Implications of the U.S.-China Trade Impasse

Treasury Economic Research
May 2019

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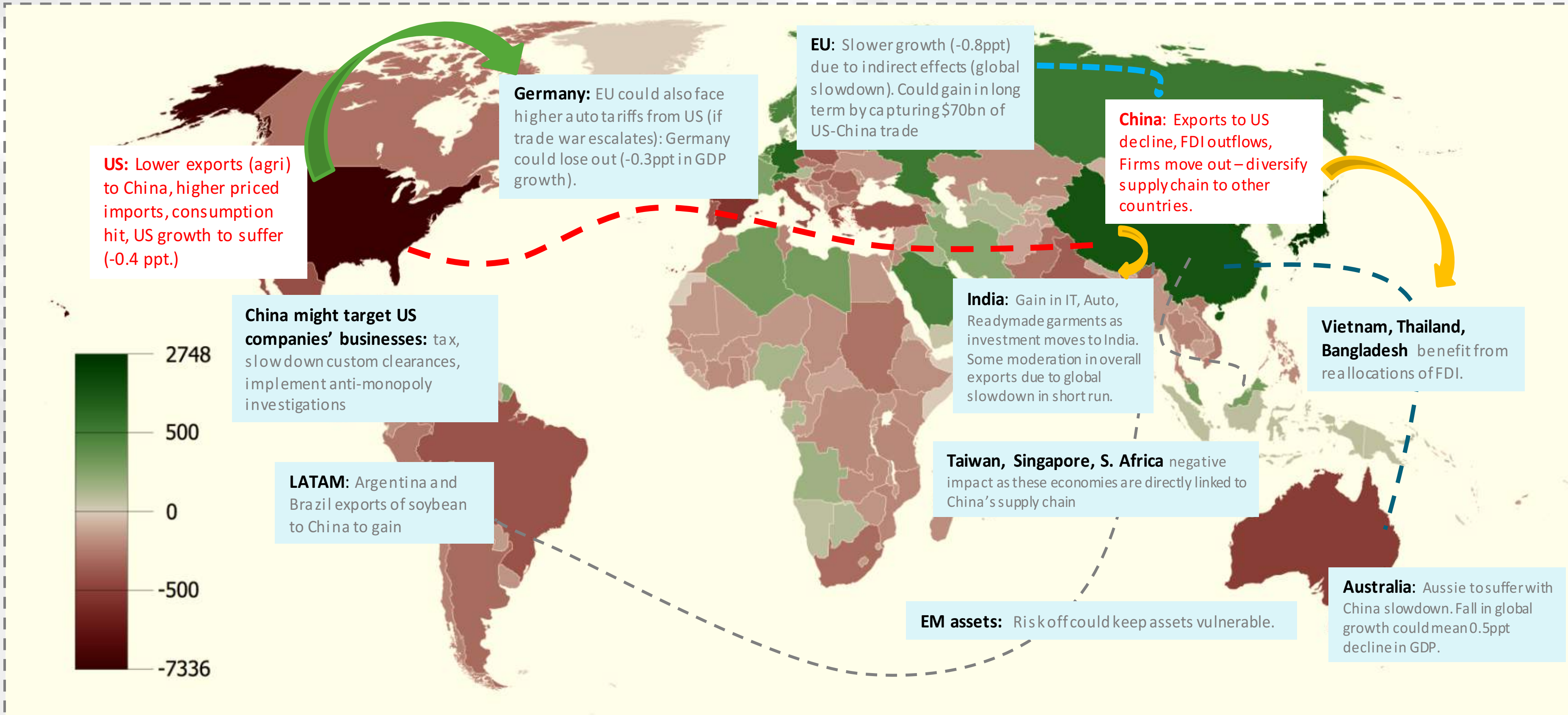
1. Global Economic Impact

What does a full-blown Trade War mean for the World?



Colours shows the trade balance across the world

Source: HDFC Bank, IMF, World Bank, OECD

Full-blown trade war Impact*

* Tariffs on $300bn of Chinese imports by US in addition of current tariffs & retaliation by China through higher tariffs.

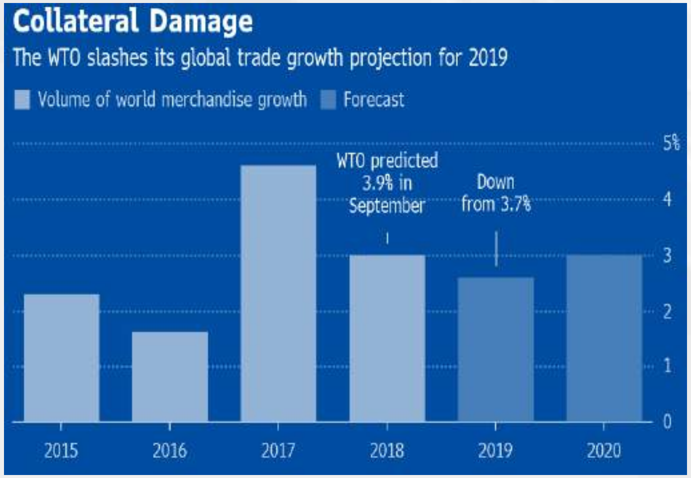
Global Growth to reduce by 0.5ppt – 0.8ppt

Latest IMF projection for now at 3.3% in 2019, down from 3.6% in 2018.

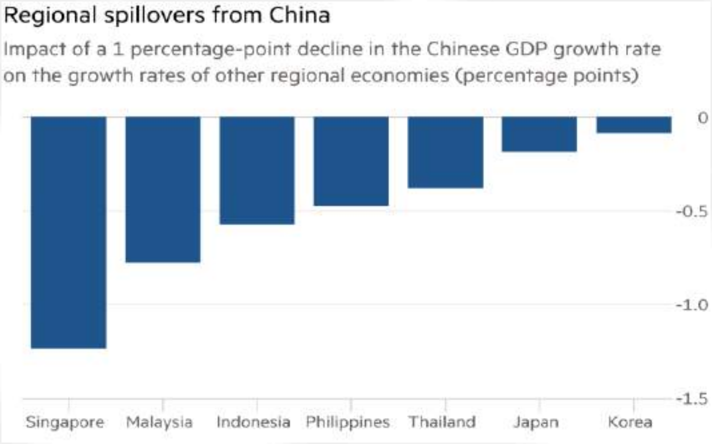
World trade to slowdown by 0.2ppt in 2019

Growth Impact greater in China than the US due to direct trade effects

In the developed world, Europe could see growth slowdown by 0.8ppt (net impact) due to indirect trade and financial links



In Asia, global growth slowdown and trade compression could lead to a slowdown. Also, slow Chinese growth could hurt economies like Singapore that have greater trade linkages with China. Some countries like Vietnam and India could gain due to a shift in supply chains from China to these countries.



