GLOBAL TRADE DISRUPTED

January 2019 marked the halfway point of the Trump administration, a presidency that has been embroiled with disruption and a break from traditional US trade policy. Under Trump's leadership, the United States has pulled out of the Transpacific Partnership (TPP), threatened to leave the North American Free Trade Agreement (NAFTA), started a trade war with China, and imposed tariffs on traditional allies on the grounds of national security considerations. 2019 will be a pivotal year for global trade in which uncertainty surrounding a few key trade developments in the first half will determine the extent to which the global trading system will be interrupted for the remainder of the year and the years to come.

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For better or worse, President Trump has followed through on his campaign promises regarding trade policy: He has pulled the US out of the Transpacific Partnership (TPP), renegotiated NAFTA, used tariffs to punish countries' alleged unfair trade practices, and is working to reduce the trade deficit with China.

These actions are rooted in the belief that America has been taken advantage of by others with regards to trade in the past decades,[1] leading to his campaign of "America First." In the realm of trade, this translates to protectionist policies and the belief that trade is a zero-sum game. In this light, President Trump focuses on bilateral relationships over multilateral ones, and considers a country's trade deficit with the US the determining factor of their economic relationship. Accordingly, to the Trump administration, a big trade deficit in goods equals a loss for the United States. This disregards the principle of competitive advantage and underlying domestic factors like high domestic investment and falling national savings, which are the actual causes for the current account deficit.

While US tariffs on imported goods would have no significant direct effect on either national savings nor the current account deficit, tariffs are an integral tool of the current US administration's trade policy and its strategy to reduce the US trade deficit. Against this background, the Trump administration has been using Section 232 of the Trade Expansion Act of 1962 as a justification for its tariff regime. This measure was traditionally created with the Soviet Union in mind— the US' security threat at the time. By using section 232 as a justification for imposing tariffs broadly, traditional allies like the European Union (EU), Canada, and Mexico are now denounced as a threat to US national security. Accordingly, Trump's "broad blanket" approach to his tariff regime has created a new normal in which he no longer differentiates between traditional allies and adversaries.

> *I am a Tariff Man. When people or countries come in to raid the great wealth of our Nation, I want them to pay for the privilege of doing so. It will always be the best way to max out our economic power.* [2]

In light of these dynamics, many trading partners of the US are suffering under the current unpredictability and seeming lack of a US trade strategy. Yet, one could argue that disruption might ultimately be at the core of the US strategy. This "strategy" appears to have three core elements:

[1] "Remarks by President Trump to the 73rd Session of the United Nations General Assembly New York, NY," *The White House,* 25 September 2018, https://www.whitehouse.gov/briefings-statements/remarks-president-trump-73rd-session-united-nations-general-assembly-new-york-ny/

[2] Donald J. Trump, (realDonalTrump), 4 December 2018, 6:03 PM, Tweet, https://twitter.com/realDonaldTrump/status/1069970500535902208

The use of excess leverage: Favorable domestic economic and political conditions such as the power and strength of the US dollar, the depth of the US consumer market, and record levels of employment, provide leverage for the US administration to disrupt the system in its favor. Important policy and trade announcements are often made via Twitter—a favored tool of the President—and catch negotiating partners off-guard.

The tendency to disrupt first and negotiate later: With threats that would disrupt the global trading system (pulling out of NAFTA or the WTO, imposing additional tariffs on traditional allies), the US administration creates high levels of uncertainty and chaos that force affected countries to travel to Washington D.C. and compete for a chance to talk with the President or his small circle of entrusted trade and economic advisors.

The demand "to pick a lane": Fueled by favorable domestic conditions and a goal to isolate China, President Trump has replaced the distinction between traditional allies and adversaries with the categorization of "with the United States" or "with China."

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The Transatlantic Relationship: Allies to Frenemies?

The transatlantic relationship has been off to a tumultuous start during the first two years of Trump's presidency and remains a significant source of uncertainty for the global economy. As trade tensions between the US and China are reduced, they could escalate quickly on the transatlantic front.

