

US trade protectionism is bad for Emerging Markets

A replay of the 1930s trade war would cost EMs dearly

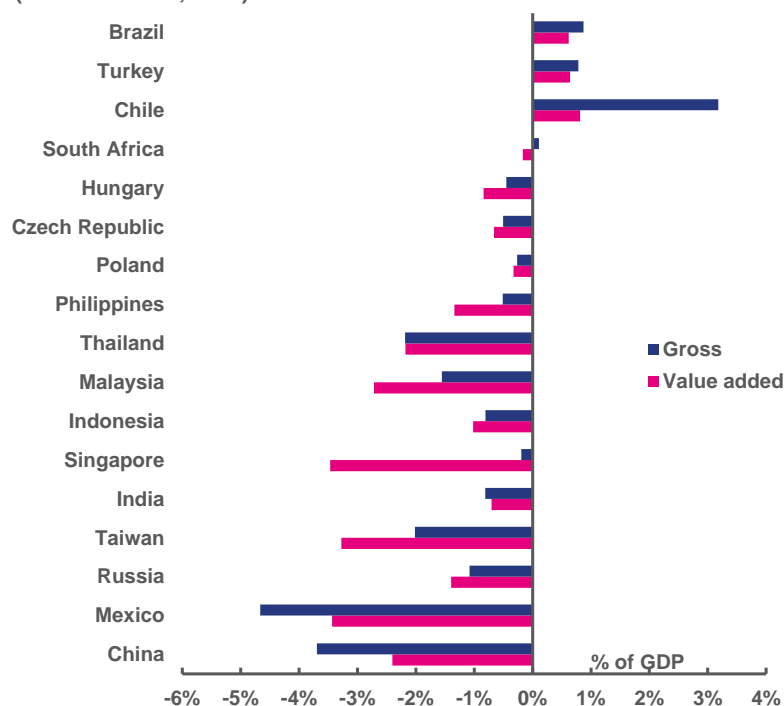
Key points

- Trade-unfriendly policies expressed by the two leading US presidential candidates in the run-up to elections create uncertainty for EM exporters.
- Donald Trump blames trade deals for the closing of US factories and the loss of jobs, while Hillary Clinton has tried to soften her past support for trade deals.
- Mexico and China top the league as the most vulnerable to any new anti-trade bias because of large bilateral trade surpluses they run against the US.
- Financial and trade centres, like Singapore and Hong Kong, are also highly exposed, because of investment ties with the US.
- We find that the sensitivity of real GDP growth to a hike in tariffs is more pronounced for Asia followed by Latin America, while it is not significant for Central Eastern Europe.
- We consider three scenarios: in the worst scenario, trade protectionism in the US triggers a drop in global trade volumes and protracted recession similar to that experienced after the adoption of the Smoot-Hawley Act in the '30s in the US.
- Under the very bad scenario a regional trade war erupts with US trade policy targeting Mexico and China.
- In the baseline scenario, status quo is maintained, acknowledging as the bilateral US trade deficits are not as wide once correctly measured, while trade has contributed significantly to the US job creation.

Exhibit 1

Mexico and China would be mostly exposed to US trade protectionism

Bilateral trade balance of the US with EMs (% of EMs' GDP, 2015)



Source: OECD and AXA IM Research

US macro policies matter for the world

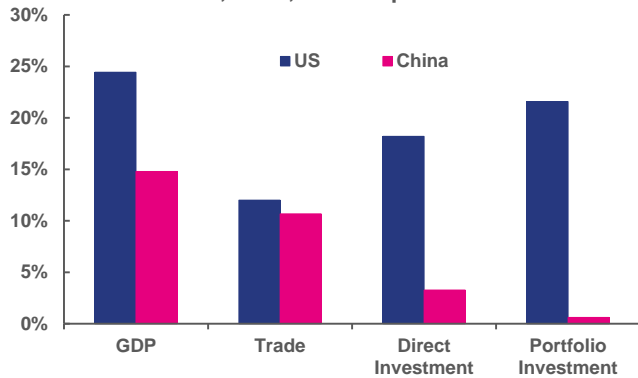
With China fears subsiding and Brexit set in stone, the US presidential election has become a top risk for global financial markets in the near-to-medium term. Significant policy divergence from the status quo will inevitably affect the trajectory of the US economy in the coming years. But as the world's largest economy, with a currency that dominates global capital flows, these changes will also likely have a significant spill-over effect onto the world.