Source: HDFC Bank, WTO, IMF, World Bank, OECD

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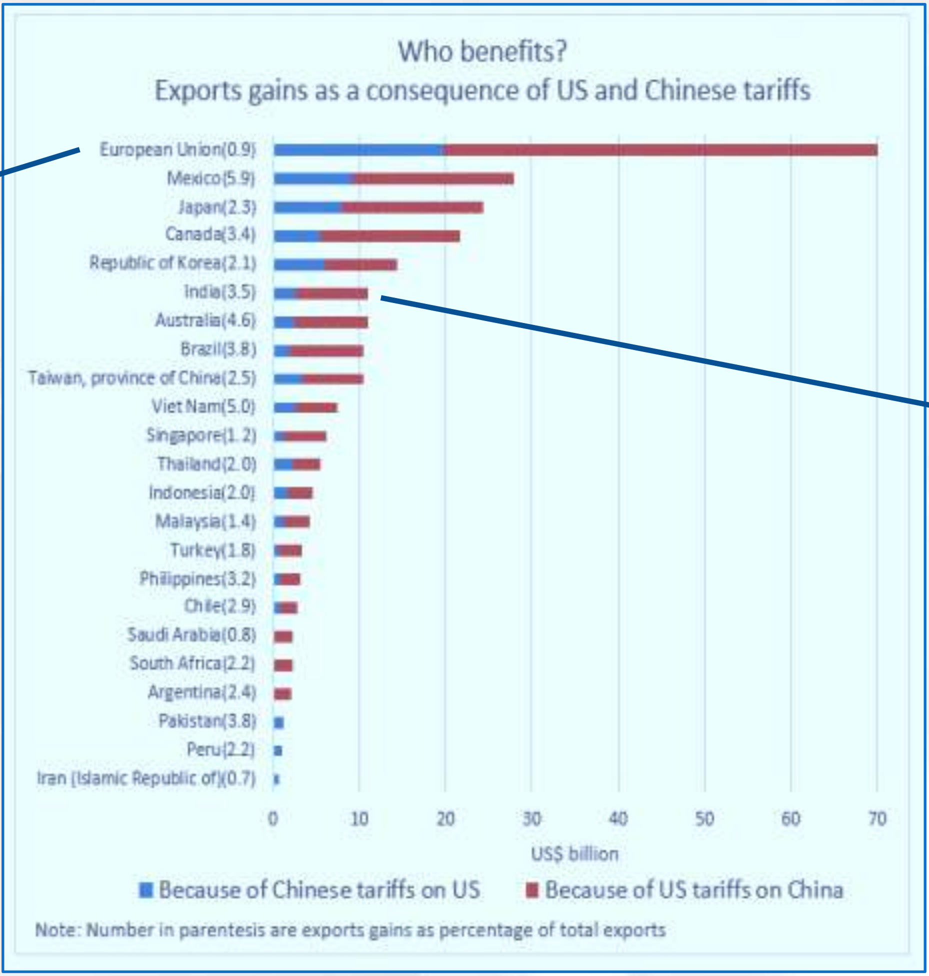
While short term exports could take a hit there are long term opportunities for some

Some countries could benefit in the long term from US-China tensions as they have the economic capacity to replace US and Chinese firms.



EU could gain, capturing $70 billion of US-China bilateral trade ($50 billion of Chinese exports to the US, and $20 billion of US exports to China).

Japan, Mexico and Canada will each capture more than $20 billion.

India could capture as much as $10bn (3.5% of total exports) – especially in sectors such as readymade garments and tech.

Source: HDFC Bank, UNCTAD

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2. How things have unfolded?

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A quick recap: what has been announced?

Contrary to markets' expectations, the US-China trade war has escalated in recent days, with both countries announcing higher tariffs on each other's goods.

- **US increased tariffs on $200 billion of Chinese goods from 10% to 25% on 10th May 2019** and released a list on 13th May 2019 of the roughly $300 billion worth of products that could face up to a 25 percent tariff.
  - *The public hearing will be held on June 17 followed by another week for comments, meaning the earliest possible action for tariffs on $300 bn of remaining Chinese exports would be on 24 June 2019.*

- **In response, China** announced higher tariffs on about $60 billion of U.S. goods on 13th May 2019. These will be effective from 1 June 2019.
  - 25% tariffs on 2,493 items from current 10%
  - 20% tariffs on 1,078 items from current 10%
  - 10% tariffs on 974 items from current 5%
  - 5% tariffs to continue on 595 items.

Higher rates have been announced on September 2018's effective tariff base of $200 bn in case of US and $60 bn in case of China

Source: *Media Reports & HDFC Bank*

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Markets were caught off-guard!

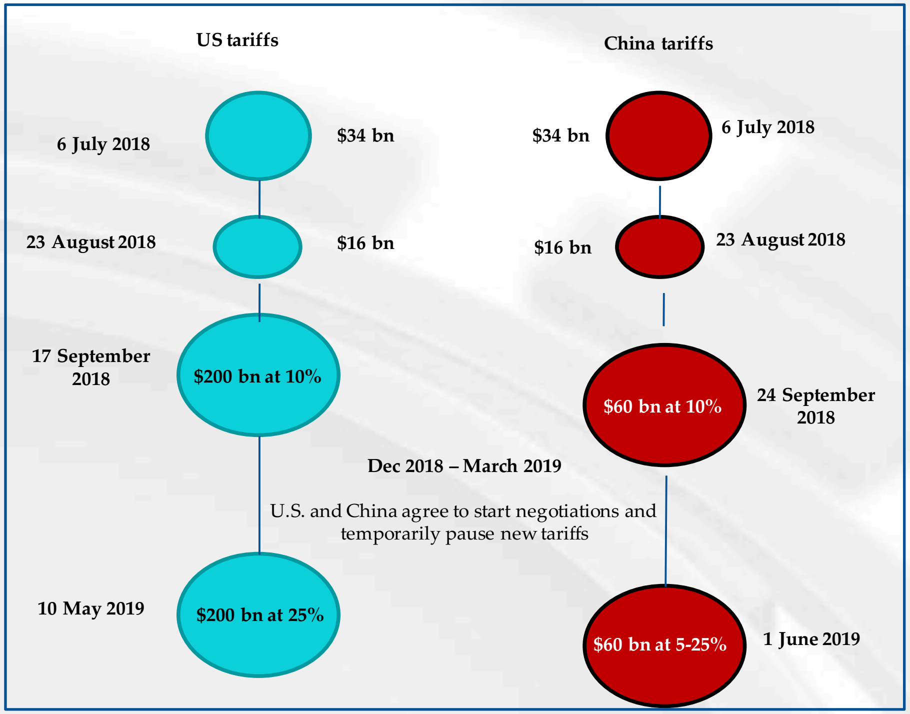
Both the U.S. and China agreed to a temporary truce to de-escalate trade tensions, following the G20 Summit in Buenos Aires on December 1, 2018. According to the agreement, both the US and China were to refrain from increasing tariffs or imposing new tariffs for 90 days (until March 1, 2019). This deadline was then then put on hold "until further notice" due to "substantial progress" in trade talks.

