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PROTECTIONIST THREATS AND RISKS FOR THE MARKETS

"Wars begin when you will, but they do not end when you please." Machiavelli

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The protectionist measures that have been announced are modest but there are still great fears, because the markets tend to agree with Machiavelli's words and fear an escalation.

For several decades, Westerners viewed globalization optimistically, with global trade posting annual growth at twice the rate of global GDP and appearing as a growth driver, while businesses' foreign direct investment (FDI) expanded and still represented 3.3% of global GDP in 2007.

Since 2008, following the slowdown in global economic growth, globalization has come to be perceived by some critics as a factor exacerbating inequalities and causing job losses. In OECD countries, there is a will to redevelop industry because it is a job creator, and a will to protect corporate capital to prevent foreigners taking control of strategic sectors. While the WTO estimates at just 5% the volume of global trade affected by binding measures, this could get worse. An illustration of this is 2016, when global trade growth was half GDP growth for the first time, excluding the crisis year of 2009. Although an improvement was perceptible in 2017 (+3.7%), doubts persist and FDI declined from \$1,810 billion in 2016 to \$1,520 billion in 2017. There are several reasons for this slowdown in trade and transnational investment: reshoring of production units, sometimes facilitated by automation, economies becoming less dependent on industry and therefore more tied to domestic services, protectionist measures and a reorientation of the Chinese economy away from exports and towards the promotion of domestic consumption.

Long an apostle of free trade, the United States under Donald Trump is tempted by political isolationism, economic protectionism and trade war. While this isolationism is purely verbal, given the active US presence in Syria, Afghanistan, Ukraine and Korea, what about protectionism? We will study Trump's analysis and then his errors, before concluding that we do not really believe in an extension of protectionism because the Americans would have more to lose than to gain. In the short term, however, markets cannot completely ignore the risk of a possible trade war and an escalation in protectionist reprisals.

I. Trump's analysis: "Nations have no permanent friends or allies, they only have permanent interests". Lord Palmerston.

This statement by Queen Victoria's former British Prime Minister summarizes the politics of Trump, who does not hesitate to antagonize "friendly countries".

It is true that while the first industrial revolution indisputably benefited European countries, the recent wave of globalization has favoured the emerging nations, where it has enabled a fantastic expansion of the middle class, and this partly explains the stagnant wage growth of the middle class in developed countries. According to German philosopher *Sloterdijk*, the employees of Western countries have lost their "civilisation rent" in recent decades because of the spread of job insecurity, while hundreds of millions of people have emerged from poverty in the countries of the South.

In the United States, the conflict between advocates of free trade and protectionists goes back a long way, having been one of the causes of the Civil War between an industrial North advocating free trade and a protectionist, agricultural South. After the Second World War, the Americans were resolute advocates of free trade, which they tied in with their preaching on democracy, but with Donald Trump, that is all finished.

We will take a look back over the previous protectionist measures of US governments, then present an overview of America's competitive position, before describing Donald Trump's measures.

Previous protectionist measures:

The Americans first tried protectionist measures with the application of the Hawley-Smoot tariffs in 1930. Stock market operators will remember that this announcement wiped 10% off the performance of the US market, already shaken by the 1929 crisis.

Since then, only targeted measures have been adopted. In 1986, Ronald Reagan passed measures to protect the machine-tool sector. After him, Bill Clinton pragmatically stuck to the principle of his Secretary of State, "unilateralism when you can, multilateralism when you must". In March 2002, George Bush decided to levy a tax of up to 30% on imports of European steel, resulting in an upturn in previously declining prices, but he had to repeal this measure in December 2003 when challenged by the WTO. Barack Obama also decided to levy a duty on tyre imports.

Outside the United States, Europe has also taken occasional measures. In 2013, for example, it levied a 47% tax on Chinese solar panels. In India, recently, to boost fiscal revenues, Prime Minister Modi levied high import duties on motor cars, smartphones and television sets.

Since the 2008 crisis, populists concerned by losses of sovereignty, critical of free trade and in favour of withdrawal, have been gaining influence. Trade infringements remain limited, but if bilateralism were to become widespread, the losers would be the small countries, and this is worth bearing in mind choosing stock market investments.