As our colleague David Page explains¹, the economic policies proposed by the two presidential candidates are radically different from one another. If fully implemented, they will likely take the US economy down two very different paths. Our note, however, takes a different angle by focusing on what the relevant policies (i.e. those relating to trade) mean for the rest of the world, particularly emerging markets (EMs). We explore the key linkages between the US and EM countries, and try to understand the economic transmissions under various policy scenarios.

Exhibit 2

US remain the largest economic power in the world

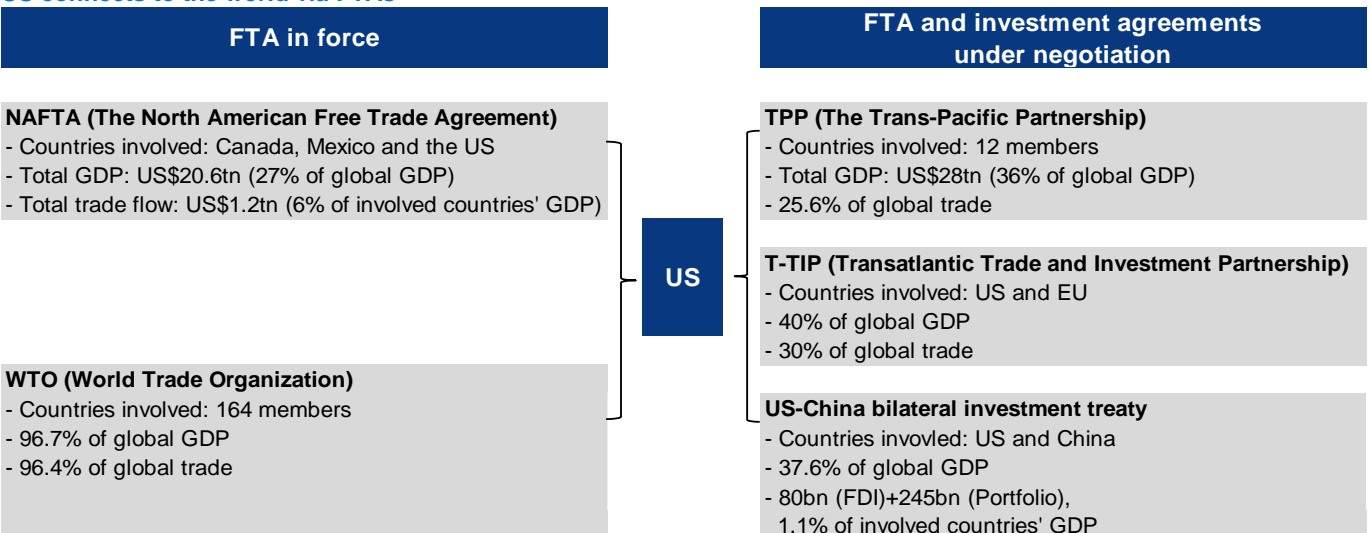
Share of world GDP, trade, FDI and portfolio investment



Source: IMF, OECD, and AXA IM Research

Exhibit 3

US connects to the world via FTAs



Source: Bloomberg, CEIC, various media sources, and AXA IM Research

While the significance of the US economy has dwindled since the Great Financial Crisis (GFC), it remains the preeminent economic superpower in the world, as measured by its shares of global GDP and trade. The US is also the dominant source of investment in Foreign Direct Investment (FDI) and portfolio flows, and its lead over the second largest economy, China, is substantial (Exhibit 2). Finally, with the dominance of the US dollar in global trade and capital flows, policy changes by the Fed can have a significant impact on the credit cycles of EMs.

Anti-trade rhetoric particularly concerning

Given the importance of trade in connecting the world economies, rising protectionist rhetoric in the US presidential election is particularly alarming. Both candidates, Hillary Clinton and Donald Trump, have made anti-trade and Free Trade Agreements (FTAs) remarks during their respective campaigns: Clinton indicated that she would renegotiate the North American Foreign Trade Agreement (NAFTA) and Trans-Pacific Partnership (TPP), while Trump was more radical, threatening to impose harsh tariffs on Mexican and Chinese imports, and pull the US out of all existing trade agreements, even the World Trade Organization (WTO)². On investment, Trump also voiced tough words against US companies investing overseas, and threatened to punish them for costing jobs at home.