What happens next? Negotiations are likely to continue while tariffs remain in place with a hope that the two sides are able to reach an agreement before the June 1st - the effective date of Chinese tariffs. Mr. Trump will also likely meet Chinese President Xi Jinping at the G20 summit in Japan in late June.

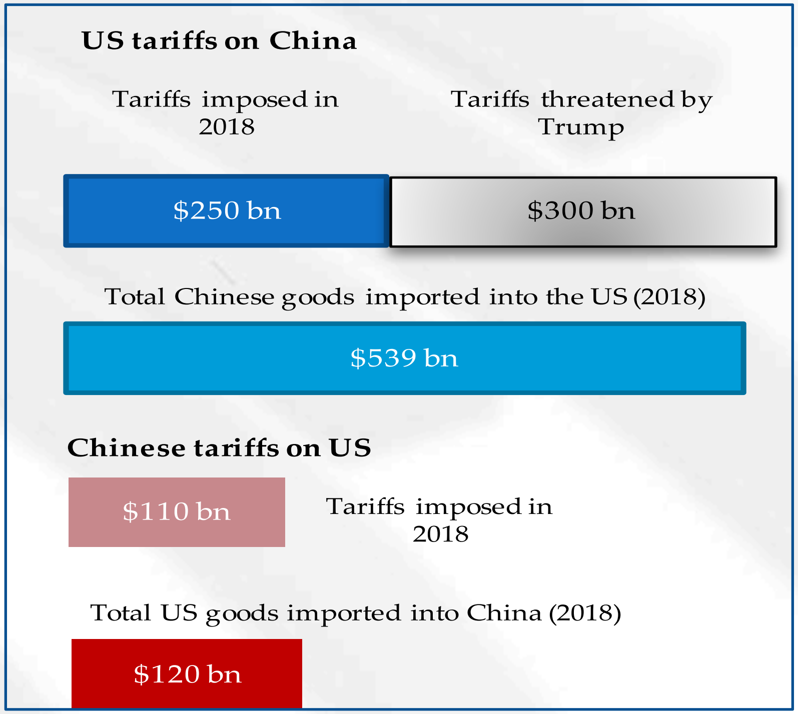
Source: *Media Reports & HDFC Bank*

How have we reached here?

Tariff timeline



Tariffs imposed so far….



Source: *BBC Research & HDFC Bank*

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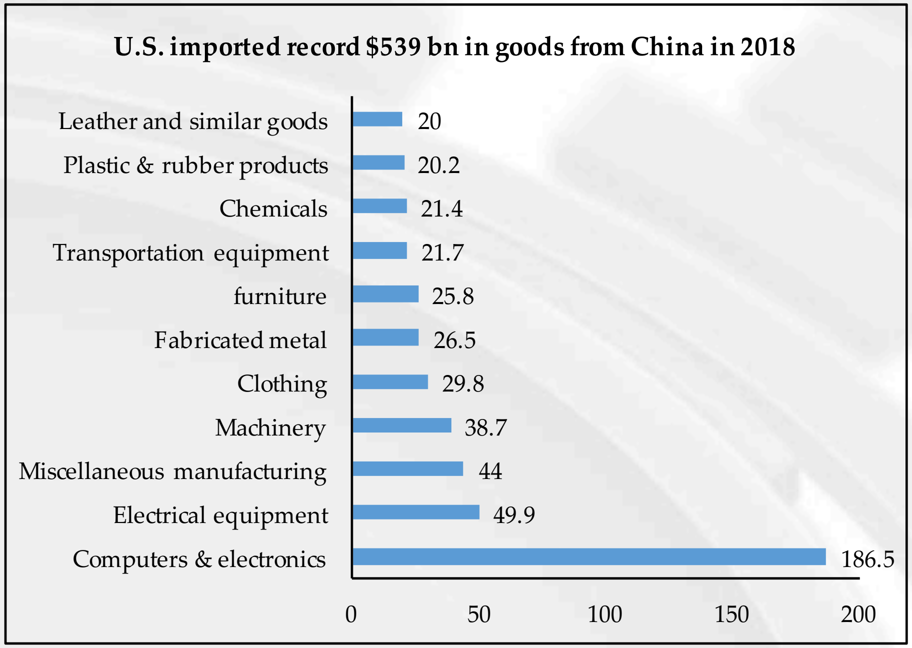
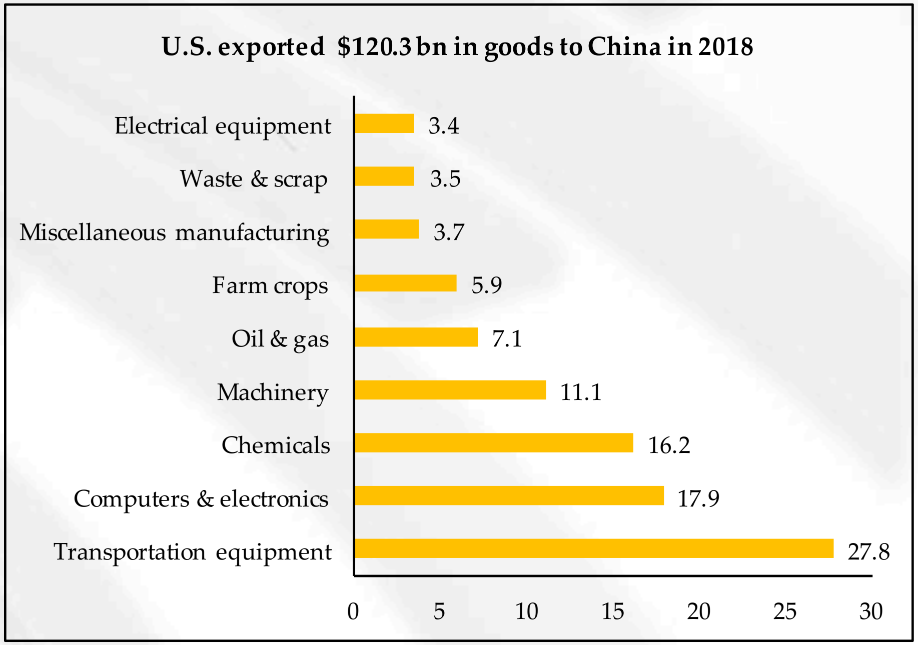
Some statistics on US China Bilateral trade

- China was the largest exporter of goods to United States in 2018.
- U.S. imports from China account for 21.2% of overall U.S. imports in 2018.