Looking back over these three decades, we should remember the failure of the Doha negotiations after some fifteen years of discussions, and also that the breaches of free trade may well be frequent, but are also very much local and temporary. This, so far, is the sense of the recent decisions by Donald Trump, who does not have a monopoly on protectionism, given that Japan has several protected sectors, Europe is not against giving local preference in awarding contracts, and all countries adroitly use standards or subsidies to protect certain sectors.

America's competitive position:

Donald Trump has presented a threefold analysis: global, sector-specific on steel and bilateral with China.

- **The global approach:**

In 2017, the US current-account deficit widened by 12% to \$566 billion. What is worse is that if we subtract the surplus in services, the trade deficit amounted to \$810 billion, or more than 4% of GDP, and the United States has a trade deficit with about one hundred countries: \$375 billion with China

(\$275 billion according to the Chinese), about \$100 billion with Mexico, \$60-70 billion with Japan and Germany, \$55 billion with Canada and \$30 billion with Vietnam. Donald Trump fears that things will get worse in 2018, because the statistics for January showed a 16% increase in the deficit, to \$75 billion excluding the surplus for services, but the cause of this deterioration is the good US economic situation.

- **The sector perspective for steel:**

The major suppliers of steel to the United States are Canada, with 4.3 million tonnes, Brazil 3.6MT, South Korea 2.7MT, Mexico 2.4MT, but not China. In aluminium, we again find Canada with 2.9MT, Russia with 0.7MT and China 0.37MT. In other words, the imports come mostly from "friendly countries", Canada 16%, Brazil 13%, South Korea 10%, Mexico 9%, the European Union, etc.

Since 1998, the US steel sector has lost 75,000 jobs, mainly because there is a global overcapacity, especially in China. Startled by the leap in steel imports, up 19% for the first ten months of 2017 according to the *America Iron and Steel Institute*, and encouraged by the powerful steel lobby, Donald Trump wants to increase steel production again in the United States.

Donald Trump has decided to levy a 25% tariff on steel and 10% on aluminium, but exempted the NAFTA partners, Canada and Mexico, to their relief, because Canada sells almost 90% of its steel exports to the United States, and Mexico more than 70%. It will probably be the same for Europe, which exports \$5 billion worth of steel and \$1 billion worth of aluminium to the United States.

- **The relationship with China:**

The United States has a surplus of \$38 billion in services (travel), but the trade deficit was \$6 billion in 1985, \$100 billion in 2002 and \$375 billion in 2017. The two countries are closely linked: China provides the United States with 20% of its imports, or the equivalent of 2.5% of US GDP. Chinese exports to the United States represent 1/8th of total Chinese exports.

In 2017, the US bought \$505 billion worth of goods from the Chinese (\$70 billion in telephones, \$45 billion in computers, etc.), or 4% of Chinese GDP (\$12,362 billion) and sold China only \$130 billion in goods (aircraft for \$16 billion, soya beans for \$14 billion, motor cars for \$10 billion), i.e. 0.6% of US GDP (\$19,377 billion). So the asymmetry is clear.

Donald Trump notes the increase in China's trade surpluses, recently at a rate of \$21 billion/month, and is determined to apply taxes worth \$60 billion to a hundred products from China, in electronics, telecommunications and the toys sector, in order to reduce the bilateral deficit by \$100 billion.

In steel, China will be affected only marginally, on 0.5% of its exports. Therefore, so far, it's much ado about nothing, and so much the better.

II. Trump's five errors: "*Misnaming things adds to the world's misfortune*". Camus.

Economic history teaches that free trade benefits the strongest and protectionism helps the weakest. At present, in a world where US multinational firms are dominant, it is hard to understand the American initiatives. The United States has the largest portfolio of foreign equity investments and this yields it more, in the form of

dividends, than the cost to the Treasury of bonds issued to finance the deficits and often bought up by foreigners. So why want to protect itself? Why expose itself to reprisals? The US trade deficit is substantial because it is the result of over-consumption, a shortfall in savings and a lack of competitiveness.

Globalization wrongly accused:

Wage stagnation and job losses in manufacturing industry in developed countries preceded the expansion of China's trade surpluses, and so do not result from globalization. It is innovation and automation that are the major causes of job losses, not international competition.

