

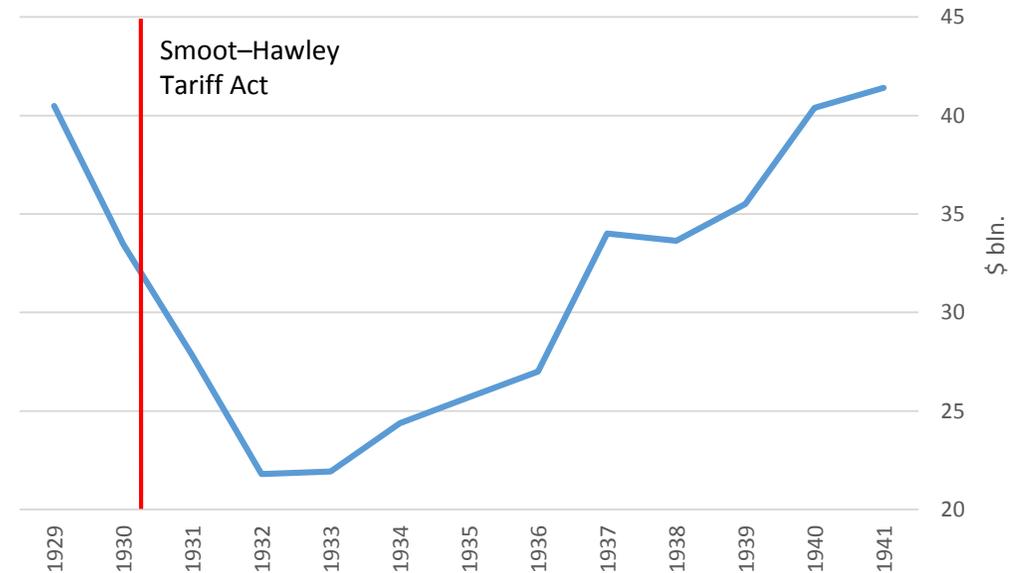
The Second World Trade War

Since 2018, U.S. President Donald Trump began to fulfill his election promises to reduce the foreign trade deficit. To date, tariffs have already been introduced for more than \$70 billion of U.S. import goods, and Trump is not going to stop.

Trump is concerned about the foreign trade deficit of his country. The reason for the deficit, in his opinion, is the unfavorable trade agreements of the USA with other countries. Trump has already withdrawn from the Trans-Pacific Partnership (TPP), intends to review the role of the United States in the North American Free Trade Area (NAFTA) and the World Trade Organization (WTO). In addition, Trump actively introduces duties against various countries.

Strict protectionist measures of the USA are setting off a full-scale trade war. Similar things happened in the thirties of the twentieth century, when the USA, trying to fight the Great Depression, introduced tariffs on 20 thousand imported goods (the so-called Smoot-Hawley Tariff Act). This further worsened the economic situation of the USA, as it caused a symmetric reaction of their trading partners. After the introduction of the Act, U.S. exports reduced by more than 65% for two years and returned to its previous level only at the end of the 30s.

Volume of exports of goods and services, the USA, in prices of 2009



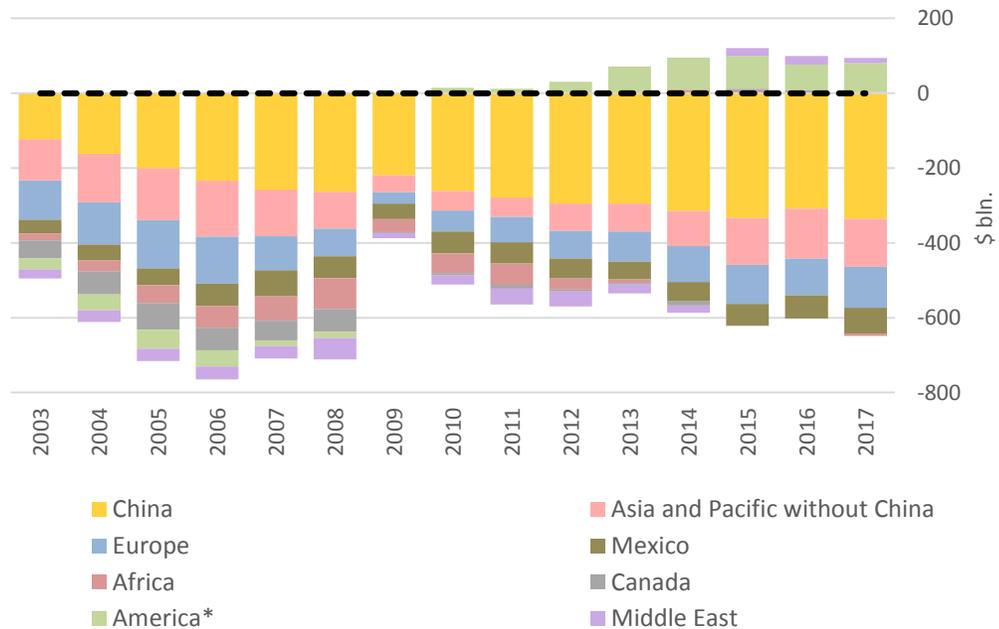
Source: Bureau of Economic Analysis (BEA), USA

U.S. foreign trade deficit

In recent years, U.S. foreign trade deficit as a whole remains at the same level, but the structure of the deficit by regions has considerably changed. Only the deficit with Europe, Mexico and Asia-Pacific (including China) remained stable. The deficit with all other regions became zero or turned into a surplus.

The basis of the trade deficit (96%) is a deficit with three regions - Europe, Mexico and East Asia, but mainly with China. 80% of the trade deficit is provided by only 10 countries, four of them (China, Japan, Germany, Mexico) – more than 60%.

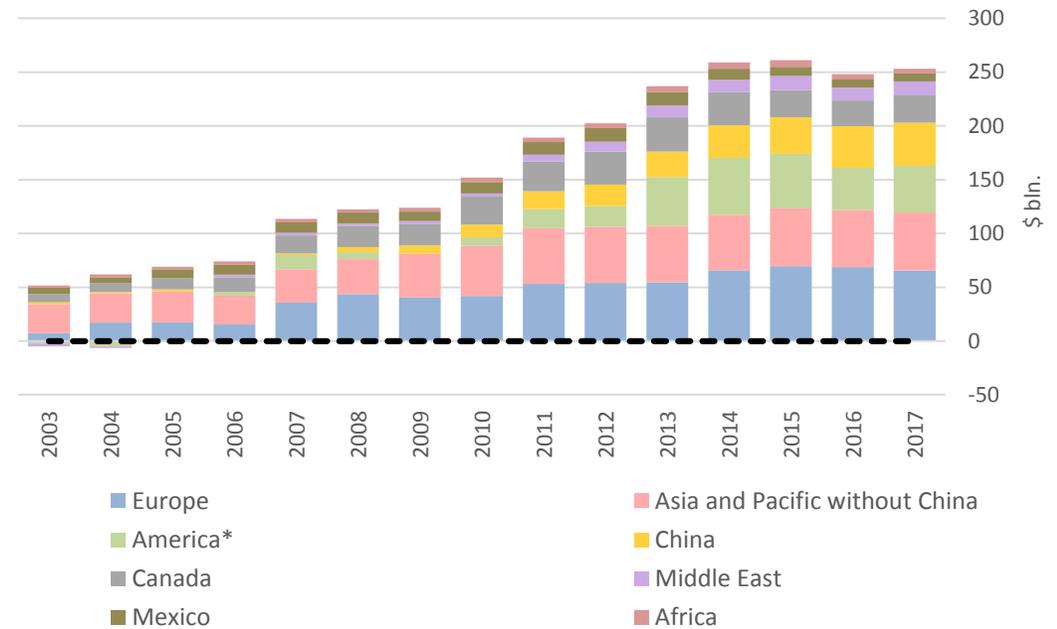
Balance of U.S. goods and services regions (surplus (+), deficit (-))