- China was the United States' 3rd largest goods export market in 2018.
- U.S. exports to China accounted for 7.2% of overall U.S. exports in 2018.
- U.S. total exports of agricultural products to China totaled $9.3 billion in 2018 - making up its 4th largest agricultural export market.



Source: *United States Census Bureau & HDFC Bank*

3. Winners & losers

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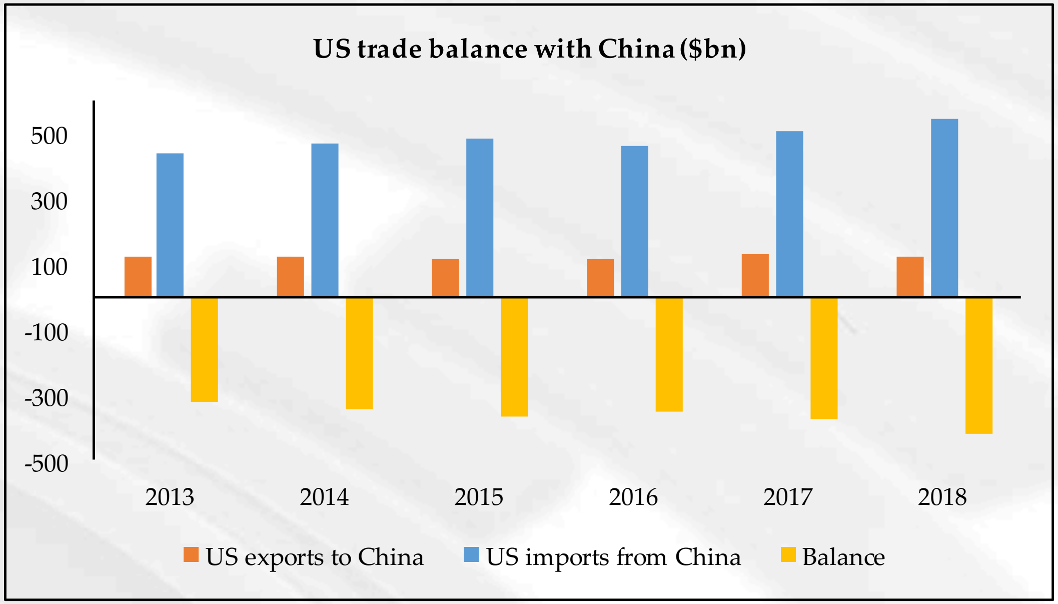
Who gets hurt more?: A "trade war" with the U.S. is not in China's interest

In 2018, the value of Chinese exports to the US ($539.5 billion; ~4% of China's GDP) exceeded the value of American exports to China ($120.3 billion) by $419.2 billion.

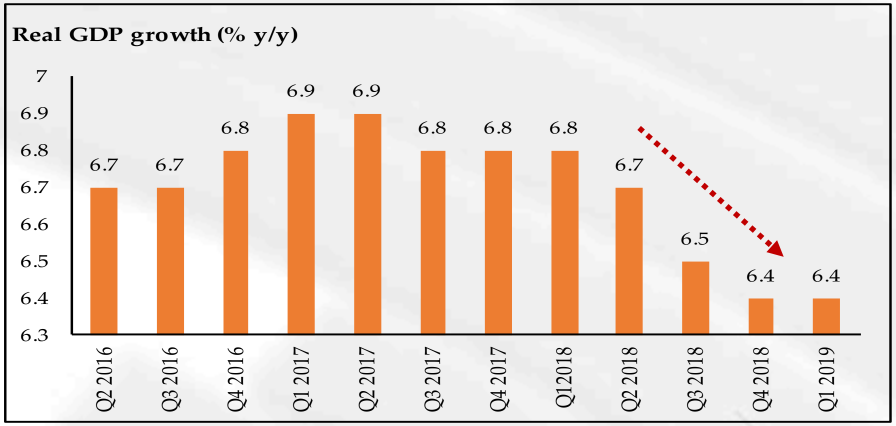


- **U.S. goods imports from China totaled $539.5 billion in 2018, up 6.7% ($34.0 billion) from 2017**
- **U.S. goods exports to China in 2018 were $120.3 billion, down 7.4% ($9.6 billion) from 2017**
- **As a result, US trade deficit with China worsened to $420 bn in 2018 from $376 bn in 2017**
- **However, recent monthly data suggest growth moderation in Chinese exports to the US**

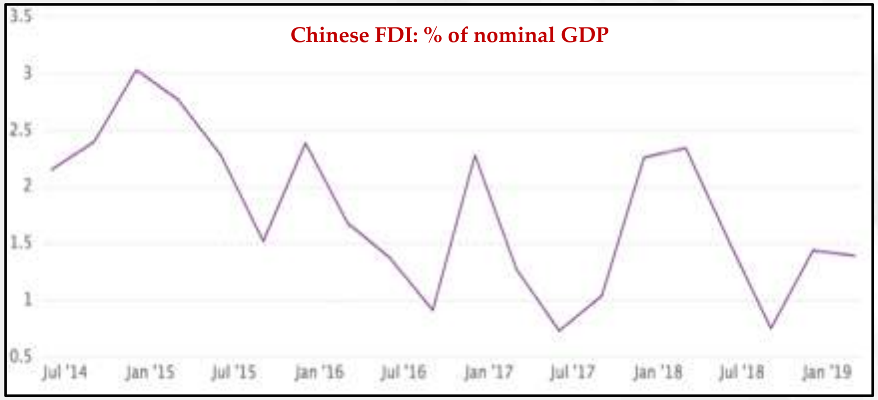
Source: *United States Census Bureau & HDFC Bank*

Potential impact on China

- **Market estimates show that tariffs on the entire ~ US$539 billion worth of Chinese exports to the US would shave off ~0.5 - 1.0% of China's growth.**

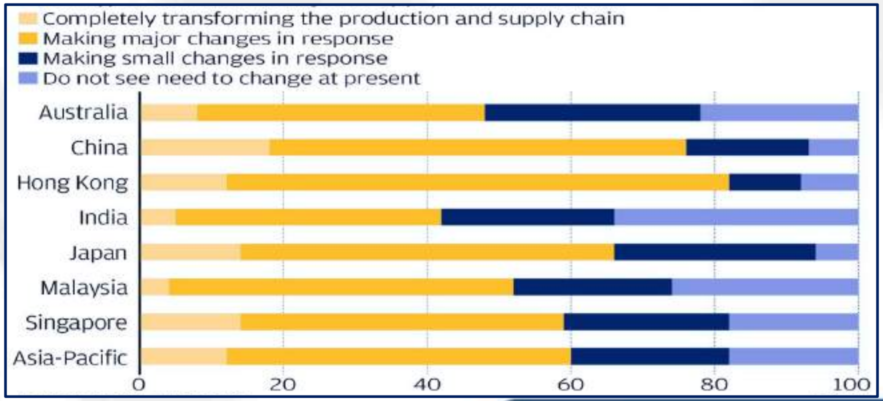


Foreign Direct Investment inflows are declining in China and seeking other destinations



Due to tariff pressure, Chinese companies lead the pack in diversifying their supply chains away from China – *India could benefit from this shift*

In a poll conducted by the law firm Baker McKenzie, 93% of Chinese companies were considering making some change to their supply chains to mitigate the effects of trade tariffs



Source: *South China Morning Post, CEIC, investing.com & HDFC Bank*

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How is China likely to respond to further rounds of tariffs proposals?

