GLOBAL ECONOMY

7/18

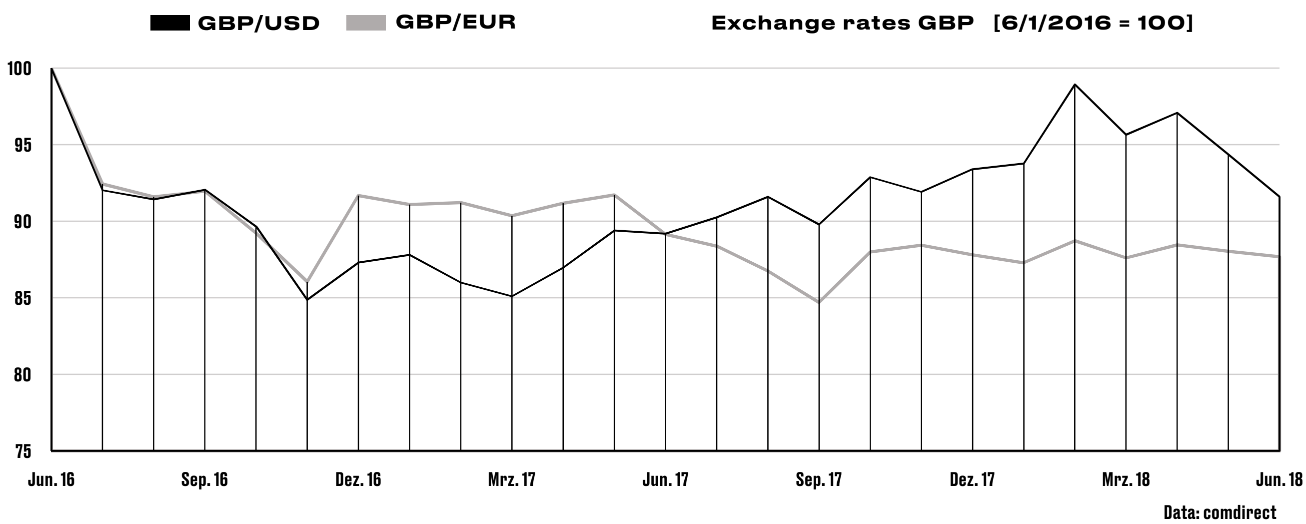
Trade war might soon lapse into non-tariff blows

China and Australia locked in side-battle in Western Pacific

J.S. Research

The government narrowly avoids defeat as its stability sustains further damage

That was a close shave, and two times at that: On June 13th and 20th, Theresa May and her government escaped defeat over several amendments made to its centrepiece of Brexit legislation, the EU Withdrawal Bill. Not only had the Europhile Lords made many amendments to the effect of softening Brexit as much as possible; Dominic Grieve, backbench MP of the Conservative Party and former Attorney General, too, tabled an amendment attempting to bring Parliament into the driving seat should the government return with an unpalatable result or even empty-handed from the negotiation table in Brussels. Yet on both occasions, Theresa May managed to stave off rebellion by promising the Europhiles among her backbenchers to give Parliament some kind of a “meaningful vote” over Brexit – albeit nobody still exactly knows, what this allegedly meaningful vote will entail. What is certain, though, is that the original Grieve amendment, which would have granted Parliament an unequivocal meaningful vote right up to the possibility of starting the Brexit negotiations all over, has been voted down eventually. What does this mean for the Brexit process from here? Two things, primarily. First, the authority of Theresa May and hence the stability of her government has yet been weakened further. Yes, she has succeeded to fend off rebellion again, the price-tag of which, however, is becoming ever heftier. By making lots of promises to both the Europhiles and the Eurosceptics in the Conservative Parliamentary Party, she has haplessly manoeuvred herself into a devilish quandary: Sooner or later, she now will have to disappoint one of those two factions, thus simply postponing her downfall to a later day. Yet the closer that potential collapse of the government falls to the all-decisive EU summit in the autumn, the greater the potential for ensuing chaos becomes for the simple reason of a lack of time until the end of March. The second consequence of Westminster’s latest Brexit chapter is that apart from the most turbulent, improbable turn of events, Parliament has given away its last chance to secure a definite say over a no-deal Brexit in exchange for a vague compromise yet to be defined. Taken together, this has not lowered the risk of a chaotic Brexit without any agreement in place at the very least. In our view, it has even aggravated it. Incidentally, all that was written well before the Cabinet meeting at Chequers