Source: Bureau of Economic Analysis (BEA), USA

* excluding Mexico and Canada

Balance of U.S. services by regions (surplus (+), deficit (-))



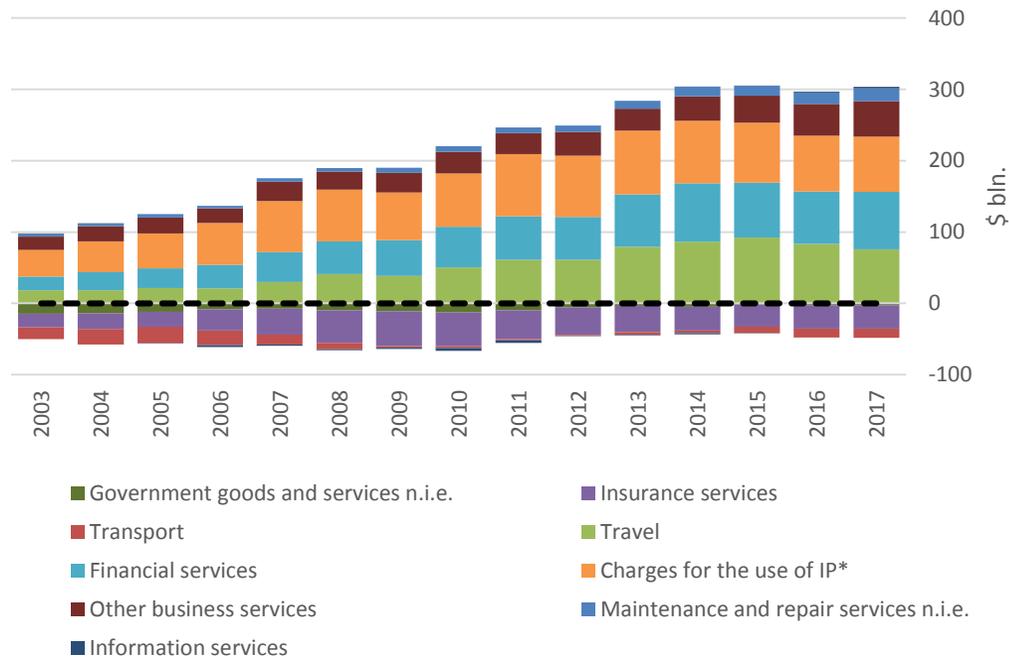
Source: Bureau of Economic Analysis (BEA), USA

* excluding Mexico and Canada

The volume of U.S. services exports is more than \$300 billion, which is comparable to all Russian exports. The U.S. services balance is surplus with all regions and in almost all key sectors. Travel, financial services and the use of intellectual property provide the USA with over 77% of the total surplus in the services balance.

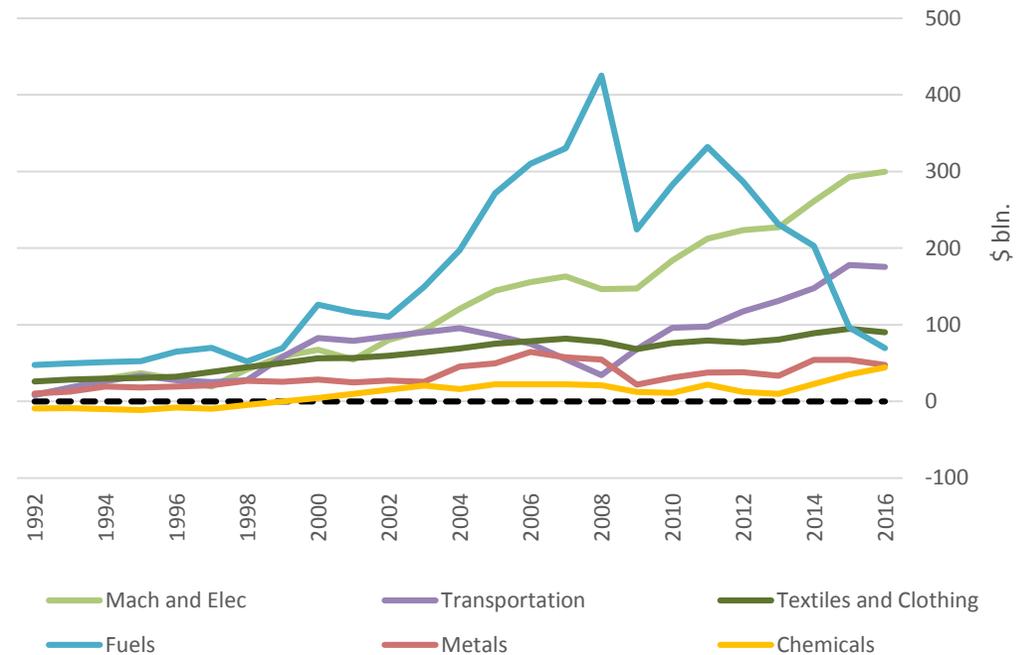
From the point of view of the trade industry balance, the USA has succeeded to reduce dramatically its main deficit – fuel – thanks to the revolution in the development of unconventional oil and gas fields. This explains the dramatic reduction in the deficit with the Middle East, Latin America and Africa.

U.S. services balance by sectors with the whole world (surplus (+), deficit (-))



Source: Bureau of Economic Analysis (BEA), USA
 * intellectual property n.i.e.