The "Tit-for-tat" Math: *While the U.S. could potentially place tariffs on more than $500 billion worth of Chinese items (value of imports from China in 2018 - $539 bn), China has limited room to retaliate through trade in goods as it imports much less from the US (imported $120 billion worth of U.S. goods in 2018).*

Possible non-tariff measures?

Selling US treasuries	**Unlikely –** *losses on China's existing bond portfolio and lack of alternative to reinvest the holdings*
Devaluation of Yuan	**Unlikely –** *higher servicing cost for China on its external debt and forced discipline being a part of the IMF's SDR basket*
Target US Companies' businesses	**Likely –** *might tax, slow down custom clearances, implement anti-monopoly investigations or use safety checks as a way of temporarily shutting businesses down.*

Source: *Media Reports & HDFC Bank*

While China is at risk…...the US will feel the burn as well

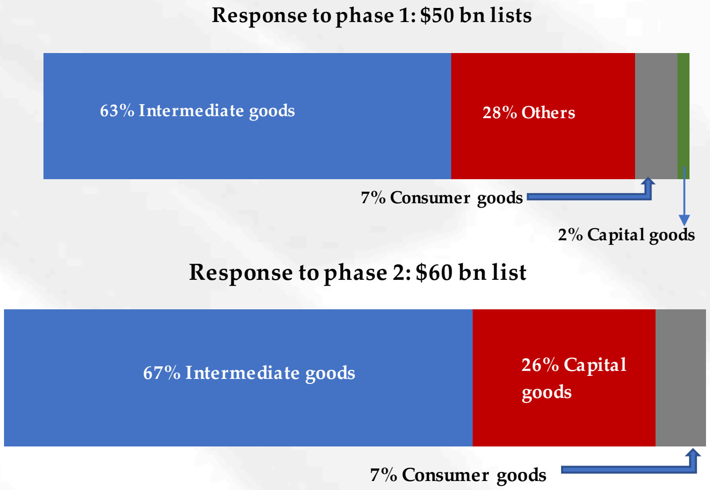
- **Direct impact on US exporters due to retaliatory measures by China**
- **<u>US being a consumption dependent economy and heavily reliant on intermediate goods supplied by the China</u>, will also face an indirect impact of escalating tariffs**

  ❖ *US based companies, which have complex supply chains, will see an escalation in costs*
  ❖ *US consumers will face higher consumption cost*

US tariffs on Chinese imports

US tariff threat on rest of Chinese imported goods (~300 bn) would mostly hit Final consumer products

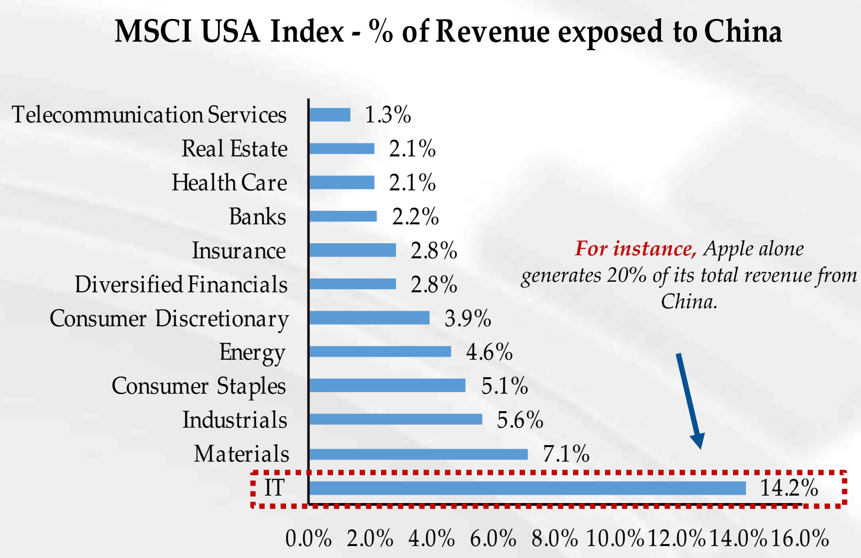
Chinese tariffs on US imports

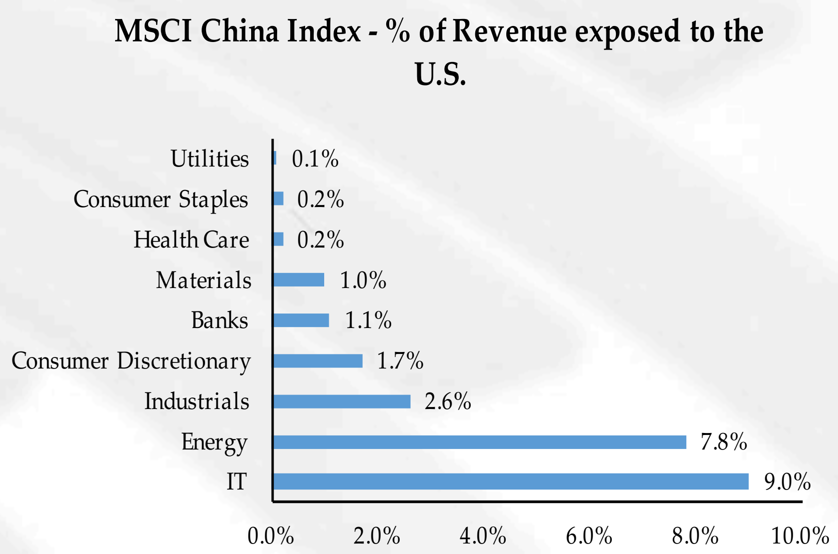


Source: *Peterson Institute for International Economics & HDFC Bank*

US company revenues are highly vulnerable

About 5.1% of the revenues of companies in the MSCI USA Index come from China and may be at risk as a result of a trade war. In comparison, only 2.8% of the revenues of the companies in the MSCI China Index come from the U.S.





