Flash Note
20/06/2018

Alex Fusté
@AlexFusteAlex
alex.fuste@andbank-lla.com

Facts are facts, but incentives matter

The facts: The belligerent rhetoric has increased

Admittedly, recent events have caused the perception to increase on the risk of an escalation in commercial tensions between the US and China. The US is in the process of implementing a 25% tariff on $50bn in Chinese imports as of July 6. If China retaliates, as it said it would, Trump says the US will respond with a 10% tariff on an additional $200bn in imports. If China responds to that, the US would tax yet another $200bn in imports (presumably at 10%).

The incentives matter, and there are strong incentives on both sides not to escalate the tension

1. The US economy is humming along nicely for this late in the cycle, and is even booming following last year's tax cuts. Presumably, Trump does not want to put this at risk, since it provides him with the ideal atmosphere to face the next elections.
2. From the China's side, if Beijing retaliates (as it pledged by matching the US's tariff with its own), the tit-for-tat sequence of responses will lead to an effective tariff of 11% on practically all products that China exports to the USA. That is something that Beijing will try to avoid at all costs in the current situation, with Beijing engaged on an important supply reforms agenda (as defined in the 19th congress).
3. In the recent US-Sino tensions, that resulted from the severe sanctions that the US Commerce Department decided to impose on Chinese giant ZTE, Beijing choose to avoid the conflict and secure a lifeline to ZTE from the Trump administration after agreeing to pay a $1B fine, put an additional $400M in escrow and change its board and management within 30 days. This was a clear sign that Beijing tried to avoid an escalation of tensions. Following this logic, it could be perfectly plausible that China decides to do the same this time around and avoid retaliation that could escalate the conflict . If Beijing sticks to its recent pattern, the final outcome would not go beyond the effects of the cosmetic action announced with great fanfare by Trump to impose tariffs on imports worth US$50bn. We do not expect any noticeable impact in macro data if tariffs remain focused on particular products and for this limited amount.
4. Current perception is that the response by US trade partners (not only China) will tend towards retaliation rather than conciliation following Trump's decision to end steel and aluminum tariffs exemptions for EU countries and others. Well, in another front of tension, namely the failed agreement with Iran, the French minister of Economy and Finance has just suggested the conciliatory way with the USA is the most pragmatic. The minister has said exactly this: "Let's be honest, the French companies will not be able to continue operating with Iranian partners, …", in what represents a clear gesture to avoid sanctions and conflict with the USA. This makes me think that conciliatory actions still have more options. Also for the case of tariffs.

Look, "incredible" as it may seem, I do not know what's going to happen. Said this, we do know that the incentives are in place (and are strong enough) so as not to adopt extremely belligerent positions. Furthermore, recent experience shows us that rhetoric usually falls far behind the actions finally taken.

Of course I did not like at all when I have read this morning in the FT that China is lining up retaliatory tariffs of 25% on US oil, gas, and coal as part of the second wave of tariffs threatened by the Chinese government. For the moment I prefer to look at this news from another angle. It is another incentive for Trump to limit tariffs to the initial US$50bn. Let's see how the events unfold.

Best