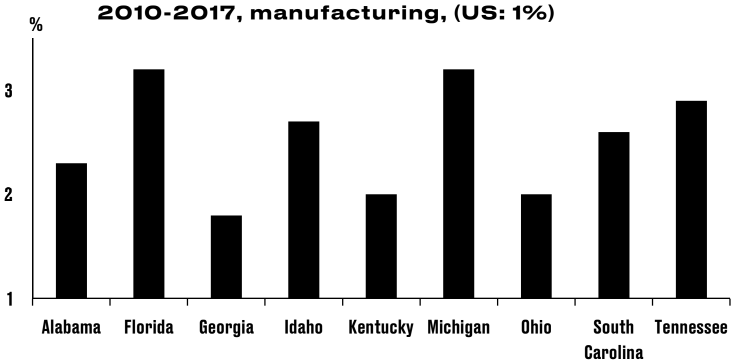


where Theresa May managed a huge coup, cajoling leading Brexiteers such as Boris Johnson and Liam Fox into the softest version of conceivable Brexits up to date – only to see both the Brexit as well as Foreign Secretary, David Davis and Boris Johnson resigning on the Monday thereafter. Cabinet unity, for all the smoke-screening deployed at Chequers, is in tatters, with the EU Commission's President Jean-Claude Juncker acidly remarking just that within minutes of Boris Johnson resigning. At the same time, there is virtually no chance that the EU will – even by and large – agree to the proposal agreed at Chequers, for the latter still does not accept freedom of movement as corollary for smooth access to the Common Market. If, however, the EU will follow up demanding even greater concessions, this will become the straw to break the camel's back of Brexiteers. And with David and Johnson out of office, they now have the leaders they were waiting for to head an uprising. A full 80 of Tory backbenchers gathered at a meeting of the notorious European Research Group, the faction of declared Eurosceptics in the Conservative parliamentary party – well in excess of its usual numbers of around 50. Even though this still is the minority on the government's side of the House, in a minority government every vote counts; and 80 rebels are therefore an enormous problem. For the only chance for the Chequers plan to survive, then, would be Labour propping it up, either in line with or against the will of Jeremy Corbyn, both is more unlikely than not. Meanwhile, the first financial firms in the City of London saw no alternative but to begin shifting part of their activities to the European Union, among them prominent names such as Baring Asset Management, MFS and Legg Mason, while the regulatory bodies of Luxembourg and Dublin have been deluged with a wave of applications for EU operating licenses. And the financial industry is not the only one to get nervous about Brexit. Airbus stated bluntly that it might have to relocate its operations away from Britain should a no deal-Brexit come to happen. And most recently, it was the turn of logistics businesses to point out that from now on, anything other but a complete continuation of current customs procedures as envisaged for the transition phase between Brexit-legal and Brexit-effective in 2021 will wreak total havoc at Britain's ports, particularly that of Dover. Point is: Transition as much as everything else agreed so far is dependent on the overarching Brexit deal being struck in October. Were that to fail or to be postponed in an unforeseeable fashion, the bosses of logistics companies then fear the worst – and they ought to know what they are talking about.