Source: *MSCI, Peterson Institute for International Economics & HDFC Bank*

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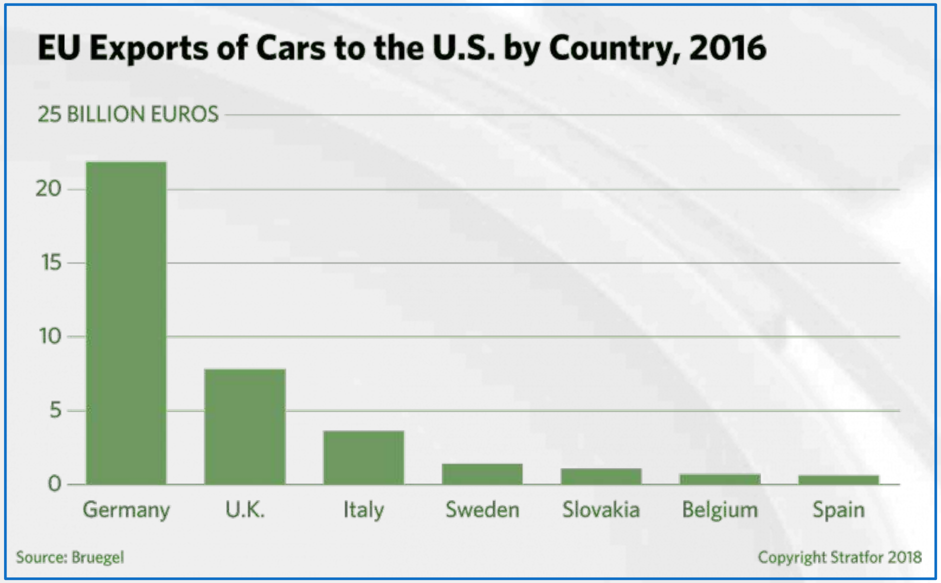
Escalation of trade war raises the risk of further tariffs on EU as well

If US decides to raise tariffs on all auto imports, in an effort to increase pressure on China, the EU (especially Germany and Ireland) could be hit hard.

SO FAR: *Last year European Commission President Juncker and US President Trump agreed to "work together toward" a trade agreement on non-auto industrial goods. But little progress has been made, and the US Commerce Department has reportedly concluded that vehicle imports are a risk to national security.*

Next Deadline: *President to decide by 18th May whether or not to impose tariffs on vehicle imports. Even if that deadline is pushed back, with President Trump taking a harder line on China, there is a risk that he eventually does the same with the EU.*



Impact: *Effect of higher vehicle tariffs on Eurozone GDP would be small (close to 0.1ppt). But some countries would be hit hard! Direct effect of a 20% increase in US vehicle tariffs would reduce German GDP by 0.3ppt.*

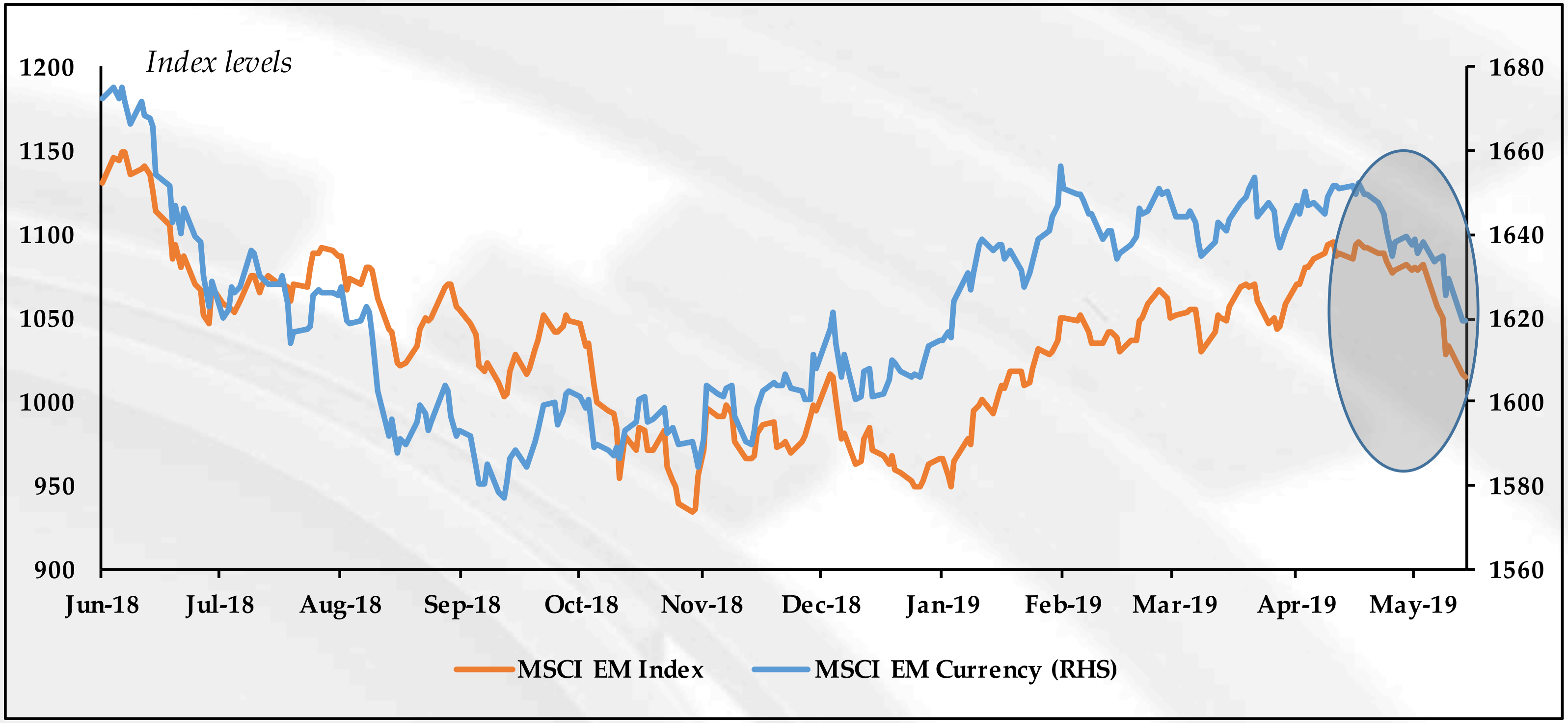
Broader escalation: *US could extend tariffs beyond vehicles if the EU continues to reject the US's desire to include agricultural goods in any potential trade deal.*

In this case, Ireland would be the hardest hit euro-zone economy, with manufacturing exports to the US equivalent to almost 10% of its gross value added. Germany is the next most vulnerable member state.