Traditionally viewed as an ally in both security and economic matters, President Trump has called the EU a "foe," particularly with regards to trade, claiming that the EU has been taking advantage of the US.[3] While the EU was initially excluded from the US tariffs on steel and aluminum imports, it has failed in the eyes of the US to come to a satisfactory agreement (e.g. a self-imposed quota on EU exports of these products to the US). This led to the imposition of tariffs on 1 June 2018.

[3] Cat Contiguglia, "Trump: EU is one of United States' biggest foes," *Politico*, 16 July 2018, https://www.politico.eu/article/donald-trump-putin-russia-europe-one-of-united-states-biggest-foes/

In response, the EU retaliated in kind, targeting key products originating from US states that have a large base of Trump supporters.

In a meeting between European Commission President Jean Claude Juncker and President Trump in July 2018, the two presidents agreed to launch a new phase in the transatlantic relationship.[4] More specifically, their joint declaration set out four main areas of cooperation. They decided to work towards zero tariffs, zero non-tariff barriers, and zero subsidies on non-auto industrial goods, and reduce barriers and increase trade in services, chemicals, pharmaceuticals, medical products, as well as soybeans. Secondly, to strengthen their strategic cooperation in the energy sector, with the EU planning to import more US liquefied natural gas (LNG) to reduce its energy dependency on Russia. And thirdly, to work closely on establishing a dialogue on standards to reduce costs for companies on both sides of the Atlantic. Their last commitment—to jointly tackle unfair trade practices while pursuing WTO reform with like-minded countries—was a thinly concealed strike against China. This set the stage for a multilateral approach towards China.

The agreement also mentions the wish to lift the aluminum and steel tariffs on the EU yet no further action has been taken to walk back the tariffs. As part of the July agreement, the US pledged not to impose further tariffs on the EU as long as bilateral trade negotiations are progressing. Yet the deadline for delivery of the US Commerce Department's 232 investigation into whether the imports of foreign cars and car parts pose a threat to national security was delivered to President Trump on 17 February, who has up to 90 days to decide on further action. If the report were to recommend tariffs, it would provide the President with additional leverage in trade negotiations. However, the EU has made clear that additional tariffs on Europe would bring transatlantic negotiations to an abrupt halt.

In line with the July agreement, negotiating objectives have been published on both sides. While any deepening of the transatlantic trade relationship is a positive development, the scope as currently envisioned is fairly limited. It is clear that this is not an attempt to revive negotiations on anything remotely as ambitious as the Transatlantic Trade and Investment Partnership (TTIP), which were negotiations launched in 2013 aimed at a comprehensive agreement in the areas of trade and investment.

TTIP negotiations were put on hold during the transition from the Obama to the Trump administration but had already encountered a lot of criticism on the European

[4] European Commission, "Joint US-EU Statement following President Juncker's visit to the White House," 25 July 2018, http://europa.eu/rapid/press-release_STATEMENT-18-4687_en.htm; "Remarks by President Trump and President Juncker of the European Commission in Joint Press Statements," *The White House,* 25 July 2018, https://www.whitehouse.gov/briefings-statements/remarks-president-trump-president-juncker-european-commission-joint-press-statements/

side long before the change in US government. Combined with the rocky start for the transatlantic relationship under President Trump, these developments explain the limited scope of the European negotiating mandates. Focused on conformity assessment and the removal of tariffs for industrial goods, they are strictly aligned with the objectives of the July declaration. In contrast, the US negotiating mandate's overall aim is to "improve the US trade balance and reduce the trade deficit with the EU,"[5] and to secure "comprehensive market access for US agricultural goods in the EU"— an area explicitly excluded from the European side from the onset.