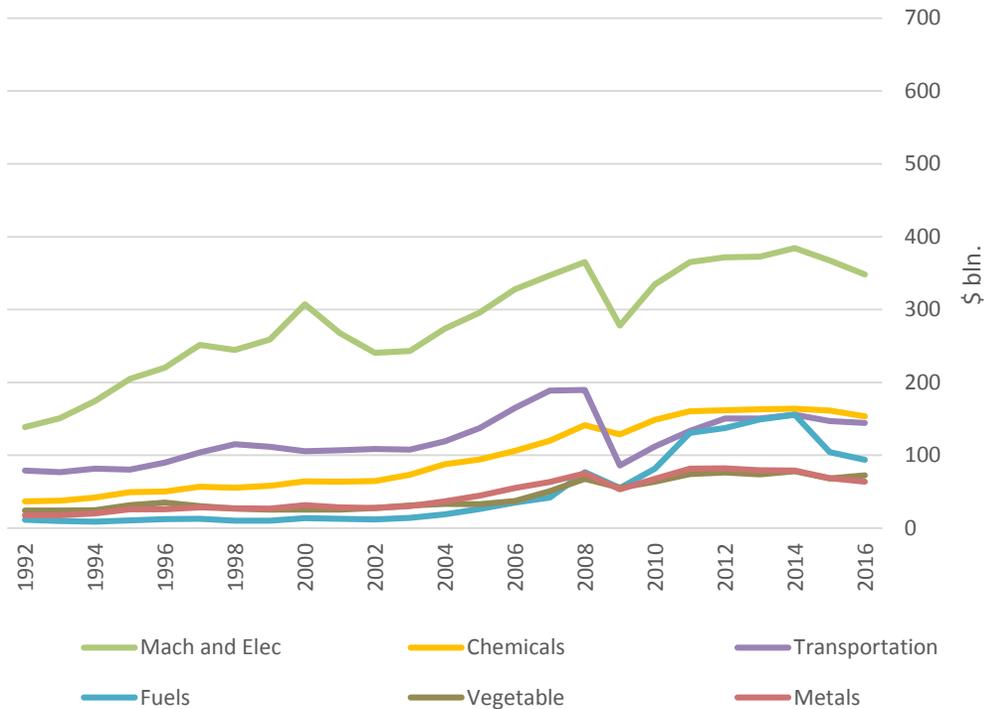
The largest U.S. industries with trade deficit (deficit (+), surplus (-))



Source: World Bank

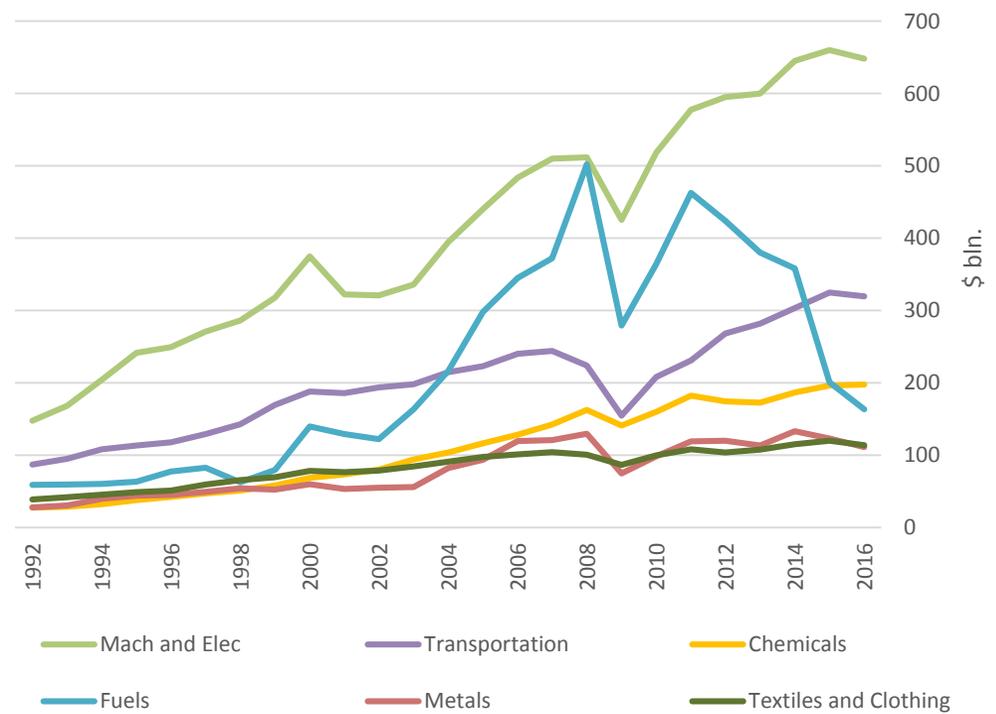
The dependence of the States on imports of machinery, equipment, transport and products of chemical industry is increasing. Even though these industries are the largest items of U.S. exports, after 2008 their volume stagnates, and import is steadily growing. For ten years, the total deficit for these items has grown more than two times.

The largest items of U.S. trade export



Source: World Bank

The largest items of U.S. trade import



Source: World Bank

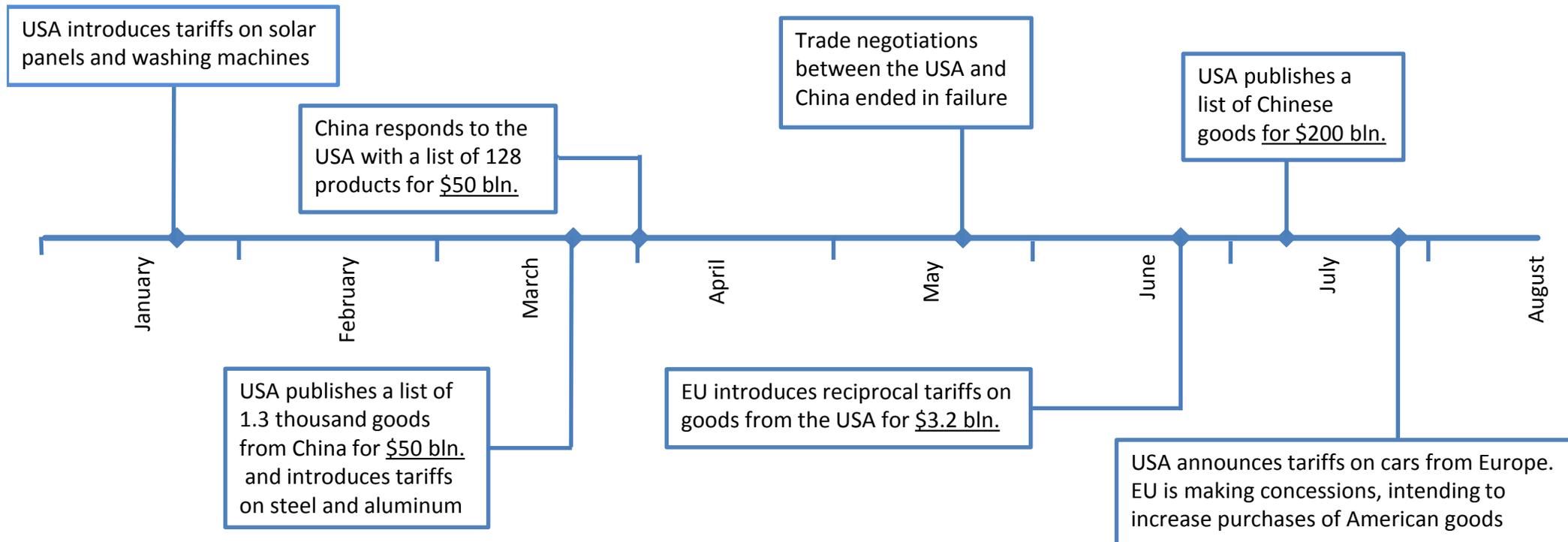
The beginning of the trade

The first blows of Trump concerned rather narrow branches - solar panels, washing machines, steel and aluminum. This affected a small ratio of imports of major U.S. trading partners – from 1 to 3%.

The next round of trade restrictions fell directly on China – tariffs on a wide range of goods for \$50 billion and threats to introduce duties for another \$200 billion. Thus, the duties on 10% of China's imports to the USA have been already introduced, and half of the remaining import is under the gun.