Source: HDFC Bank, Capital Economics, Bruegel

EM assets remain vulnerable to an escalation in trade war

Emerging market stocks and currencies retracted to their lowest since January 2019



Source: Bloomberg and HDFC Bank

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But EM economic impact is differentiated

While stakes for a trade war remains high, EMs will not be affected equally

Source: Capital Economics and HDFC Bank

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Some EMs could benefit from the "China shift"

Trade diversions, as a consequence of tariff hikes, could benefit other countries that have a similar export mix. For instance,

For instance,

- Producers of agricultural goods in Argentina and Brazil benefitted from Chinese tariffs on US soybeans.
- With higher tariffs on China, US companies could buy semiconductor parts from Malaysia, data storage units from Thailand, or ready made garments from India.
- **Reallocations in terms of foreign direct investments** - markets in Southeast Asia or Latin America might benefit as manufacturing destinations with geographical advantage and competitive labor costs.

Asia's winners in the US-China trade war: A report by the Economist Intelligence Unit			
	Strong benefits	Mild benefits	Disruption
Information and communications technology	Malaysia Vietnam	India Indonesia Thailand	Philippines Japan Singapore South Korea Taiwan
Automotive	Thailand Malaysia	India Indonesia Philippines Vietnam	Japan South Korea Taiwan Singapore
Readymade garments	Bangladesh Vietnam India	Sri lanka Pakistan	Indonesia Cambodia Myanmar

Source: Economist Intelligence Unit and HDFC Bank

4. Policy and market implications

Trade war unlikely to sway the Fed from a "no-change" path

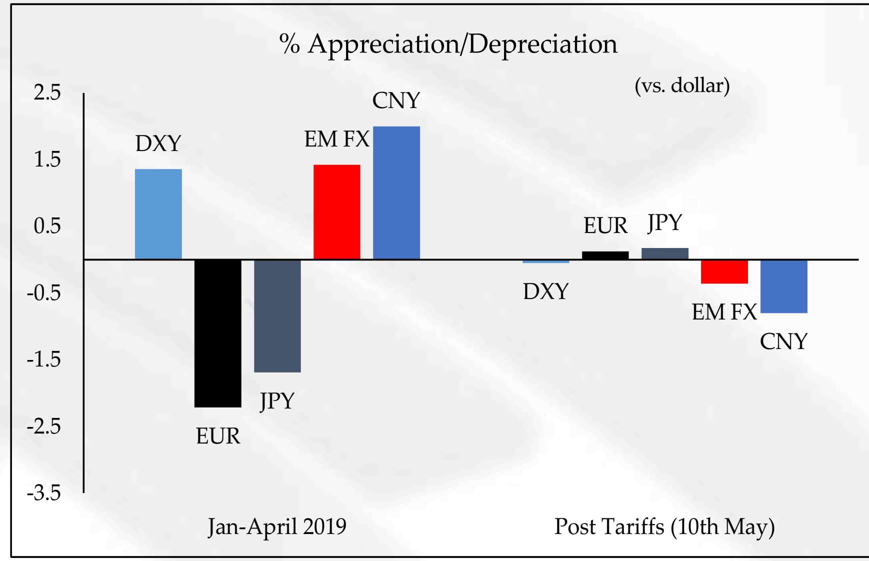
- **Dollar appreciation offset impact of US tariffs so far:** US Tariffs on Chinese imports, already enforced, have had limited impact on domestic US prices (+0.19 ppt) as dollar has strengthened by 10% against the renminbi.
- **But now more difficult to absorb additional tariffs:** Additional tariffs by the US, announced last week, could be more difficult to absorb and lead to an increase in import prices. If tariffs imposed on $300bn of imports, inflationary impact could be larger (core PCE to rise by 0.9ppt.). Less opportunity for US consumers for substitution.
- **However, US inflationary pressures remain broadly low for now** (below 2%).
- **Further, growth concerns are likely to increase in a full blown trade war scenario.**

The Fed is likely to find itself on a tight rope. Call for rate cuts to support growth from the White House could increase while inflationary pressures would limit the scope for further rate cuts. On balance, in the event of a resolution on the trade war issue, the Fed is likely to stay on hold in 2019.

Source: Media reports, Capital Economics and HDFC Bank

FX Implications: From Risk On to Risk Off

Trend until April: Dollar was up against the G3s and down against the EMs



- Just 10 days ago, the US and China were close to a deal to end their trade dispute. Moreover, since the beginning of this year, the central banks globally had turned dovish. These two factors had supported a risk-on rally in favor of the EM currencies - until the end of April.
- Given the growth slowdown worries in the Euro zone and uncertainty related to Brexit, the DXY was still trading with a positive bias against the G3 currencies until April.
- The trend has reversed this month with the implementation of fresh tariffs. Investors are pulling out of EM currencies and the USD, and instead favoring safe havens like the JPY. Within the EM World, CNY was an outperformer earlier and is an underperformer now.

Source: CEIC, Reuters, and HDFC Bank

Going forward

- **The prospect of a new summit** between Xi Jinping and Trump could signal that both the administrations are more willing to reach a deal.
- However, until then, the **volatility and uncertainty** related to trade talks could weigh on the EM currencies.
- **Thus, in the short-term, until the negotiations restart, we prefer a Long JPY Short USD, and Long USD Short EMs strategy**.

Periodic Volatility: As announcements for new tariffs or the enactment of existing ones becomes public, short-term volatility is likely to weigh on the USD and on the EM assets.

Negative EMs

Fed Policy: Tariffs are likely to be inflationary but the net impact, taking into account the slowdown impact of trade and growth, could make it a complicated decision for the US Federal Reserve. In the short-term, the Fed is likely to be in a wait-and-watch mode, keeping the rates on hold.

Neutral USD and Neutral EMs

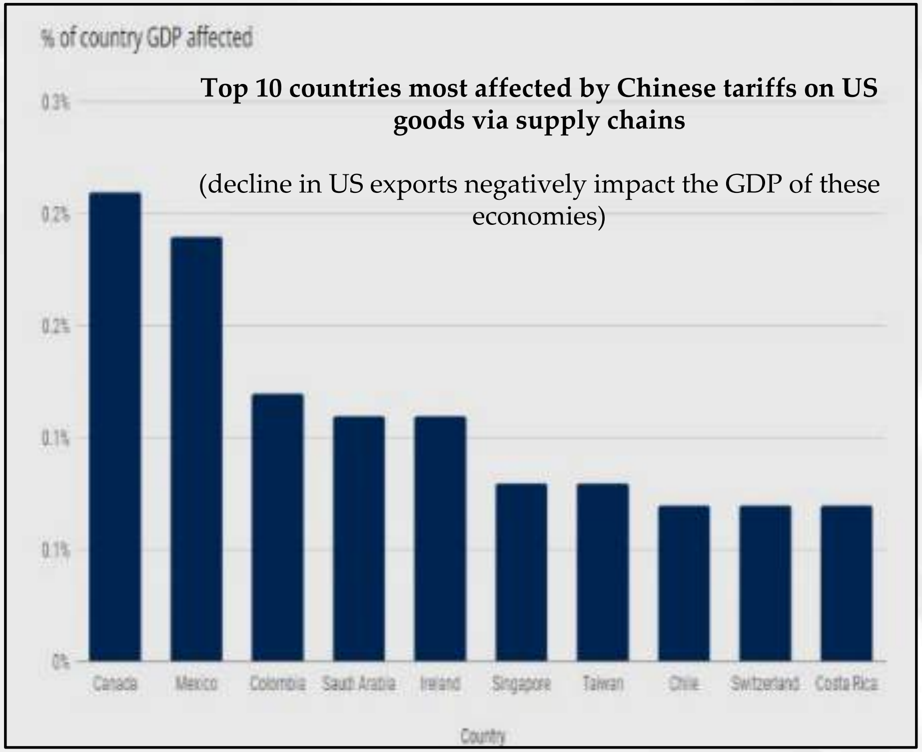
Policy driven depreciation: While unlikely, it is possible that the EM currencies could have policy induced depreciation in the spirit of promoting economic growth. This scenario becoming a reality depends on the US-China trade war producing an extended and negative global impact.