Trade war, phase 2 – China might opt for non-tariff retaliation soon

It is bad enough as it is: Just as we had anticipated in the blog section of our website back in January, Donald Trump has escalated the trade war in general and that against China in particular. Now, the sum of goods affected by tariffs levied by both the US and China is about to reach some $250bn; and there are still many arguing that this relatively small figure in terms of the economies involved certainly does not have the firepower to capsize economic relations in their entirety, much less world trade as whole. Yet that figure already represents close to fifty per cent of total trade between the US and China, amounting to some $635bn in 2017. And the US actions against China do not even stop there. In its most recent step, the Trump administration invoked legislation from the 1970s, giving the President sweeping powers to block foreign investment in case of a "national economic emergency." Under those provisions, Donald Trump intends to interdict Chinese (and potentially other) investment in a range of IT industries, from software to robotics. What is even more worrisome, however, is what weapons China might feel pushed to opt for when running out of American exports to be taxed which, due to the lopsided nature of Sino-American trade, will be the case pretty soon. The Chinese have said as much already. In reaction to the US's most recent round of tariffs slapped on Chinese products, China's commerce ministry stated that the country "will have to adopt strong countermeasures, which will be comprehensive measures combining quantity and quality." Quality is the keyword here, since it might mean just about everything outside of tariff-related retaliation. In a first and detrimental enough step, this undoubtedly will mean regulations directed at prominent single US businesses exporting to as well as operating within China, such as Boeing and other Dow Industrials constituents. On the state level, erstwhile manufacturing hubs of the recent US economic expansion since the aftermath of the financial crisis such as South Carolina, Tennessee, Kentucky, and Michigan are particularly vulnerable to Chinese retaliation, both broad and specific (see chart). Since international corporate behemoths sport huge, ramified supply networks, impediments to their doing business with and in China will unfailingly hit their suppliers into the addition. The incipient trade war is already throwing foreign exchange markets off balance, too, and might by that indirect effect create even bigger disruptive effects. EM currencies have been hit in particular, not least in Southeast Asia where countries have been on a borrowing binge in US dollars. Indonesia and Malaysia, having racked up external debt to the tune of a third and even some 90 per cent of gross national income, respectively, which is overwhelmingly denominated in US dollars, are extremely vulnerable to a capital flight à la 1997 should the Sino-American trade war get out of hand. The region in general is home to a big chunk of global intermediate goods manufacturing and thus more sensitive to supply chain disruptions than others. That said, what is way more disconcerting are the macroeconomic instruments China might resort to in retaliating against American trade barriers. First and foremost among these are the huge holdings of US Treasuries accumulated by the Middle Kingdom in years of current account surpluses, resulting in China vying with Japan for the position of the US federal government’s single biggest creditor. So far, Chinese officials have averred not to use those holdings as the ultimate weapon against the US in the incipient trade war – knowing well that a full-blown sell-off of Treasuries in order to lift yields and thus inflict damage on the US economy will end up shooting into the own foot by deflating the value of Chinese currency reserves. All the same, if push comes to shove, Beijing might see no alternative left other than this ‘nuclear option’ to bring the Trump administration back to its senses. Needless to say that, if that scenario were to become reality, it would entail repercussions on a global scale, wreaking havoc on financial markets in general and debt markets in particular, easily triggering a debt crisis with many businesses not being able to refinance their obligations then filing for bankruptcy. A trade war never ends with trade, but typically mushrooms into a general economic crisis once a certain point has been passed. Beware its inception, then.

Compound annual real GDP growth rate, 2010-2017, manufacturing, (US: 1%)



Data: Bureau of Economic Analysis

Panda and Koala lock horns in trade war sideshow – Australia frets about increasing Chinese activities

One of its primary resource suppliers and, in terms both of immodest claims and global dimensions, a virtual neighbour to the Middle Kingdom, Australia has become increasingly uneasy about the Panda's cuddling. In a kind of investment blitz, Chinese investors have swarmed all over Down Under to buy resource royalties, stakes in infrastructure as well as media companies, and above all, real estate, fuelling an already red-hot house prices boom even further (see issue 6/17 of this report). These days, however, the Koala tries to break free from its cousin's embrace which has come to feel somewhat suffocating – and China reacts with its customary mixture of pique and threat. The tussle had been opened with a pointed warning from the governor of the Reserve Bank of Australia: Philip Lowe stated that the risk of China's intricate, opaque and massively geared economy imploding was huge, dragging the rest of the world down in its wake. Even apart from such a calamity, Chinese purchasing power sending house prices skyrocketing around the globe was a threat to global financial stability, the governor continued. The Chinese reply came without delay, delivered by the Global Times, a state-owned newspaper, calling for reduced imports from Australia to punish it for its arrogance. In a bemusing off-remark, the newspaper continued to suggest substituting American imports for Australian goods, particularly those of agricultural nature. Australian wine growers have been complaining about impediments at Chinese customs procedures already. Intermittently, a Chinese freeze on the granting of diplomatic visas to Australian ministers was in effect, too, while an Australian MP popped the name of a Sino-Australian business man in a corruption scandal, met by energetic protestations by the Chinese foreign ministry. Yet the conflict has long since entered the sphere of geopolitics, too. After China's unabashed colonising and militarising most of those contested islands in the Chinese Sea as well as the Indian Ocean, it now reaches out to the Western Pacific. And neighbouring Australia is looking for partners to mount at least a token of resistance, with the United States increasingly retreating from its leading that effort, in spite of the protestations of its defence minister. In a symptomatic case, Canberra deliberated to block again Chinese telecoms giant Huawei to supply Down Under with next-generation mobile infrastructure for fear of security breaches, after a similar decision in 2012. Taken together, this has set China and Australia on a confrontational course which might become the more ugly the more the Sino-American trade war heat up. Should Australia find itself trapped between millstones, the country might well face its first, pronounced economic cooling-down in years – which would, then, render our projection of a strong Australian Dollar obsolete, too.