On July 24, Trump promised to introduce duties against cars from the European Union. This will influence the European Union much more than the first Trump attacks - the import of cars from the EU to the USA reaches \$36 billion or more than 7% of all imports.

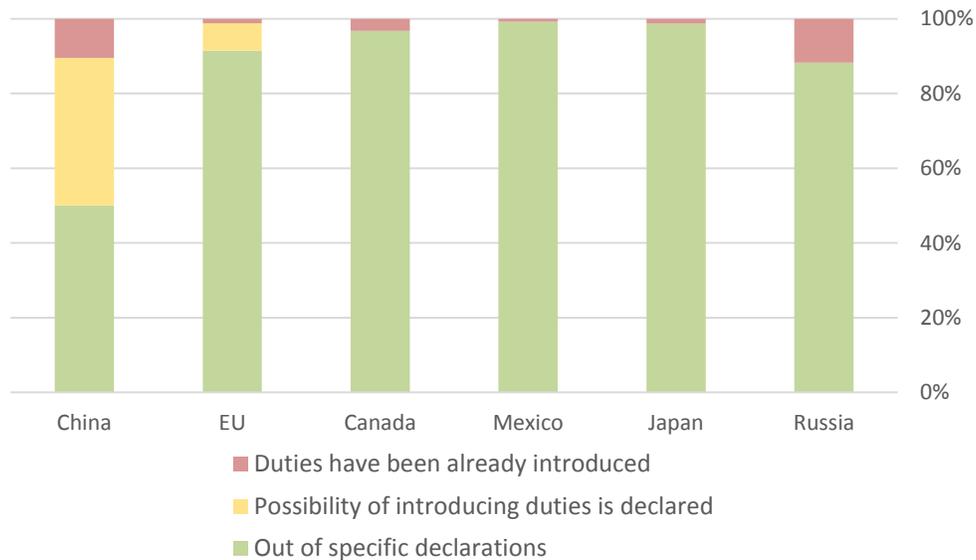
Chronology of trade war in 2018



Now Europe and other countries are on the periphery of U.S. trade war, even the threats of Trump relate to a relatively small part of their imports. In addition, the EU has already agreed to buy more U.S. liquefied gas, soybeans and other goods from the USA. Possibly, the EU is ready to negotiate with the USA and complete the trade war.

As for Russia, the tariffs on steel and aluminum affected almost 12% of imports to the USA. However, in absolute terms, this is not much- \$ 2.1 billion. Russian-American foreign trade is small in volume; the countries are not key partners for each other.

Import ratio in the USA depending on the stage of introduction of duties



Source: U.S. Department of Commerce

Alternative channel of influence

The USA has indirect instruments of influence on world trade.

In April of this year, the USA accused the Chinese telecommunications company ZTE of violating the sanctions regime against Iran and the DPRK and banned American companies to cooperate with it. After attempts to challenge this decision, ZTE agreed to all U.S. demands, including a change of leadership and the creation of a special commission monitoring the company's trading operations, the members of which will be approved by the Americans. Thus, the Chinese technological giant was so dependent on American suppliers and consumers that it had to go to very humiliating conditions. Of course, this could not happen without the knowledge of the PRC political leadership.

A similar story happened to the Russian Rusal. Having accused the owner of the company Oleg Deripaska of interfering in the presidential elections, the USA closed its market for Rusal and demanded a change of owner. Deripaska reduced his share in the company, but U.S. Department of Treasury declares it will take a decision to lift sanctions only after a "thorough analysis of all circumstances." It is very likely that this process will drag on for a long time. Rusal supplied to the USA 60% of all Russian aluminum (or supplied to the USA about 6% of all aluminum imports).

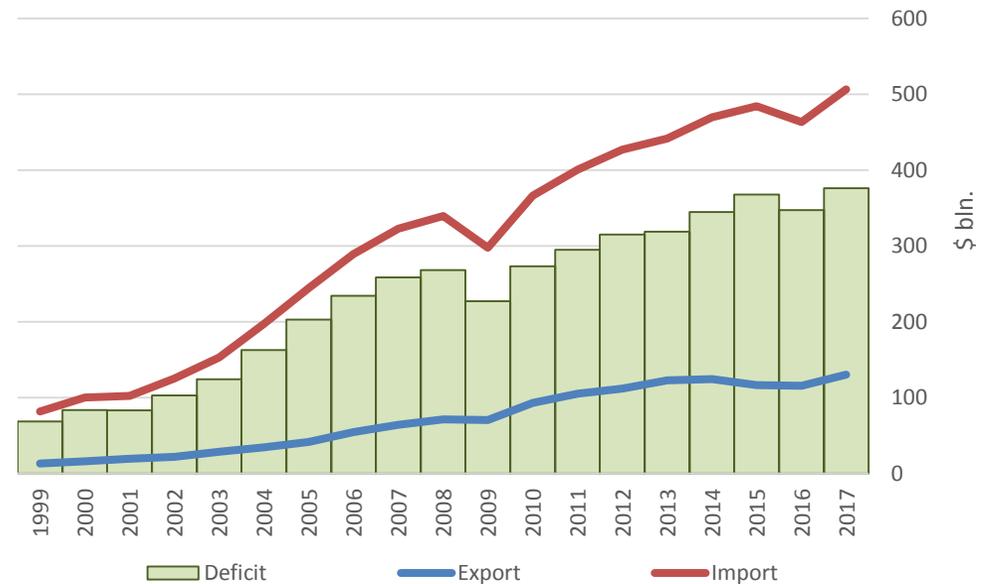
American-Chinese War

The PRC is the main direction for U.S. trade attack, and this front is worth paying special attention. Trump has much more opportunities in the trade war with China - the exports of U.S. goods to the PRC are \$506 billion (in 2017) and imports – \$130 billion. However, it should be remembered that the surplus of the balance of U.S. services with China (\$40 billion in 2017), can become the goal of the PRC.

To this day there are (or will soon come into effect) reciprocal tariffs on goods for \$50 billion, but if Trump put into action his threat and impose even higher tariffs for \$200 billion, then China will not be able to respond symmetrically.

The introduced duties against China have a low impact on U.S. consumers, concentrating mainly on manufactured goods (with the exception of separate tariffs on washing machines at the beginning of the year). In the fall, there will be elections to Congress, and Trump does not want to annoy the electorate.

