July 9, 2018

GLOBAL ECONOMIC HIGHLIGHTS

Gus Faucher
Chief Economist

Stuart Hoffman
Senior Economic Advisor

William Adams
Senior Economist

Kurt Rankin
Economist

THE PNC FINANCIAL SERVICES GROUP | The Tower at PNC Plaza | 300 Fifth Avenue | Pittsburgh, PA 15222-2401

TARIFFS, RETALIATION, BUT NO CURRENCY WAR; CANADA SET TO HIKE IN JULY; BRITISH GOVERNMENT FRACTURES

UNITED STATES: The United States implemented incremental tariffs of 25 percent on $34 billion of Chinese goods imports on July 6, targeting capital and intermediate goods used in US manufacturing, equipment used in US agriculture, mining, and construction, and medical equipment. China retaliated with dollar for dollar tariffs on US agricultural, aquacultural, and auto exports. China also is retaliating with non-tariff measures. On June 28, the Chinese embassy to the United States issued a warning to Chinese tourists about the dangers of visiting the United States, which was widely covered in the Chinese press; tourism and educational services for foreign exchange students are high value US services exports to China. On July 3 a Chinese court ordered Micron Technology, a US company, to cease selling some of its products in China, in a move widely interpreted as retaliation for either the tariffs or the US sanctions against Chinese telecom equipment manufacturer ZTE. However, China has not depreciated the yuan in response to the tariffs and in fact has taken steps to stabilize it in the first week of July. Governor of the People's Bank of China Yi Gang stated July 3 that China will continue to pursue a managed float of the yuan and "maintain the basic stability of the exchange rate around a reasonably balanced level" – this is the PBoC's standard language to describe their exchange rate policy. China Banking Regulatory Commission Chairman Guo Shuqing stated July 5 in comments that "China's economic fundamentals do not allow for the possibility of a large depreciation." The tariffs implemented July 6 will have a modest negative effect on US real aggregate incomes. US manufacturers that compete against Chinese imports will benefit, but industries that use Chinese goods as inputs to production and companies caught up in Chinese retaliation will see larger, albeit more diffuse, negative effects: Higher input costs will squeeze profit margins; companies that pass on the cost of tariffs in higher prices of their products will see end demand fall; and US companies will lose sales in China. The longer tariffs last and the wider they become, the more they will dampen investment and hiring by US businesses engaged in global value chains. An escalating cycle of intensifying tariffs is still not our base case expectation, but it is less farfetched than it seemed in early 2018. In the long run, the largest potential cost of the tariffs is the risk that US trading partners give up on the current system of world trade, whose rules were largely set by the United States, for alternatives that disadvantage American workers, businesses, or security interests. But if this happens, the effects will take a long time to become apparent, and for now, job growth is strong. The US added a strong 213,000 nonfarm payroll jobs in June with 27,000 in upward revisions to job growth in April and May; job growth averaged 215,000 per month in the first half of 2018, well above 2017's pace of 182,000 per month. The unemployment rate rose to 4.0 percent in June from 3.8 percent in May as more jobseekers entered the measured labor force; this raised the labor force participation rate to 62.9 percent from 62.7 percent in May. The labor force participation rate for prime-age men and women has been trending higher since September 2015, another sign of an improving job market. While we expect it to pick up, wage growth was still moderate in June: Average hourly earnings rose 2.7 percent year-over-year. Aside from some volatility around Hurricane Harvey, they have risen about 2.5-2.75 percent in those terms since early 2016.

CANADA: The Canadian economy added a strong 31,800 jobs in June, and the unemployment rate rose to 6.0 percent from 5.8 percent as more Canadians entered the labor force and sought jobs. Canadian employment rose 1.2 percent from a year earlier in June, and hours worked 1.4 percent. After June's solid jobs growth, we expect the Bank of Canada to raise its overnight rate target 0.25 percentage points to 1.50 percent at its July 11 monetary policy decision, and for this to be the Bank of Canada's last hike in 2018.

June's jump in labor force participation shows that the labor market is not yet a bottleneck constraining the Canadian economy, and the housing downturn will restrain Canadian growth momentum in the second half of 2018 and 2019; these factors will discourage the Bank of Canada from matching the pace of rate hikes against the Federal Reserve.

UNITED KINGDOM: The UK government's Brexit Secretary David Davis and two ministers from the Department for Exiting the European Union resigned on July 8 after deciding that they cannot support the compromise Brexit proposal reached during a senior leadership retreat on July 6. The proposal would keep the UK in the EU customs union, but not in the common market for services. The July 8 resignations will damage Prime Minister Theresa May's credibility with Tory Brexit hardliners and could lead to a new prime minister or even new elections before the UK is scheduled to leave the EU on March 2019.

CHINA: As promised, China is retaliating against increased US tariffs by enacting its own tariffs against imports of US agricultural products, including soybeans and other grains, ethanol, beef, orange juice, tobacco, and whiskey, as well as US exports of autos, chemicals, and aircraft. Where the US tariffs avoid imposing costs on consumers by imposing costs on businesses, the Chinese tariffs avoid imposing costs on businesses by imposing them on consumers. Where the US tariffs are diffused across hundreds of small-value categories of imports, China's tariffs narrowly target large-value categories of goods imports to inflict concentrated pain on politically influential US businesses. China's foreign reserves were little changed in June at $3.11 trillion US dollars; they fell $27.8 billion dollars in the first half of 2018 after rising $129.4 billion dollars in 2017.

EUROZONE: The Council of the European Union (that is, their heads of state) agreed to a free trade agreement with Japan called the Economic Partnership Agreement (EPA) which will remove 99 percent of tariffs applied on EU exports to Japan. The signing ceremony is scheduled for July 11.

MEXICO: President-elect Andres Manuel Lopez-Obrador and President Trump shared a phone call on July 2 in which they discussed economic development projects in Mexico that could reduce migration to the United States; the peso rallied sharply against the dollar following their conciliatory first official interaction. A stronger peso adds to our conviction that the Bank of Mexico will not need to raise interest rates as much as financial markets expect in the second half of 2018, since a stronger currency will reduce inflationary pressures from import prices.

JAPAN: CPI inflation was 0.6 percent in May in year-over-year terms, unchanged from April, and CPI excluding food and energy was 0.3 percent in both months. In the Tokyo metropolitan region, CPI returned to 0.6 percent in year-over-year terms in the June preliminary report from 0.4 percent in May and matched April's pace; CPI excluding food and energy was 0.4 percent, also up from May and same as April. The unemployment rate dropped to 2.2 percent in May, the lowest since 1992. Nevertheless, the Bank of Japan is unlikely to change its key monetary targets until after the impact of the value added tax hike scheduled for October 2019 fades.

INDIA: The Nikkei services PMI rose to 52.6 in June from 49.6 in May, and the manufacturing PMI rose to 53.1 from 51.2. India's economy is growing solidly, reaffirming our expectation for additional rate hikes from the Reserve Bank of India in the second half of 2018.

BRAZIL: Inflation jumped to 4.4 percent in June from 2.9 percent in May and was the fastest since March 2017 as shortages caused by Brazil's trucker strike raised prices. IPCA excluding food and energy rose to 4.5 percent from 3.6 percent. The central bank of Brazil cut its forecast for real GDP growth in 2018 to 1.6 percent in its June Inflation Report from 2.6 percent in its March Report on the impact of the strikes. Judges issued contradictory orders allowing, and then preventing, the release from prison of popular former president Luiz Inacio Lula da Silva on July 8; political tensions are running high ahead of the October presidential election.

Visit http://www.pnc.com/economicreports to view the full listing of economic reports published by PNC's economists.