protection. Instead, the world's major nations agreed to devalue the dollar and, in so doing, obviate the need for damaging protectionist actions.
- Across the 1980s, President Reagan implemented a number of tariffs and import controls. These did not seriously interfere with economic growth, were eventually lifted, and prompted Japanese automakers to shift more of their production onto U.S. shores.

Recently proposed trade barriers are set to inflict surprisingly little economic damage, according to most estimates.

Lastly, it is some relief to learn that recently proposed trade barriers are set to inflict surprisingly little economic damage, according to most estimates. For instance, based on the actions taken so far, the trade spat between the U.S. and China will cost each economy less than a quarter of one percent of their economic output. The effective U.S. tariff rate on imports will rise from just 1.6% to 2.1%—a far cry from an average tariff rate above 20% for much of the 1920s and 1930s. The world is still a much friendlier place to trade now than at almost any other point in time.

The bad

Whenever protectionism is in play, there is also going to be a considerable amount of "bad" news.

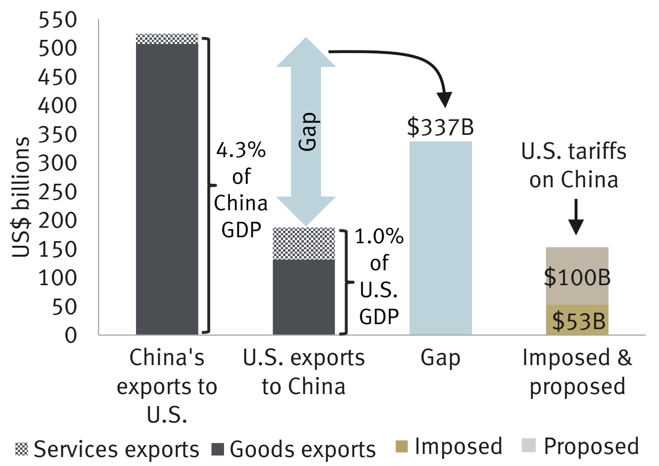
First, protectionism has long since morphed from words into action, with U.S. tariffs now in place on softwood lumber, washing machines, solar panels, steel, and aluminum. As much as President Trump promised and then delivered tax cuts, he is now clearly acting upon his protectionist mandate. The odds of further action are hardly trivial given the extent to which his more moderate advisors have fallen by the wayside.

Second, the latest Chinese tariffs are much more significant than anything that has come before, in part because of the size of the tariffs—a 25% tax on $50B of imports—and in part because China is proving to be an equally pugilistic adversary. Based on the orientation of the tariffs to date, on U.S. agricultural products versus Chinese technological products, the U.S. may take a disproportionate share of the economic hit this round because agricultural products can be more easily replaced than specialty manufactured goods. But Chinese vulnerability is ultimately significant given that the country exports three times as much to the U.S. as the other way around.

U.S.-China antagonism is hardly brand new.

Third, U.S.-China antagonism is hardly brand new. The two have been scrapping over control of the Pacific for some time. Foreign direct investment between the two fell by one-third last year and appears on track to decline further this year. Such frictions are unsurprising—the transition from a hegemonic to a multipolar world classically results in friction between the ebbing and ascending nations.

U.S. slaps tariffs on imports from China



Opening shot or a basis for discussion?

Note: 2017 exports shown in chart. Actual tariffs on China include tariffs on steel and aluminum products estimated based on 2017 imports and tariffs on $50B of goods from China announced on April 3, 2018.
Source - U.S. Census Bureau, Haver Analytics, RBC Global Asset Management, RBC Wealth Management

Fourth, even for aggrieved countries that seek redress through the proper channels—filing a dispute with the World Trade Organization (WTO)—any remedy is typically slow to come and the medicine might just be worse than the disease. The complainant is often told by the WTO to impose its own tariff on the "trade bully."

Fifth, both the U.S. and China have taken to ignoring the WTO anyway, threatening to undermine the existing scaffolding of global trade. While U.S. courts and Congress could try to impede the president's trade actions, the laws of the land grant him extensive powers that would be hard to neutralize.

Sixth, the U.S. is even further off the globalization course than its recent tariffs would suggest. On a counterfactual basis, it has also failed to sign on to several deals that were previously full steam ahead, including the aforementioned TPP and a deal with Europe. True, President Trump spoke recently of rejoining the TPP, but that is not a realistic aspiration given the concessions he would likely demand.

Seventh, the protectionist trend is not limited to the U.S. The British decision to flee the EU is another prominent example. Subtly, quite a number of countries have also been skirting trade rules by fortifying their non-tariff barriers. This appears to be the newest trick in the protectionist arsenal. With tariffs and import quotas now frowned upon, countries have found more subtle ways to give a (Pyrrhic) victory to the home team.

Eighth, and turning to Canada, the prospect of a NAFTA deal, even a slightly sour one, is undeniably a marked improvement on expectations from just a month ago. But it does not get Canada completely off the "bad competitiveness" hook, which has even more to do with divergent tax policy, labour laws, and the broader regulatory environment.

The ugly

Our best guess is that protectionism will merely act as a pesky drag on global growth, avoiding outright economic carnage.

One must acknowledge something like a 20% chance of a rather uglier outcome—a full-blown trade war.

But alternate scenarios abound, and one must acknowledge something like a 20% chance of a rather uglier outcome—a full-blown trade war. This might not be outright recessionary based on the modelling done to date, but it could certainly suck all of the juice out of recent U.S. tax cuts.

The scenario goes as follows: It is far from clear that the U.S. is done conjuring up Chinese tariffs. To the contrary, the tariffs thus far merely respond to China's steel glut and the country's questionable intellectual property practices. China can also be accused of subsidizing and shielding a slew of other sectors.

From a broader perspective, China is responsible for much of the gaping U.S. trade deficit that the White House finds so objectionable. President Trump is already threatening another round of Chinese tariffs that would be twice as big as the prior round. And while it takes two to wage a trade war, China has proven its willingness to punch back.

Bottom line

To reiterate, a trade disaster should not be anyone's base case. Given a number of positive tailwinds still blowing from other points on the compass, the global growth story looks capable of surviving a modest trade drag. U.S. dalliances with protectionism in the 1970s and 1980s ultimately did little damage, and there is still the chance that U.S. pressure manages to dismantle some foreign barriers.

But one cannot speak with precision about these things, and the potentially deleterious effects of second-order considerations such as uncertainty and skittish financial markets are hard to model. We are inclined instead to acknowledge this threat by flagging protectionism, alongside an aging business cycle (for what it's worth), as the key macro risks for the coming year at least.

Research resources

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