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These huge divergences in the scope of the negotiations were just one of many concerns of the European Parliament who reviewed the European Commission's negotiating mandates before they were sent to the European Council. Consistent of the 28 European heads of state, the Council makes the final decision whether to approve the European Commission mandates to negotiate a trade agreement with the United States. On the European side, grave concerns persist[6] regarding tariffs currently imposed by the US (on Spanish olives and on imports of EU steel and aluminum) as well as potential future tariffs. More broadly, the re-imposition of US sanctions on Iran due to its withdrawal from the Joint Comprehensive Plan of Action (JCPOA), the continued US blocking of new nominations to the WTO Appellate Body, and the withdrawal of the US from the Paris Agreement add to European skepticism.

If the European Commission's mandates get approved by the European Council, negotiators could move ahead to reap the "low hanging fruit" in the areas of conformity assessment and the removal of tariffs for industrial goods. However, the window of opportunity for this is very brief given the upcoming EU elections in May, followed by the start of US presidential primaries. While any such agreement is limited in scope, it could potentially be sufficient to keep the transatlantic dialogue open, kicking the can of additional tariffs down the road. Regardless, there is no guarantee that President Trump will deem the proposed trade talks ambitious enough to continue negotiating if agriculture remains excluded. In this case, he may well impose

[5] "Summary of Specific Negotiating Objectives for the Initiation of United States-European Union Negotiations," Office of the United States Trade Representative, January 2019, https://ustr.gov/sites/default/files/01.11.2019_Summary_of_US-EU_Negotiating_Objectives.pdf

[6] European Parliament, "European Parliament resolution on the recommendations for opening of trade negotiations between the EU and the US," 30 January 2019, http://www.europarl.europa.eu/meetdocs/2014_2019/plmrep/COMMITTEES/INTA/RE/2019/02-19/1175518EN.pdf

the car tariffs he has so long threatened. This would put a stop to negotiations before they even started and would be sure to prompt European countermeasures.

China at the Heart of the Transatlantic Relationship

It has become increasingly clear that China is at the heart of the US trade strategy. This has spilled over into negotiations and relations with other countries, with the renegotiated NAFTA being a prominent example. A provision added to the new US-Mexico-Canada trade agreement forbids trade deals with "non-market" economies. Accordingly, if one of the partners entered a free trade agreement with China, the other two could leave the pact within six months. This provision exemplifies the US strategy to force partners to "pick a lane" outlined above.

Equally, China is at the center of the transatlantic relationship. Together with Japan, the US and the EU established a trilateral dialogue in late 2017[7] that aims to combat non-market-oriented policies and practices of third countries, as well as industrial subsidies and state-owned enterprises. This initiative against China's unfair trade practices complements the US' unilateral actions against China.

At the same time, many of the European Union's member states are very dependent on Chinese telecommunications infrastructure and are working to ensure that Chinese companies will continue to operate in their markets. Prominent European operators including Deutsche Telekom, Vodafone, Telecom Italia, and Proximus have worked with the Chinese company Huawei to build out 4G networks and are likely to continue this partnership when they build out their 5G infrastructure. This contradicts American calls on Europe to abandon Chinese telecommunications infrastructure out of security concerns. Apart from security considerations, there is an added strategic motive for the United States: If Europe were to abandon Huawei, this would play into the US' approach of isolating China and could provide further leverage for their ongoing negotiations. Once again, the US asks a partner to "pick a lane." At a time where transatlantic relations are veiled in uncertainty, a European decision to partner with China on telecommunications infrastructure could further cloud prospects of a transatlantic trade agreement.

US-China: Economic Short-term Wins Over Structural Changes?