As an illustration of trade connections between the US and the rest of the world, Exhibit 3 summarises the major FTAs – signed and under negotiation – involving the US. It is worth highlighting that combining the under-negotiated trade and investment deals – TPP, Transatlantic Trade and Investment Partnership (TTIP) and US-China Investment Treaty – would allow the US to have trade access to the countries producing almost 90% of the world GDP. Terminating or delaying these negotiations, as Trump and Clinton both indicated, would therefore represent a significant set-back for globalization.

¹ David Page, "US elections: a post-primary primer – Part 1 and Part 2", AXA IM Research, August 2016.

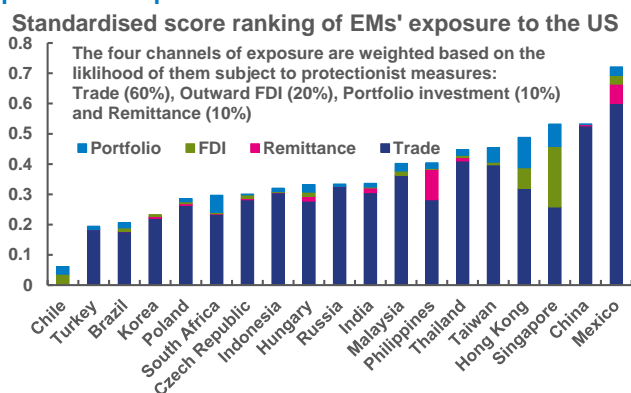
² Laurence Arnold, "Quick Take Q&A: Why Global Trade is Central to Clinton-Trump Race?", Bloomberg, 25 July 2016.

Worse still, if the US – as the world’s largest economy and trading nation – starts to impose punitive tariffs on all its import trade, then portfolio and international flows alike would be affected. Trade protectionism would most likely be accompanied by constraints in the free movement of capital in order to increase the efficiency of constraints on trade flows. Constraints in capital movement could curb the flow of remittances from immigrants in the US to their home country. In *Exhibit 4* we rank each country by the portfolio and FDI and remittance flows it receives from the US and the bilateral trade balance with the US. For each country, we calculate the z-score using the cross sectional mean and standard deviation; compute a weighted³ sum of the z-scores with a subjective 60%-20%-10%-10% weight to Trade, FDI, portfolio investment and remittance respectively, and rank the country relative to its peers by the sum of z-scores. The higher the ranking, the higher the exposure of a country to the US via trade, portfolio, foreign direct investment and remittance flows.

As anticipated, Mexico and China top the league of most vulnerable countries because of the large trade surpluses they run against the US. Financial and trade centres, like Singapore and Hong Kong, are also highly exposed, because of investment ties with the US. Across the regions, Asia has the strongest link to the US, taking seven of the ten top spots. Since trade makes up for most of the exposure, it hints at the region’s vulnerability to any protectionist policies under the next US president.

Exhibit 4

Mexico and China are the most vulnerable to protectionist policies from the US



Source: IMF, OECD, World Bank and AXA IM Research

Assessing impact of a protectionist US

In this section, we construct three scenarios of US trade policies and analyse their potential impact on EMs.

The worst case – a global trade war: a full implementation of trade-unfriendly policies from the US – including exiting all Free Trade Agreements (FTAs) and imposing severe sanctions on all imports – could significantly disrupt the current order of world trade. Worse still, these protectionist actions will most likely be countered by immediate and fierce retaliations of its

³ We imposed a higher weight to trade relative to the other elements considered as this is the most significant contributor to EMs’ economic activity followed by portfolio flows.

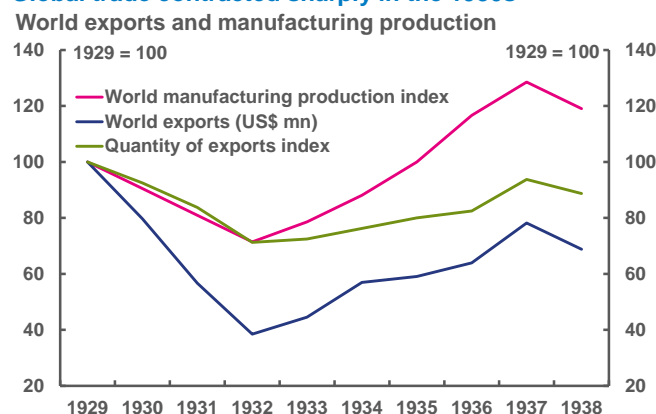
trading partners, resulting in a globalized trade war. We acknowledge, though, that this worst-case scenario is extreme, a thing of the past and unlikely to happen, given the established checks and balances in the US political system. For purely analytical purposes, we look at the global trade war of the 1930s as a benchmark.