Poor targeting:

While a tariff generates income for the State, it is also a consumer tax on households which puts a strain on their purchasing power, and a tax on intermediate consumption for businesses that strains their competitiveness. In no case will tariffs solve problems of competitiveness.

The US steel industry employs only 140,000 of the 145 million US workers and generates only \$35 billion of the \$18,000 billion of US GDP. The angle of attack chosen by Trump, steel and aluminium (imports worth \$50 billion, 2% of US imports and 0.2% of US GDP), misses its target which, in Trump's mind, is China: only 2% of the \$22 billion worth of steel purchased by America comes from China and \$3.5 billion worth of aluminium, which is peanuts compared with the \$580 billion in trade between the two countries.

The substance of the problem is sometimes dumping by certain foreign firms, but more fundamentally it is the insufficient competitiveness of US firms, due to under-investment and, in some cases, insufficiently skilled labour.

Ignorance of interdependence:

- **Imports as a factor of competitiveness of the US economy:**

US exports include only 40% of American content and 60% of US imports are components, so US competitiveness largely depends on component import prices. Taxing these important components will affect the competitive position of US firms in export markets and reduce purchasing power because, thanks to globalization, many products are less expensive than if they were produced locally.

It has been observed that firms which have foreign production units innovate and create more jobs than domestic firms. The expansion of US multinational firms boosts US employment, and wages in the US multinationals are higher than those paid in other firms.

- **The need to preserve NAFTA:**

By leaving the TPP, the Trans-Pacific Partnership Agreement negotiated by Obama, Trump deprived America of benefits that the eleven other signatory countries will enjoy without it and he gave the lie to *Churchill, who wrote "You can always count on Americans to do the right thing"*. While the Americans become withdrawn, the European Union has signed an agreement with Canada and is negotiating agreements with Japan and Australia. There remains NAFTA, signed in 1995, an agreement

that is inherently unequal, because the GDPs of Canada and Mexico represent only 10% and 8% of US GDP respectively, but an agreement which has benefited each of the partners. Building a wall with Mexico would be overlooking the fact that there are now fewer Mexicans entering the United States than returning home. It would mean having US consumers pay the cost of building, more than \$20 billion, via the increased cost of imports. Breaking up NAFTA would be unpopular with the representatives of farm states such as Kansas, Iowa and Dakota, would favour the election of a populist in the Mexican elections at the end of the year, and it would in no way stop immigration.

A possibility of reprisals:

The United States is exposing itself to reprisals. Imposing tariffs, given that 30% of steel is imported, will not enable the US steel industry to recover competitiveness but will increase the production costs of other major US industries such as the aerospace industry, defence, construction and the automotive industry, which could therefore lose jobs. It is estimated that six million jobs and \$1,000 billion of GDP are accounted for by these sectors exposed to a rise in the cost of imports, and according to a study conducted by *Baughman*, for every job created in steel, 18 jobs would be lost in client sectors. Other (less pessimistic) studies suggest that for one job created in steel, six jobs will be lost in related sectors. Along these lines, *Hufbauer* calculated that Obama's 2009 measure to tax Chinese tyres had created only 1,200 jobs in the sector but had cost three times more in related sectors. Clearly the cost-benefit balance of this protectionist measure is negative and it will adversely affect US growth and, marginally, push up inflation.

If the United States has such a trade deficit in manufactured goods, it is above all a problem of competitiveness. Manufacturing value added as a percentage of GDP is only 11%, way below the percentage observed in Germany (22%) or in the Eurozone (16%). US imports of manufactured goods are 1.6x times greater than exports, whereas in the Eurozone and in Japan, exports far exceed imports. It is not necessarily the fault of the Chinese if just over 5% of US exports go to China.

China's capacity for reaction:

Although China is worrying, three things should be specified: in the globalized world, China is the leading exporter, with a 12% market share, but 40% of Chinese exports in fact come from foreign firms established in China, such as Apple, for example. China has greatly increased its FDI flows (foreign direct investment) in recent years, from \$90 billion in 2015 to \$170 billion in 2016 but in terms of stocks, its investment portfolio, worth about \$1,200 billion, represents only one-fifth of the American portfolio, or the equivalent of the stock held by the French or the Germans. Finally, China is less dependent on foreign trade than before: in 2007, the positive trade balance represented 10% of GDP, while it is now 3%, and the model is evolving toward consumption, with 45% of the labour force now employed in services, versus less than one-third in manufacturing industry.