The tensions between the US and China started in early 2018 when the US administration announced a 30 percent import tariff on solar panels and 20-50 percent

[7] "Joint Statement by the United States, European Union and Japan at MC11," Office of the United States Trade Representative, 12 December 2017, https://ustr.gov/about-us/policy-offices/press-office/press-releases/2017/december/joint-statement-united-states

on washing machines, both of which mostly affected Asian exporters. These tariffs were quickly followed by import tariffs on steel (25 percent) and aluminum (10 percent) for most countries except Australia and Argentina. Over the past seven months, the US has narrowed its tariff target down to China, intending to rebalance the US-China trade relationship to "achieve more fair and reciprocal trade."[8] To this end, US tariffs have been targeting the large trade deficit with China (375 billion dollars in 2017), as well as "China's acts, policies, and practices related to technology transfer, intellectual property, and innovation"[9] (section 301 of the Trade Act of 1974). The US has imposed tariffs between 10 and 25 percent on a total of 250 billion dollars of Chinese imports. China retaliated imposing 5 to 25 percent of tariffs on 110 billion dollars of US imports. Taken together, 360 billion dollars which is more than half of the trade flows between the US and China, are currently subject to additional duties.

"The US trade deficit with China was at a record high in late 2018—the exact opposite of what President Trump set out to achieve with the tariffs."

Furthermore, the US has sharpened legislation to restrict foreign (mainly Chinese) investment in the US, as well as vis-à-vis exports of certain goods to China. After months of threatened escalation by the US to raise tariffs on 200 billion dollars' worth of Chinese goods from 10 percent to 25 percent on 1 January 2019 the US and China agreed to a three-month ceasefire on the sidelines of the G20 in Buenos Aires in late November 2018. These developments are part of the US administration's strategy to "disrupt first and negotiate later": The tariff war with announced potential escalations created chaos and uncertainty that ultimately forced China to the negotiating table. Favorable domestic conditions[10] such as the power and strength of the US dollar, the depth of the US consumer market, record levels of employment, and political support for the administration provided the US with the domestic leverage to disrupt the system to their advantage.

The economic impact of US-China trade tensions has been relatively contained, with Chinese exports to the US moderately steady. Yet, the US trade deficit with China was

[8] "Section 301 Fact Sheet," Office of the United States Trade Representative, March 2018, https://ustr.gov/about-us/policy-offices/press-office/fact-sheets/2018/march/section-301-fact-sheet

[9] Office of the United States Trade Representative (March 2018).

[10] Bart Oosterveld, "Opinion: 3 reasons why the U.S. will keep escalating its trade wars," *Market Watch*, 28 June 2018, https://www.marketwatch.com/story/3-reasons-why-the-us-will-keep-escalating-its-trade-wars-2018-06-28

at a record high in late 2018—the exact opposite of what President Trump set out to achieve with the tariffs. Several factors play into this development: On the Chinese side, a slowing economy means less capacity of consumers to buy imported goods, while a depreciation of the Chinese Yuan of 12 percent between March-October 2018 helped to offset many of the US tariffs' intended effects. This was further supported by increased frontloading of US goods by Chinese companies aimed at beating potential tariff increases. On the US side, low unemployment and steady growth allowed consumers to purchase more goods, further exacerbating the trade deficit.

The original deadline for a potential US-China deal and the end of the "tariff ceasefire" was set for 1 March 2019. After several rounds of negotiations, the deadline has been extended based on the progress made to date. By the end of February, the two sides have worked on drafts for both more immediate changes as well as potential structural changes in their trade relationship. In the short term, the parties are looking at a 10-item list that outlines how China could decrease its trade surplus with the US, including increased purchases of agricultural produce, energy, and specific goods (e.g. semiconductors). For changes in the medium to long term, China and the US have drawn up six memoranda of understanding (MOUs) on forced technology transfer and cyber theft, intellectual property rights, services, currency, agriculture, and non-tariff barriers to trade.[11] In addition, the US will continue to press for structural changes of the Chinese economy at the WTO level, most notably through its trilateral dialogue with the European Union and Japan.

Despite recent progress, current negotiations could still end in failure. The memoranda of understanding were a pivotal step to agree on both broad principles and specific commitments. However, it is highly unlikely that China will abandon its state capitalist model or its overall "Made in China 2025" strategy of emerging as a global leader in high tech fields and higher value products and services. Equally, doubts remain as to what extent structural concerns about Chinese trade practices that have been a point of contention for years, can be addressed within a short timeframe. In order to claim a win in the negotiations, fears are that the US administration's adamant focus on reducing its trade deficit with China could ultimately lead it to agree to a watered-down trade deal that focuses on quick economic wins. Given the high profile of the remaining challenges to be addressed before the conclusion of negotiations, any agreement is likely to be finalized personally between presidents Trump and Xi. It is important to take note that apart from the potential removal of US tariffs currently imposed on China, the US is not offering any concessions in return for the changes it demands from China.