The “war” started by the US, following the passage of the Smoot-Hawley Act, which allowed the US to impose across-the-board tariffs on over 20,000 imported products. This was quickly followed by retaliations from 27 of the US’s major trading partners, and the situation quickly degenerated into a global tariff war.

The result: a sharp contraction in global exports – 60% in value terms and 30% in volumes – between 1929 and 1932 (*Exhibit 5*). Not all of this weakness was due to trade protections, of course, given the severe decline in global demand amidst the Great Depression which was well underway. However, if one compares the recovery in global manufacturing production and trade, the former had recouped all the losses by 1935, while the latter did not get back to the pre-1929 level until well into the 1940s. The much more protracted recovery in global trade was, in our view, a result of wide-spread protectionist barriers, which persisted until the 1940s.

Exhibit 5

Global trade contracted sharply in the 1930s



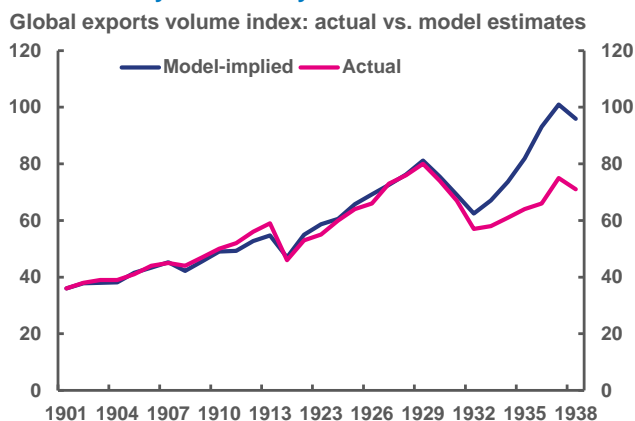
Source: UN and AXA IM Research

Supplementing this analysis, we run a regression of the level of global trade volume (dependent variable) on the level of manufacturing output (independent variable) for the period up to 1929, and let the model “predict” (forecast) trade volume in 1930-1938. The distance between the actual and model-implied trade volume widened significantly after the 1929 crisis (*Exhibit 6*). Had global trade followed its usual relationship with manufacturing production, it would have recovered to its pre-crisis level by 1935. The accumulated gap between the model-implied and actual exports mounted to roughly 20% of model-implied exports by end-1938⁴. The discrepancy between the actual and the model-implied trade growth implies that factors other than the recession induced by the 1929 stock market crash were responsible for the protracted slowdown in global trade with the world trade war being among one of them. Overall, the anti-trade measures, originated in the US but

⁴ The model predicts a 45% recovery in trade from the trough, versus the 23% actually occurred.

quickly spread across the globe, did have a significant and standalone impact on global trade. These results are consistent with the mainstream views in the US (see Bernanke, 2013)⁵.

Exhibit 6
Trade recovery hindered by a tariff war



Source: UN and AXA IM Research

A repeat of the 1930s trade war would have a catastrophic impact on the global economy today. It is fair to assume that such a severe shock – e.g. a 20% decline in global trade⁶ – would be enough to arrest the fragile recovery and send the world economy into another recession. According to our past research, a 1% decline in exports results in a 0.6pp drop in EMs’ annual real GDP growth, on average⁷. Examining the direct impact of raising tariffs on real GDP growth reveals a similar impact to EMs’ real GDP growth implying that there is a one-to-one relationship between tariffs and exports⁸. Specifically, a 1% increase in tariffs is equivalent to a 1% decline in exports resulting into a 0.6pp drop in average EM real GDP growth. We see in *Exhibit 7* that the sensitivity of real GDP growth to a hike in tariffs is more pronounced for Asia followed by Latin America, while it is not significant for Central Eastern Europe (CEE).

