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INTERNATIONAL ECONOMIC REPORT

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US DOUBLES DOWN ON TARIFFS ON CHINESE IMPORTS; TRADE WAR IS BECOMING LESS FARFETCHED

SUMMARY

- President Trump on June 18 started the process to impose 10 percent incremental tariffs on an additional $200 billion in US imports from China in response to Chinese retaliation against earlier US tariffs.
- His avowed strategy fits the standard definition of trade war. The more the US follows through on tariffs and foreign governments on retaliation, the larger the downside risks to the US and global economic outlooks.
- China could retaliate against US tariffs with non-tariff measures, including currency depreciation. This tail risk, if realized, could pressure other countries to follow suit with competitive devaluations.
- Tariffs have become a headwind to the hiring and investment of America’s larger and more global companies. These effects will spread to the rest of the US economy in time.
- The US and Chinese government have strong incentives to de-escalate trade frictions, but the new strategy of retaliating against retaliation makes a trade war a less farfetched risk to the outlook.

In a June 18 statement, President Trump announced that he has directed the US Trade Representative to identify an additional $200 billion in Chinese goods imports to subject to incremental tariffs of 10 percent. This action is in response to China’s promised retaliation against US tariffs announced in April of 25 percent on $50 billion of Chinese goods imports. The US announced June 15 that the April round of tariffs would become effective July 6. President Trump also warned China that he will direct the USTR to pursue “additional tariffs on another $200 billion of goods” if China again responds to US escalation with dollar-for-dollar retaliation. If so, nearly all US imports from China would be subject to tariffs, including consumer goods. The 25 percent tariffs on $50 billion in goods imports announced in April applied mostly to capital and intermediate inputs to US businesses, and exempted consumer goods to avoid imposing tariffs’ costs directly on American consumers. But tariffs on consumer goods would likely trigger faster consumer price inflation.

The US’s escalating tariff strategy fits the standard definition of a trade war, in which trading partners fall into a self-reinforcing cycle of retaliatory tariffs. The strategy’s ultimate impact depends on the extent to which the US and China follow through. If enacted to the letter, tariffs announced to date would modestly slow US real income growth. US manufacturers that compete against Chinese imports would benefit, but industries that use Chinese goods as inputs to production would see costs rise, squeezing profit margins; if they pass the cost of tariffs on through higher prices for their products, end demand would fall. US exporters and businesses with Chinese operations would pay the cost of tariffs more directly through Chinese retaliation, losing sales to businesses from other countries that compete for Chinese customers. These effects would reduce the roughly $1 trillion annual earnings of the S&P 500 companies by tens of billions of dollars. If tariffs escalate beyond what has been announced to date, their costs would be higher. Since the goods imports the US plans to subject to tariffs exceed China’s total imports from the US (See Chart), China could conceivably expand the scope of retaliation to boycott US businesses, tax profits repatriated to the US, turn a blind eye to intellectual property piracy or industrial espionage, or violate sanctions against pariah states like North Korea.

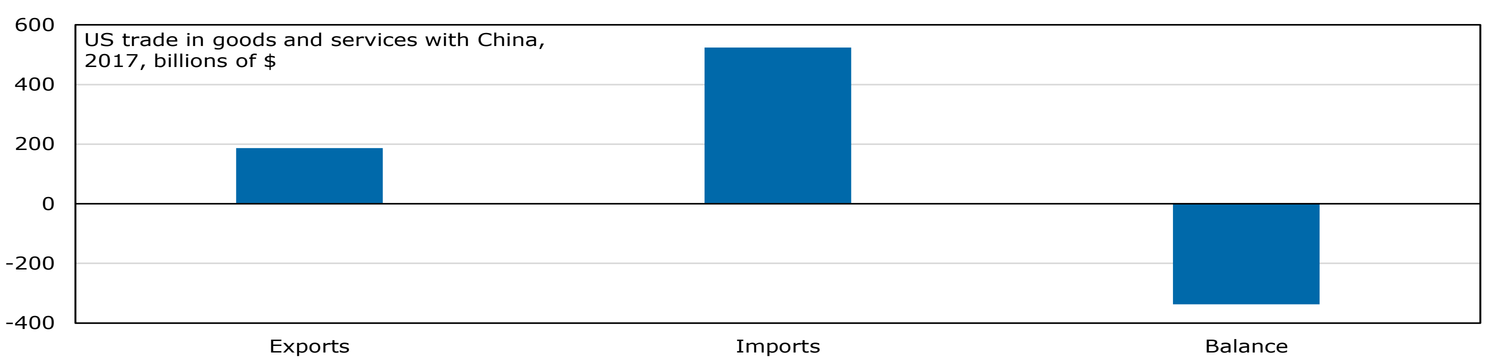
China also could respond to tariffs by depreciating the yuan. The yuan has already weakened to ¥6.53 per dollar on June 25 from under ¥6.27 per dollar in April, but this is no great surprise: PNC's second quarter exchange rate forecast anticipated a depreciation of the yuan and currencies of other commodity-importing emerging markets, as higher US interest rates and a reduced pace of asset purchases by the European Central Bank draw capital out of emerging markets. But going forward China could deliberately engineer a much larger depreciation if its policymakers wanted to offset the damage from tariffs to export competitiveness. While unlikely, the tail risk of a Chinese devaluation would be very bad news to the global economy if realized, since other countries would be pressured to follow China's suit.

America's larger and more global companies are turning cautious about hiring and investing in response to trade frictions. This is apparent in diverging business sentiment surveys: The National Federation of Independent Business' Index of Small Business Optimism rose to 107.8 in May, the second highest reading in the index's 45-year history. Similarly, the PNC Small Business Economic Outlook reported the strongest small business optimism in the survey's 15-year history in the spring 2018 survey. By contrast, the Institute for Supply Management Manufacturing Report on Business® reported less upbeat sentiment in April and May after reaching its highest level in 13 years in March. The ISM PMI's aggregation method reflects operating conditions for large businesses, which are generally more exposed to trade, as well as smaller ones. In their comments many ISM survey respondents expressed concern about the effect of metal tariffs on their businesses.

The Federal Reserve is hearing similar concerns about trade policy from businesses. Fed Chairman Jay Powell stated in the press conference following the June 13 Federal Open Market Committee decision that business contacts' "concerns about changes in trade policy are rising … you're beginning to hear reports of companies holding off on making investments and hiring people." Over time, these decisions will dampen overall business activity, indirectly affecting even businesses with limited involvement in trade.

De-escalation of trade friction still seems more likely than a trade war, and that is reflected in PNC's baseline US and global forecasts. The US government describes tariffs as leverage in negotiations, meaning they prefer not to implement them. They want to avoid Chinese retaliation against agriculture that would harm rural communities, important political constituencies; the President's often-stated preference for high stock prices is incompatible with a trade war. China, in turn, bases its economic model on close trade ties with the outside world. But the US's strategy of escalating retaliation nevertheless increases the risk of a spiraling trade war and related downside risks to the US and global economic expansions.

CHART: US PLANS FOR TARIFFS ON CHINESE IMPORTS EXCEED ALL CHINESE IMPORTS FROM THE US; COULD PROVOKE NON-TARIFF RETALIATION FROM CHINA



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