China has been a member of the WTO since 2001 and claims to be a proponent of free trade, but since it is not subject to the rules of capitalism, it does not hesitate to subsidize uncompetitive State-owned enterprises which, via their investments, exacerbate the situation of overcapacity in some sectors, thereby weakening their international competitors or even taking them over. All these are debatable actions which could justify protective measures in Western countries and pressure to ensure that the Chinese reduce this overcapacity more swiftly. We may add that this Chinese policy is equally debatable for the Chinese taxpayer who thus subsidizes the US consumer.

The Chinese have hardly felt any need to react to Trump's measures on steel, because only 1% of their aluminium exports are sent to the United States and this amount is less than the excess capacity that they plan to shut down. China's attitude could change, however, because Donald Trump wants to invoke Section 301 of the US Trade Act for the treatment of intellectual property and plans to slap \$60 billion in taxes on Chinese exports, which so far concerns only 2.5% of Chinese exports and would cost 0.1% of Chinese GDP. All these possible measures are creating panic among US retailers, in the textile industry, and among those who buy components from China. To react to any US protectionist measures, the Chinese will probably make concessions and accept greater openness of financial services and healthcare and offer better protection for patents, and also brandish the monetary weapon and the agricultural weapon.

- **Monetary weapon:**

By brandishing the threat to reduce its \$1,170 billion portfolio of US Treasury Bills, China would be able to push up US interest rates and hence cause a stock market collapse. China could also devalue the yuan.

- **Agricultural weapon:**

The United States is still the leading agricultural exporter in the world, far ahead of Brazil. By themselves, they account for one-third of global trade in maize (corn) and even 40% of soya bean exports. China could take advantage of good harvests at home and in Brazil to reduce its purchases of American soya beans. In 2017, by itself it purchased 60% of the soya beans sold in international markets, or a total of 100m tonnes, including 50m tonnes from Brazil and 30m tonnes from the United States, worth \$14 billion.

Conclusion: *"Politics is the art of misleading people by making them believe that you are working for their happiness". D'Alembert.*

Donald Trump is misleading his electors by letting them believe that protectionism will create jobs. Protectionism is a bad policy which reduces the purchasing power of the people it aims to protect. We remain sceptical, however, as to the likelihood of this scenario which would exacerbate the risks of inflation and

reprisals. Donald Trump is mistaken in his fixation on the \$375 billion deficit with China, because on a value-added basis, after deducting non-Chinese components, it is possibly smaller by half.

Donald Trump's declarations and threats, to use military language, are akin to a nuclear deterrent. The reactions of other countries suggest the prospect of a graduated response. The Chinese were able to benefit from joining the WTO in the early 2000s, subsidizing some exports, not hesitating to get around the rules protecting intellectual property and not facilitating the operations of Western companies established in China. The appropriate response is not an increase in customs duties which would shift production from China to Vietnam or Bangladesh, but a more restrictive approach to Chinese investments in Europe and the United States, greater vigilance regarding Chinese dumping in export markets, and pressure on China to open its market to corporate takeovers.

From the economic viewpoint, a trade deficit is not necessarily dramatic, because consumers and component buyers win out by importing less expensive goods. **Emmanuel Todd** and the advocates of protectionism may consider that protectionism should allow wages to rise, but where they are mistaken is that this wage growth will in fact be consumed by inflation. It is futile to imagine that tariffs could wipe out a trade deficit. The global economy is too intertwined at the corporate level to be able to untangle the web of free trade. We believe that Trump, who has made a rising stock market an indicator of the success of his policy, will merely take symbolic measures.

From the stock market viewpoint, if protectionism were to spread, markets would have two reasons to be worried. Firstly, businesses would be less able to optimize costs and would therefore suffer an erosion of their margins. Secondly, rising import prices would strain purchasing power. Protectionism would mean more inflation and in that case it would be advisable to buy floating-rate bonds (TIPS). It would also mean a depreciation of currencies and a fall in the stock markets of the very export-oriented smaller countries, such as Taiwan and South Korea. Finally, in the event of a winding up of NAFTA, a sharp fall in the Canadian and Mexican currencies would be logical. All these markets should be watched cautiously in the short term.

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