Very bad case – a regional trade war: instead of rejecting all FTAs and imposing across-the-board tariffs. Under this – less bad, but still very damaging – scenario, a trade war will break out among US, Mexico and China, with the US initiating protectionist measures, followed by in-kind retaliations by others. Different from the case above, the conflicts here will be confined within the two bilateral routes between the US and China/Mexico, and hence, the contagious effect should be more limited.

⁵ Bernanke, S. B (2013) “Monetary Policy and the Global Economy” Federal Reserve Board Speech, 25 Mar 2013.

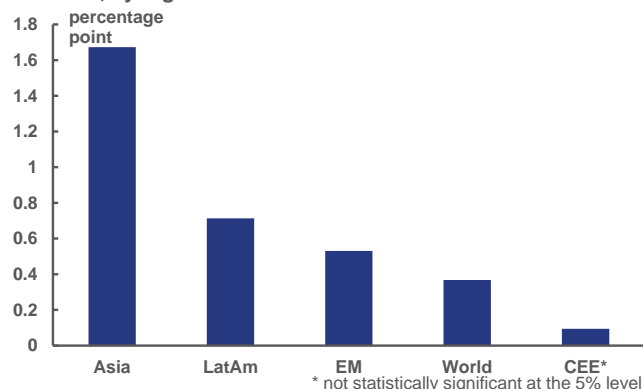
⁶ Putting this in context, the 20% drop in global exports is on par with what we saw during the Global Financial Crisis in 2009.

⁷ Manolis Davradakis, “EMs trade engine has lost power”, AXA IM Research, 22 March 2016.

⁸ We estimate a panel data model where real GDP growth is regressed on the average country tariff rate applied for 40 countries over 2000-2014. Data were retrieved from the World Bank and the IMF. The estimation is performed for all EMs, all economies (world), Latin America, CEE and EM Asia. The estimated coefficient is reported in Exhibit 7.

Exhibit 7
Asia more exposed to higher tariffs

Decline in real GDP growth from a 1pp increase in tariffs, by region

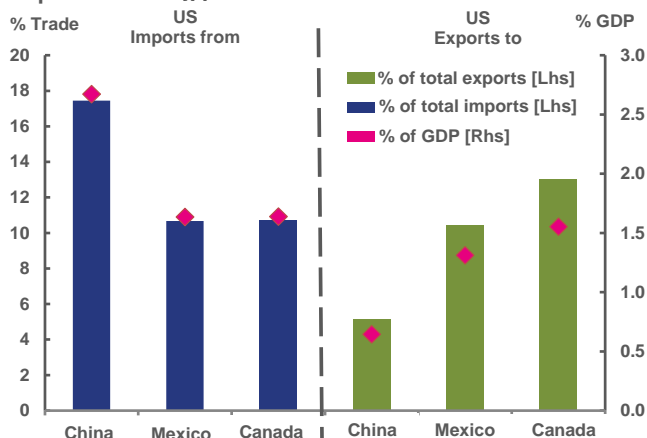


Source: World Bank and AXA IM Research

But for the countries involved, the impact will be severe nevertheless. While this will clearly inflict pains on the targeted countries (possibly leading to economic recession), the US will likely suffer badly as well. As *Exhibit 8* shows, the US economy relies significantly on products from China and Mexico, which together account for roughly 30% of total US imports in 2015. Large tariffs on these products will raise imported inflation, potentially forcing the Fed to tighten faster and the USD to appreciate sharply. In addition, retaliations from China and Mexico will add insult to injury, as US exporters face retaliatory tariffs in their second and third largest markets. One estimate suggests that a full implementation of Trump’s tariff proposal of 45% and 35% tariffs on all Chinese and Mexican imports respectively would sink all three economies into recession simultaneously.⁹

Exhibit 8
US is co-dependent with China and Mexico

Top three trading partners of the US



Source: CEIC, and AXA IM Research

Overall, we consider this scenario as also unlikely, given the full extent of policy ramifications (particularly the back-firing effect). A less-harsh version of the proposal – with much smaller and less wide-spread tariffs – is perhaps more realistic.

⁹ Moody’s, “The Macroeconomic Consequences of Mr. Trump’s Economic policies” Moody’s Analytics, June 2016.

