Trump's trillion dollar trade wars

Economic confrontation likely to spill into other fields

by Elliot Hentov in London

Wed 8 Feb 2017

President Donald Trump's spate of executive orders have dashed expectations that the president might be more restrained than the candidate. The US stock market initially responded positively, with the Dow Jones Industrial Average crossing the psychologically significant threshold of 20,000 points.

The immediate post-election boost in US equities was attributed to expectations that Trump would focus on strengthening the economy through fiscal stimulus, tax cuts and deregulation. But the market drop in the second week of Trump's presidency suggests that investors had not adequately priced in the risks associated with his commitment to 'America First' protectionism.

One of Trump's first actions was to withdraw from the Trans-Pacific Partnership, a major trade agreement between the US and 12 other economies from Asia Pacific and the Americas and a key legacy of the Obama administration. He also announced he would begin renegotiating the North American Free Trade Agreement at his first meetings with the leaders of Canada and Mexico. But his visit with Enrique Peña Nieto, president of Mexico, was cancelled, as the war of words over the border wall and trade heated up.

Trump has already flirted with a trade war against Mexico, initially suggesting a 20% surtax on all imports to help pay for his wall. That idea was quickly withdrawn after reminders that US consumers would bear the brunt of the fallout in the form of more expensive goods, and that Mexico is the second largest buyer of US-made goods after Canada.

Mexico would be in the weaker position in the event of a trade war. That said, about 5m US jobs depend on trade with Mexico, and trade between these two countries has grown more than sixfold since 1993, to over $500bn in 2016. A large share of US agricultural exports go to Mexico, and around 40% of the content of Mexican exports to the US actually originates from the US.

A face-off with Mexico is serious, but not an existential threat. Likewise, while renegotiating Nafta grabs headlines, it holds relatively little tail risk, as the combined US trade deficits with Canada and Mexico make up less than 1% of US GDP. Moreover, the power relations are asymmetric: Mexico (and to a lesser extent Canada) is unlikely to escalate tensions and disrupt trade, particularly since its export industry is benefiting from disproportionate currency weakness.

The possibility of a trade war with China is a more important consideration. The size of the US trade deficit with China is around 2% of US GDP, and roughly half of the total US trade deficit.

There is an element of game theory to trade wars. By simple arithmetic, the country bearing a chronic trade deficit stands to lose less in relative terms. The US could position itself aggressively at the outset of a negotiation, on the assumption that China is more driven by loss aversion and is therefore more likely to concede a new agreement. Trump's boisterous calls could thus be interpreted as tactical.

However, underlying trends suggest that it would nonetheless be folly for the US to pursue any trade confrontation. Oxford Economics, an economics research firm, estimates that in the extreme scenario of full trade wars with major trading partners, the US economy would be $1tn smaller in 2020 than otherwise. Moreover, while China's share in US exports is rising, the US share of Chinese exports is declining. China is the world's second largest economy, with geopolitical ambitions. It would be difficult to prevent an economic confrontation over trade from spilling into other fields.

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