Negative EMs

Source: HDFC Bank

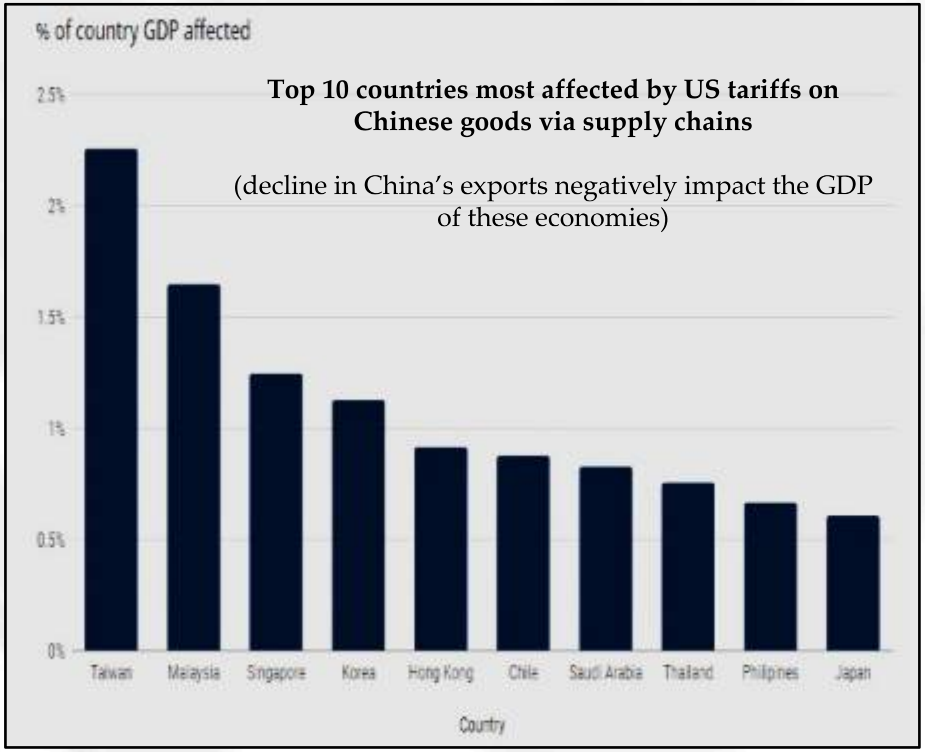
For India, a decisive election mandate could turn around the sentiment in favor of the Rupee

- OECD research highlights that relatively closed economies like Brazil and India are somewhat insulated than other economies in the event of a more global trade war.
- For India specifically, a clear-cut mandate in elections (stable government) could lead to more FII inflows. On a relative basis, the rupee could outperform within the EM world in case of escalation of trade war risks.



Top 10 countries most affected by Chinese tariffs on US goods via supply chains

(decline in US exports negatively impact the GDP of these economies)



Top 10 countries most affected by US tariffs on Chinese goods via supply chains

(decline in China's exports negatively impact the GDP of these economies)

Source: OECD, The Economist Group, Schroders Economics Group and HDFC Bank

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Election Outcome: An important factor in the amidst of the trade war

Base case scenario

Modi led NDA government with full majority

- If the existing party comes with a big margin, markets will cheer the results and rupee could appreciate
- USD/INR could touch 68 levels

BJP government with the help of non-NDA regional parties

- Although the impact is unlikely to be substantial, loss in share of the BJP could hit equity valuations and impact sentiments to some degree
- USD/INR could touch 72 levels

UPA government with the help of regional parties

- A sturdy dispensation and policy continuity is all that markets look for. With the UPA government, there could be change in the policy directive
- USD/NR could touch 74 levels

USR/INR (period end)	FY20 e			
	Q1	Q2	Q3	Q4
	71.0 - 72.0	69.0-70.0	68.5 - 69.5	68.0 - 69.0

The appreciation bias that we have penciled in for 2H-FY20 will have to be reviewed and altered if the tariffs and trade risks persist.

Source: HDFC Bank

Monetary Policy: If the trade-war risk escalates, the likelihood of a rate cut in June could go up

- **We expect the RBI to remain on hold in the June MPC meeting.** We believe that the MPC members would like to gain clarity on the fiscal math of the new government, progress of the monsoon, the extent of slowdown in the economy (if it's a pre-election phenomenon or something long-lasting), and the trajectory of food prices during the summer months. The rate cut is more likely in the August MPC meet.

- **However, if the trade-war risk escalates hereon, the likelihood of a rate cut in June could go up on fears of a global slowdown.** If the impact of freshly imposed tariffs is more in terms of global trade slowdown and less in terms of market sentiment (no substantial depreciation of EM FX), the likelihood of a rate cut in June could go up. That is the rate cut could be brought forward to support an economy facing slowdown risks on both external and domestic fronts.

Source: HDFC Bank

Our Forecasts

HDFC Bank Quarterly Forecasts (period end)								
	FY19				FY20			
	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
EUR/USD	1.17	1.16	1.15	1.12	1.10-1.13	1.13-1.15	1.16-1.18	1.16-1.19
GBP/USD	1.32	1.3	1.28	1.3	1.28-1.30	1.30-1.32	1.32-1.34	1.34-1.35
USD/JPY	110.7	114	110	111	109	110	109	107
USD/CNY	6.62	6.87	6.88	6.71	6.80 - 6.95	6.70 - 6.80	6.70 - 6.80	6.60 - 6.70
USD/INR	**68.45**	**72.5**	**69.6**	**69.2**	**71.0 - 72.0**	**69.0-70.0**	**68.5 - 69.5**	**68.0 - 69.0**

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