Foreign trade in U.S. goods with China



Source: Bureau of Economic Analysis (BEA), USA

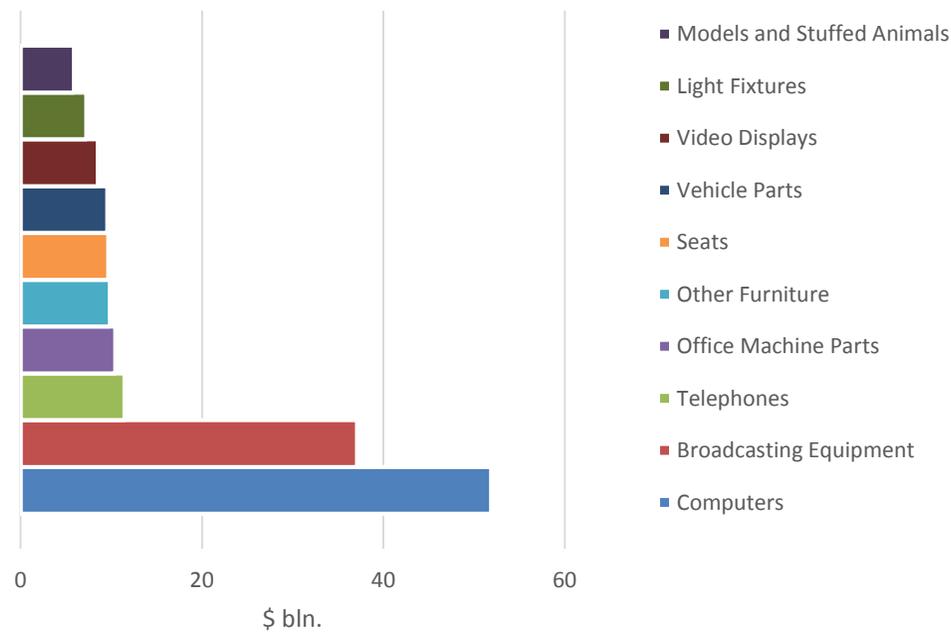
Compound Annual Growth Rate (CAGR) of the deficit – 37%

Despite the difference in trade volume, Trump has few ways to maneuver. The two largest items of Chinese exports to the USA (20% of total export) – computers and broadcasting equipment – largely consist of consumer products. Some consumer goods have been already included to the list dated December 10 for \$200 billion, and if Trump implements the threat and introduces duties for another \$200 billion, then it will not be possible to do without tariffs on consumer goods.

Trump wants to level the trade balance by reducing imports and increasing exports. No matter how hard Trump tried not to influence the population, this would in any case negatively affect the consumption volume of the Americans.

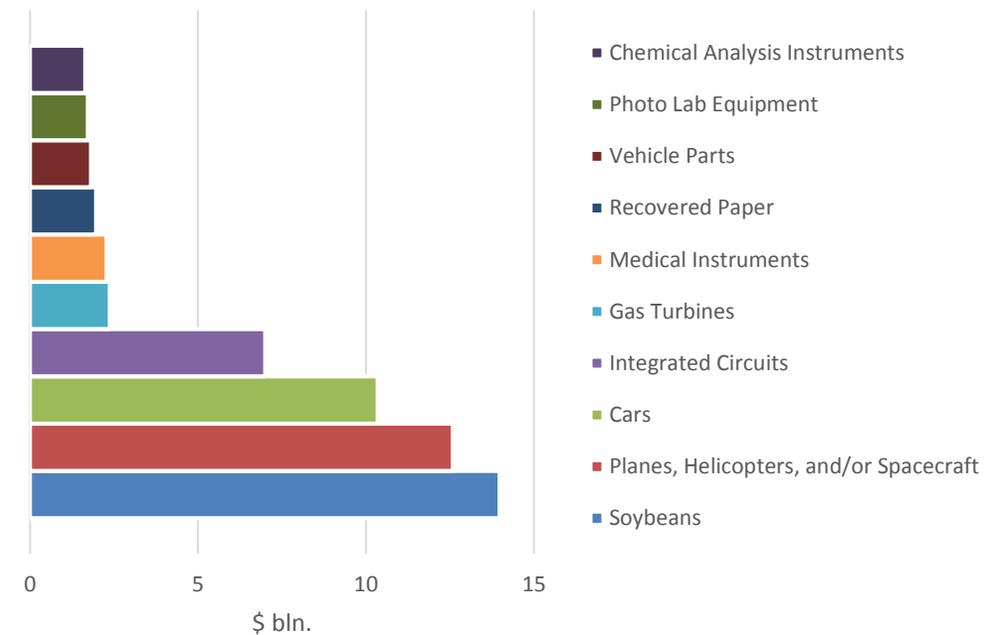
China has already imposed duties on the main items of U.S. exports - soybeans, airplanes and cars, and at a maximum ratio of 25%.

Ten largest items of trade exports of China to the USA (2016), 37% of total trade exports



Source: UN Statistics Department (UNSD)

Ten largest items of trade exports of China to the USA (2016), 46% of total trade exports

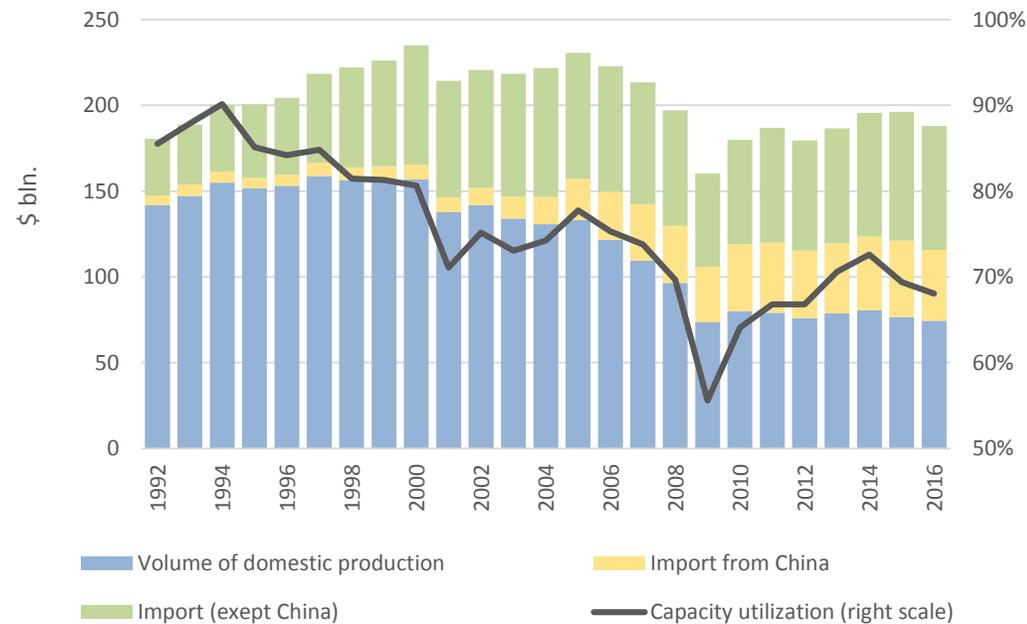


Source: UN Statistics Department (UNSD)

Will the USA be able to replace China in consumer goods? Consider one of the main branches of consumer demand – the manufacture of textile and clothing. Since China became a member of the WTO in 2001, domestic production in the USA has reduced twice; the capacity utilization has dropped from 85 to 70%. The cost of imports of textile and clothing from China to the USA in 2017 was \$41 billion, while domestic U.S production was at the level of \$74 billion. Thus, if the USA increases its own production to the level of the 1990s, they will be able to compensate for the entire volume of Chinese imports in this sector.