Statistical Bulletin

Consumer confidence (June, pts.)

Australia: 102.20 → Consumers Down Under have been keeping their spirits, trending higher ever since 2014. Yet with regards to low unemployment, healthy pay and low inflation, consumer sentiment ought to be even better; thus, there appears to remain some reserve.
Japan: 43.7 → Japan's consumers stay the laggards by comparison. Though there has been some improvement over the past two years, it still stays considerably below the 50 pts.-threshold. The latter, however, would be needed to indicate sufficient consumption demand to kick-start prices still in the trough.

Small business sentiment (Q1/18, pts.)

Japan: 14 ↑ It's an entirely different picture with confidence among SME. The statistic has been improving continuously since the aftermath of the financial crisis, now defending positive territory for the 6th quarter in a row. Indeed, the current print is close to the highs of the 1990s.
UK: -5 ↓ The mood in UK business has been sobering over Brexit lately, with SME not making an exception. Dropping back into negative territory after a flash in the pan, induced by short-lived hopes that Brexit might be sorted out benignly and in due time, the statistic shows the increasing alarm among British business people.

Inflation rate (June, y/y)

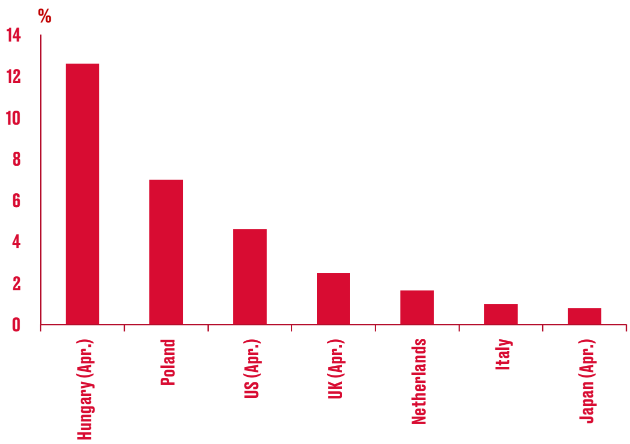
Turkey: 15.4% ↑ Turkey's inflation rate has been spiralling out of control. Meanwhile, the President has had to resort to appeal directly to the people to hold their money in Lira rather than dollars or euros, since the former had begun to take flight out of the Turkish currency.
Switzerland: 1.1% ↓ As if to confirm its credentials as a safe haven, Switzerland's inflation stays low, and lower than its industrialised peers at that. Yet do not be mistaken: Inflation in the Alps Republic is on the rise, too, even though from deeply deflationary levels before.

Services PMI (June, pts.)

France: 55.9 ↑ Activity in the French services sector remains very strong, though it has cooled a bit from its Macron-mania in the past year, underpinning a very healthy economy in general.
UK: 55.10 → Though the current reading of the UK's services PMI took many by surprise (ourselves included), it has merely served to confirm the statistic's current sideways trend, mirroring the wait-and-see mode of most UK businesses. As much as its manufacturing peer, it is now completely dependent on the way Brexit will be sorting out.

Wage growth (May, y/y)

Wage growth in Japan remains anaemic, while the UK and the US particularly have been starting to accelerate markedly. The league is headed, though, by the former low-cost outsourcing hubs of choice for manufacturing, i.e. countries in Eastern Europe.



Data: Trading Economics, bloomberg, comdirect, own calculations

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