Good case – status quo: this is our base case scenario. We expect the elected president to avoid a confrontational trade policy. There are plenty of past cases, whereby the presidential candidates tried to appeal to nationalist voters by making populist promises during elections, but acted oppositely once taking office. Both Bill Clinton and Barack Obama, for example, made protectionist remarks during their respective campaigns, but turned out to be strong FTA supporters as presidents, with the former signing the NAFTA and the latter initiating TPP and TTIP. If the above historical precedent is followed, we expect the US to continue the push for global trade integration. After all, the bilateral trade deficit the US has with some EMs narrows once we account for the fact that the corresponding EM has to import intermediate goods from the US, in order to produce the exports it ships to the US. This is particularly the case for Mexico and China for which the bilateral trade balance with the US in value added terms, which accounts for the intermediate goods' imports from the US, is lower than the bilateral trade balance in gross terms (*Exhibit 1*). This finding weakens the argument for trade protectionism in the US as the bilateral trade deficits once correctly measured, are not as wide as they appear originally under gross value added terms.

It is far from clear that trade protectionism in the US would be beneficial for the US economy too. Growth in export-supported jobs accounted for 40% of total job growth in the US in the 1993-2008 span, according to the International Trade Administration. The latter also argues that exports contribute an additional 18% to workers' earnings on average in the U.S. manufacturing sector¹⁰.

EM monetary policy

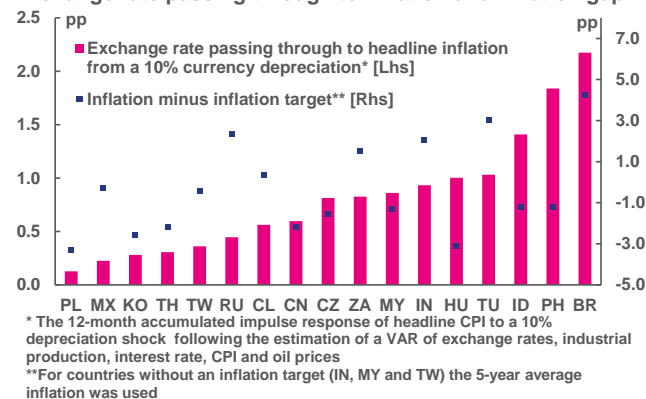
EM monetary policy is expected to remain highly alert depending on the impact of each scenario on EM foreign exchange (FX). Specifically, the first two scenarios that we envisage (worst and bad scenario) imply a significant depreciation of EM currencies as less export proceeds would be available and consequently, FX liquidity supply

would be smaller, triggering a currency depreciation. The currency depreciation would have derailed the inflation outlook due to the passing through of FX depreciation to headline inflation. Our analytics imply that a 10% currency depreciation results in a 1% spike on average in the inflation rate one year after the shock, placing Philippines, Brazil and Indonesia in the top three positions in terms of pass-through of FX depreciation to inflation (*Exhibit 9*). If trade restrictions under the two scenarios would be followed by restrictions in capital flows, as well, the EM FX depreciation would be more pronounced. EM central banks would have to tighten monetary policy to stem currencies.

Exhibit 9

FX passing through is high for some EMs

Exchange rate passing through to inflation and inflation gap



Source: Datastream, IMF and AXA IM Research

Changes in US monetary policy in support of the economic policy, which the future US president will decide, will be transmitted to the rest of the world via capital flows. As the US dollar is the principal currency of the banking system¹¹, US monetary policy is transmitted worldwide through cross-border credit flows, which results in higher leverage. A global financial cycle, mainly determined by US monetary policy, constrains monetary policies elsewhere once capital is freely mobile, regardless of the exchange rate regime.

¹⁰ David Riker, "Do jobs in export industries still pay more? And why?", Manufacturing and Services Economic Brief, International Trade Administration, July 2010.

¹¹ Hélène Rey, "Dilemma not trilemma: the global financial cycle and monetary policy independence", paper presented at the Federal Reserve Bank of Kansas City annual economic policy symposium, 22-24 Aug. 2013 in Jackson Hole, Wyo.

Country codes used in the text

CZ: Czech Republic; CL: Chili; ZA: South Africa; RU: Russia; TU: Turkey; PL: Poland; SG: Singapore; HU: Hungary; HK: Hong Kong; IL: Israel; SA: Saudi Arabia; ID: Indonesia; MX: Mexico; KO: South Korea; IN: India; BR: Brazil; MY: Malaysia; PH: Philippines; TH: Thailand; TW: Taiwan and CN: China.

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