[11] "US and China are sketching the outlines of a deal to end the trade war," *CNBC*, February 20, 2019, https://www.cnbc.com/2019/02/21/us-china-outline-of-deal-to-end-trade-war-reuters.html

Ultimately, any deal concluded is only as good as its implementation. Accordingly, the US negotiating team is emphasizing the need for enforcement mechanisms that would measure China's progress and hold them accountable to pledged reforms. Measures suggested[12] include monthly, quarterly, and semi-annual meetings at various levels of government with unanimous private sector consultations and complaint procedures. Tariffs would remain an enforcement guarantor, yet their unilateral nature raises concerns about possible abuse of this tool.

Effects on Global Trade and Growth Forecasts

A lot of unknowns remain in the foreseeable future that could quickly deepen global trade tensions and their impact on global growth. For example, the US could issue tariffs globally on cars and car parts which would immediately be met with counter-tariffs, the US could still pull out of NAFTA, or current negotiations between China and the US could still fail.

"The trade war has been confined to the US-China relationship, rather than a full-blown global phenomenon."

The EU, China, and the US account for roughly 50 percent of global economic output. When the three largest global economies are restricting trade flows to one another, these protectionist measures are destined to directly and indirectly affect global growth. Directly, these measures lead to decreasing trade flows between involved countries, as well as increased production costs, which translate into higher prices for consumers. Indirectly, these measures impact business confidence leading to lower investment and higher uncertainty in global financial markets, the interruption of global supply chains, and a shift in asset prices that is likely to affect domestic demand.

To date, the impact of the trade war, as well as the overall tariffs implemented by the US and the retaliatory measures by affected countries, has been relatively contained. This is largely attributable to the fact that so far, the trade war has been confined to the US-China relationship, rather than a full-blown global phenomenon. Global trade is not necessarily reduced but rather is experiencing a re-shifting of supply chains as both Chinese and American importers look for alternative suppliers and markets for their products.

[12] "U.S.-China Trade Relations," *C-Span*, 27 February 2019, https://www.c-span.org/video/?458285-1/us-china-trade-relations

By February 2019, affected US-Chinese trade flows amount to only 2 percent of global imports.[13] If negotiations between China and the US were to fail, and the US were to follow through on their threat to impose tariffs on all imports from China, this would equate to roughly 3.5 percent of global imports. Combined with the already imposed steel and aluminum tariffs and the threatened tariffs on automobiles and parts, the share of global trade affected could rise to 7 percent, including retaliation by affected countries.

While trade tensions are listed as one of the major downside risks to steady growth in the foreseeable future in the IMF's World Economic Outlook, this is based on the assumption that any escalation of the current situation will likely be contained to US-China tensions. In this light, instead of a recession, we can expect a gradual slowdown of global economic growth to 3.7 percent in 2019, 0.2 percent down from earlier projections.[14]

Even if the economic impact of current trade tensions can be contained, the political damage to once traditional alliances will be harder to measure and is likely to outlast economic damages. Eventually, the US will not be able to maintain its current economic leverage and will need allies to remain a rule setter in global trade. Contrary to President Trump's belief, trade wars are neither fast nor easy to win. They are a lose-lose for everyone involved.

[13] Arjen van Dijkhuizen and Bill Diviney, "Trade war: Fear versus facts," *ABN AMRO*, 17 December 2018, https://insights.abnamro.nl/en/2018/12/trade-war-fear-versus-facts/

[14] IMF, "World Economic Outlook, Challenges to Steady Growth," October 2018, Scenario Box 1- Global Trade tensions, pp. 33-35.