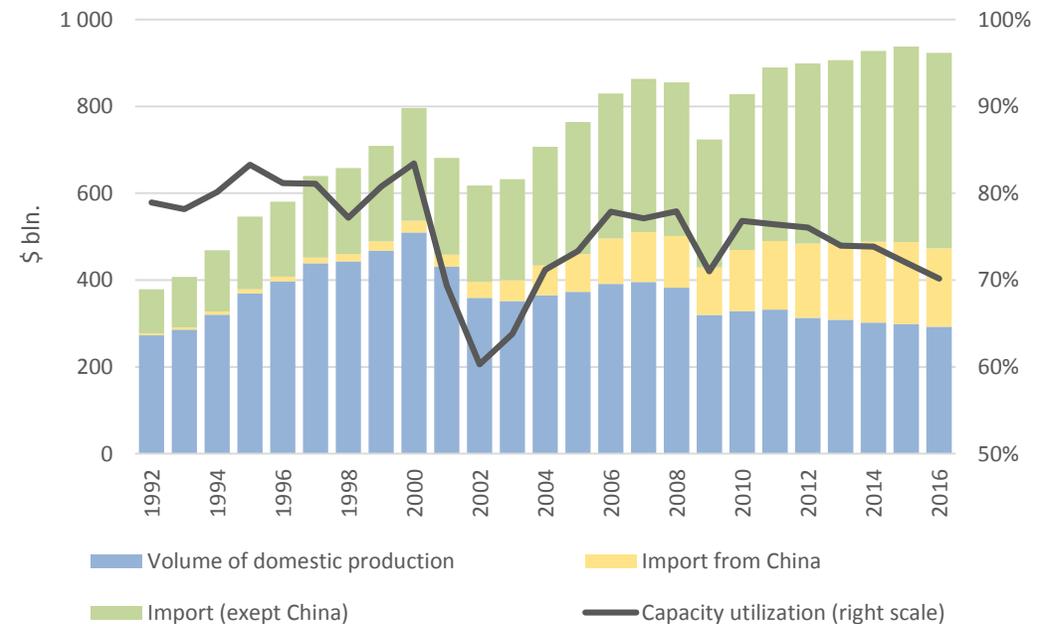
A similar story with a more technological industry – computers and other electronics – a sharp drop in domestic production after China's accession to the WTO. Now the USA produce computers and other electronics for \$200 billion less than in 2000, and China's exports to the USA under this item – is \$180 billion (less than a third of all U.S. imports of goods of this group).

Textile and clothing: domestic production, imports and capacity utilization factor, USA



Source: U.S. Census Bureau (USCB),
U.S. International Trade Commission (USITC), FRS USA

Computers and other electronics: domestic production, imports and capacity utilization factor, USA

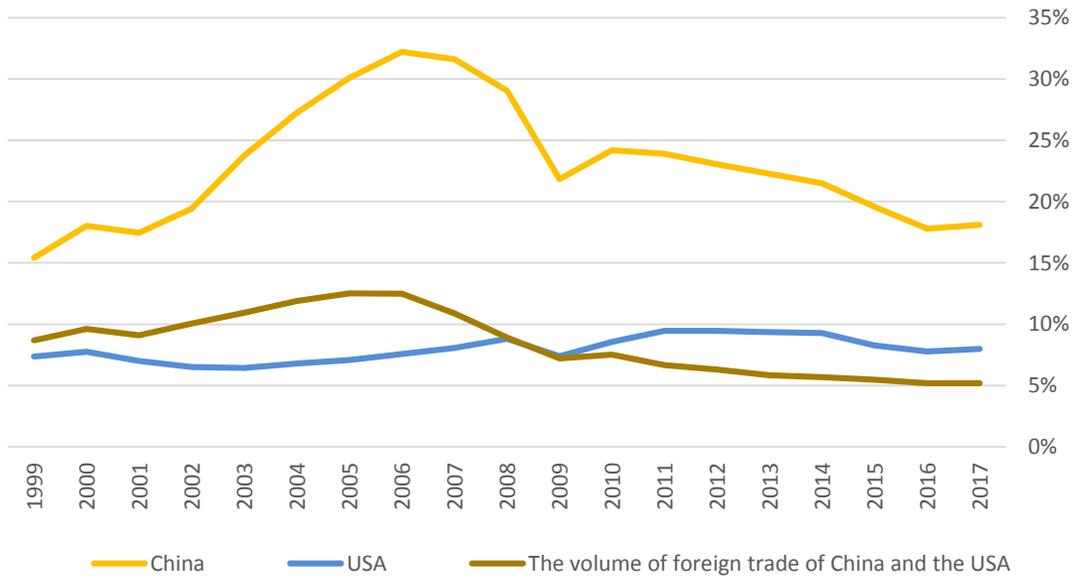


Source: U.S. Census Bureau (USCB),
U.S. International Trade Commission (USITC), FRS USA

How much painful can be the break of China with the USA? Although China has taken significant steps to develop the domestic market, almost halving its dependence on foreign trade compared to the peak value of 2006, it remains significantly higher than the U.S. rate. Accordingly, the losses to the economy from the trade war will be more significant for the PRC than for the USA.

On the other hand, the USA has trade disagreements with half the world, and China – only with the USA. The trade ration with the USA in the Chinese economy is slightly above 5%.

Volume of foreign trade (imports and exports) of the USA and China (all % of GDP)



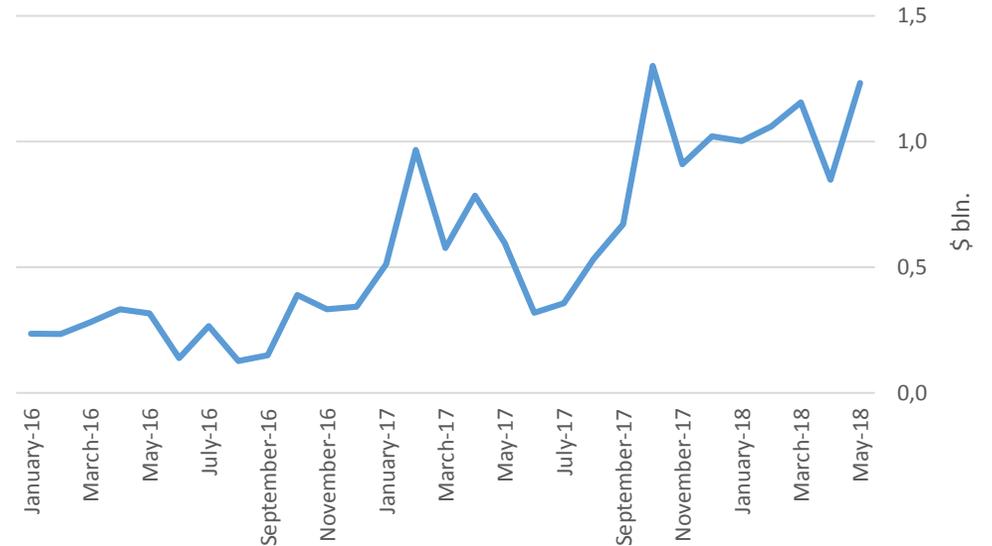
Source: National Bureau of Statistics of China, U.S. Census Bureau (USCB)

Oil and gas

Over the past few years, the USA has significantly increased oil exports to China (\$ 8.5 billion for 2017). As a countermeasure in the trade war, the PRC is going to introduce 25% tariffs on American oil. Exports of oil from the USA to China accounted for 8-9% of all U.S oil exports.

American LNG is also under the threat of Chinese duties. Here China takes about 15% of U.S. exports (\$ 485 million in 2017).

Export of U.S oil and oil products to China, by months



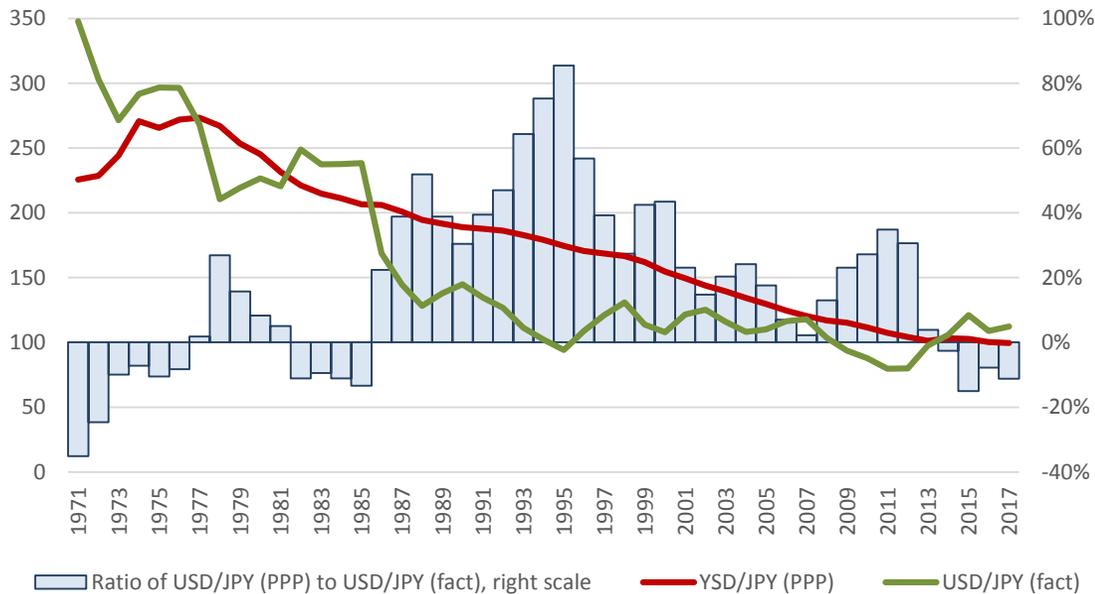
Source: U.S. Department of Energy (EIA)

Exchange rate as a weapon

The depreciation of the national currency should contribute to an increase in exports volume, as exporters receive a price advantage in foreign markets. It should be kept in mind that the effect of depreciation for the exporter can be compensated by the difference between rising prices in the trading countries. The ratio between the actual exchange rate and the exchange rate calculated in purchasing power parity (hereinafter referred to as "PPP") shows significant benefits for the exporters.

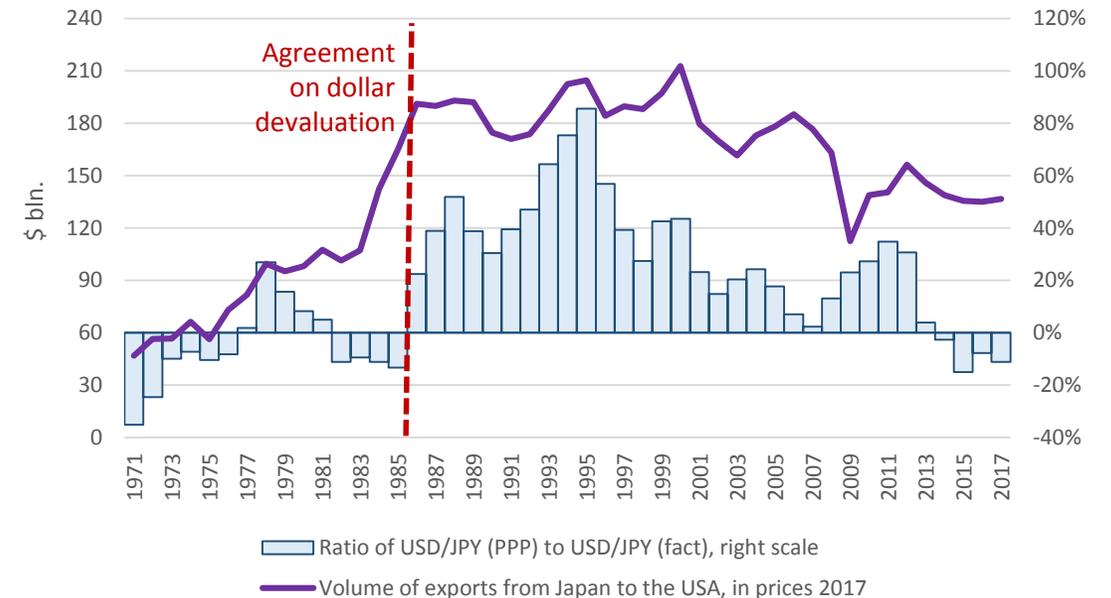
For example, the actual rate of JPY to the US dollar before 1985 fluctuated around the exchange rate calculated in purchasing power parity. In 1985, an agreement on the devaluation of the dollar, was reached between the USA and other developed economies, and JPY has become much more expensive than its purchasing power parity. This greatly affected the volume of Japanese exports to the USA – when from 1970 to 1985 the average annual increase in imports was 10.2%, further it did not exceed 0.6%. In recent years, the relationship between the rates has again become negative, but so far the Japanese exports do not show a growth trend.

Actual rate of USD/JPY, rate of USD/JPY in purchasing power parity and their ratio



Source: OECD, Bureau of Economic Analysis (BEA), USA

Ratio rate of USD/JPY in purchasing power parity to actual rate of USD/JPY and the volume of Japan's exports in the USA at constant prices

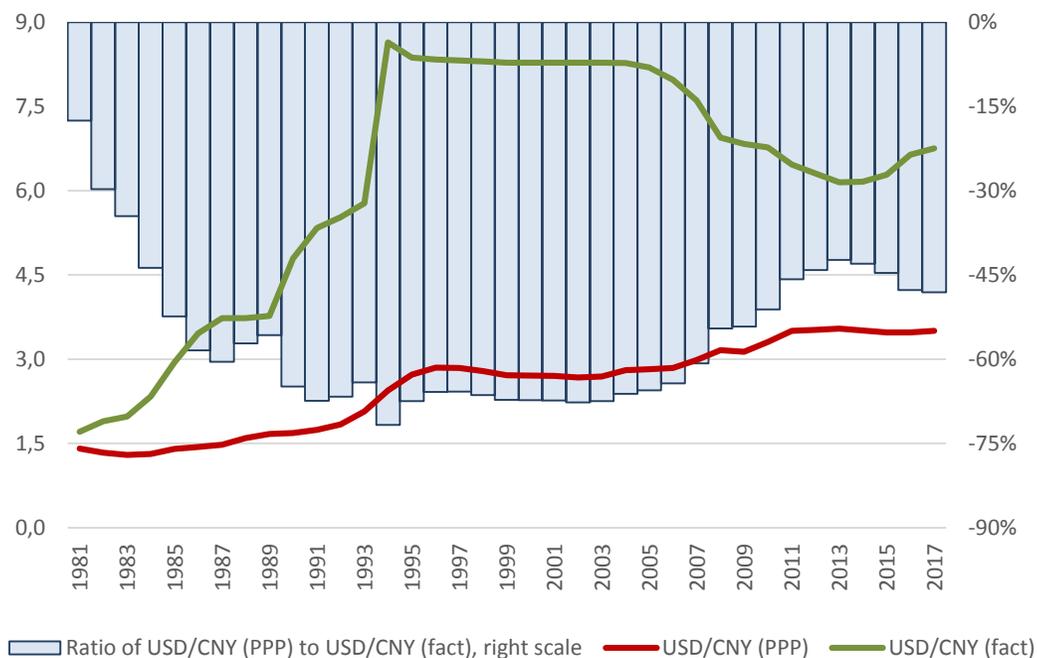


Source: OECD, Bureau of Economic Analysis (BEA), USA

The situation is more unambiguous with China - over the past forty years, the CNY at the actual rate is consistently lower than its purchasing power parity, which should contribute to the high growth rate of Chinese exports.

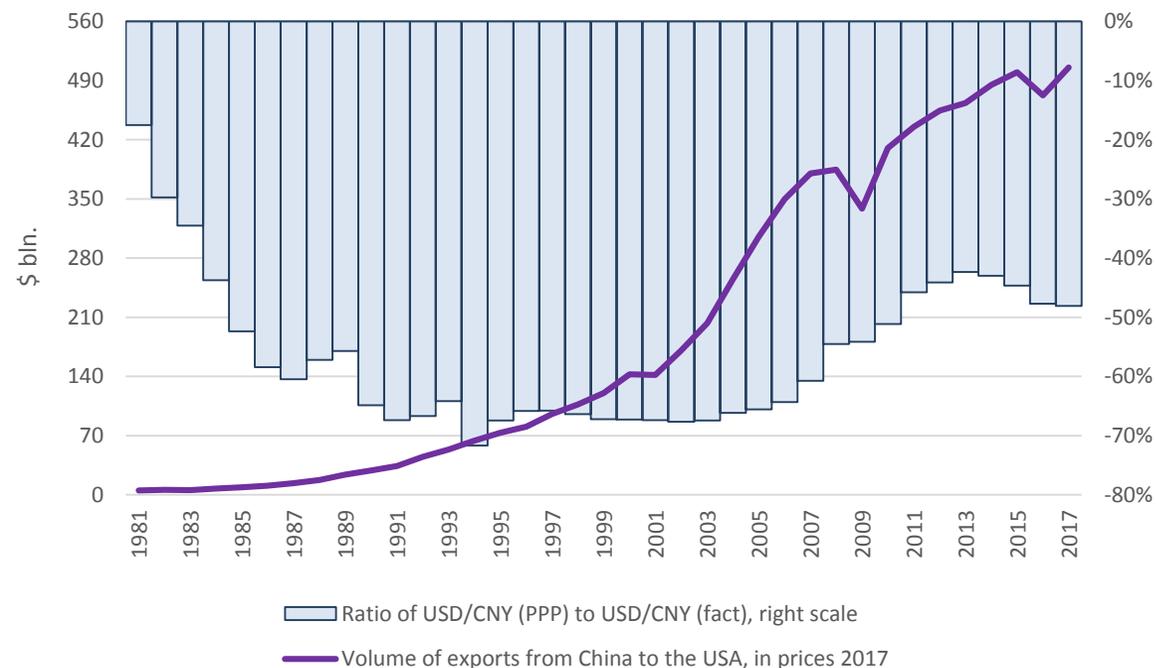
The USA repeatedly criticized China for understating, in their opinion, CNY exchange rate; however, the PRC was never recognized as a currency manipulator. After 2005, China abolished the rigid peg of CNY against the US dollar, which had been in effect for ten years, making an exception only for the 2008-10 crisis periods. Nevertheless, CNY did not become a fully freely convertible currency; its rate is determined by the People's Bank of China based on the results of market trades, but in the specified corridor.

Actual rate of USD/CNY, rate of USD/CNY in purchasing power parity and their ration



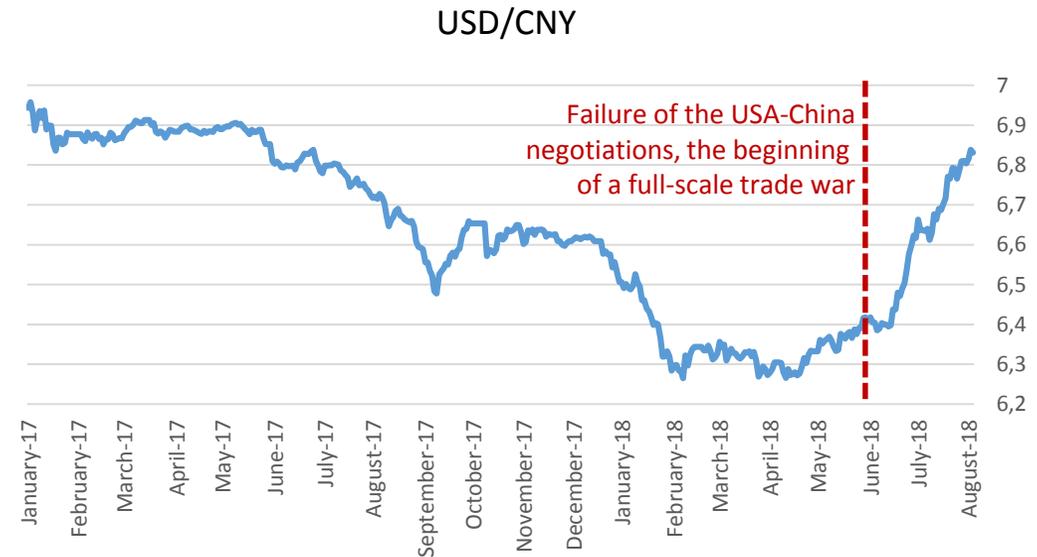
Source: OECD, Bureau of Economic Analysis (BEA), USA

Actual rate of USD/CNY in purchasing power parity to actual rate of USD/CNY and the volume of China's exports to the USA at constant prices



Source: OECD, Bureau of Economic Analysis (BEA), USA

The understated actual exchange rate of CNY cannot help giving Chinese exporters a price advantage. After the beginning of the trade war with the USA, CNY became lower, and the difference between the two rates intensified. Since the beginning of the war, CNY has weakened by more than 9%. Trump blames the Chinese authorities for this, which, in his opinion, seek to eliminate the effect of duties. Another explanation may be the outflow of capital from the PRC.



Source: Thomson Reuters

Donald Trump tries to break the international division of labor, where the USA is the center of financial services and high-tech developments, transferring physical production to countries with cheap labor.

Trump's position in the trade war is not as strong as it seems at first glance, because its escalation can lead to increase in prices and adversely affect the U.S. consumer. Unable to respond symmetrically to duties on imports of goods, U.S. trade partners may try to reduce their deficit in the balance of services with the U.S. It will be difficult for the States to force other countries to buy more American goods - they are more limited by high export prices, rather than tariffs. The USA can try to develop its own production of imported goods, but the price for them will be much higher than, for example, in China, which is unlikely to appreciate the American consumers.

Publication date: August, 2018