Escalating trade war starts to make economic impact

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3 July 2018

With the US and China set to impose tariffs on each others' goods on Friday, there are signs that the growing trade war is starting to show up in economic data. Purchasing managers' index figures for Chinese exports released on the weekend show that the index for new export orders fell to 49.8 last month, down from 51.2. A level of below 50 indicates a contraction.

Yesterday, Chinese stock markets continued the fall that has taken place over the first six months of the year. A key index of large stocks traded on the Shanghai and Shenzhen exchanges fell by 2.9 percent, its fifth largest daily decline this year.

Losses in the Chinese stock markets have been more than $2 trillion over the past six months, with the Shanghai Composite index down by more than 20 percent, making it the world's second worst performing market this year after Argentina.

The fall in the market has been set off by moves by Chinese financial authorities to cut back on credit expansion in order to try to rein in the growth of Chinese debt. However, the escalating trade war is now adding to market instability.

"Sentiment will remain bad in the near term," David Qu, an economist at the Australia and New Zealand Banking Group in Shanghai told Bloomberg. "The market doesn't hold out high hopes that China and the US will find a way out before tariffs are imposed."

The increase in financial turbulence, which is being fuelled at least in part by the rising trade war tensions, is also reflected in the fall of the value of the Chinese currency, the renminbi, also known as the yuan.

In June, the renminbi suffered its largest ever monthly fall against the US dollar since China established a foreign exchange market in 1994—down by 3.3 percent. The renminbi dropped by 1.9 percent last week, its second biggest weekly decline—only exceeded by a fall of 2.8 percent in August 2015 that sent a shock wave through global markets.

Further falls could spark a reaction from the US accusing China of seeking to "weaponise" its currency in response to the imposition of US tariffs. China has in the past been denounced by the US as a "currency manipulator." But at this point, the fall appears to be largely a response to market forces.

Chinese authorities would be wary of forcing down its value because of the impact this would have on financial markets. Any fall in the currency increases the interest and debt repayments that Chinese corporations and financial institutions have to make on loans taken out in US dollars.

Bo Zhuang, chief economist at TS Lombard, a research group, told the *Financial Times* that while the Peoples Bank of China, which intervenes in market to regulate the currency, may allow a tactical devaluation to send a signal to Washington, a large fall would be counter-productive.

"Any benefit from a major renminbi devaluation would be far outweighed by the negative consequences: accelerated capital flight, domestic liquidity tightening and the possibility of increased credit stress," he said.

Even apart from the trade war issue, there are concerns in Chinese financial circles of major instability ahead. Bloomberg cited an Internet posting from the government-backed National Institution for Finance and Development (NIFD) which warned that China is "likely to see a financial panic."

The posting appeared only briefly and was then removed, but Bloomberg said it had been confirmed by an NIFD official. The Chinese think tank warned that share purchases financed by debt had reached levels last seen in 2015 when a market crash wiped out $5 trillion in share values.

More broadly, the trade war being waged by the US is starting to escalate, with Canada imposing tariffs of $12 billion worth of US exports at the weekend, in retaliation for the Trump administration’s tariffs on steel and aluminium. The products targeted by Canada range from steel and aluminium to tomato ketchup and beer. In total, they amount to 3-4 times the tariffs imposed by the European Union in response to the US measures.

The EU has responded to the threatened imposition of tariffs of up to 25 percent on its auto exports by sending a submission to the US Commerce Department warning it could target almost $300 billion worth of exports if the US goes ahead.

There are now growing fears that medium-sized and smaller economies are going to be severely impacted by US trade war measures as many of them are dependent on Chinese markets.

A report issued by the Australian Department of Industry, Innovation and Science said that “trade tensions between the US and its major trading partners have the potential to undermine confidence and hinder global economic output.”

The warning was underscored by Australian Trade Minister Steven Ciobo. Speaking in Tokyo, he said: “Escalating trade tensions, potentially, will harm global growth: of course, there’s a correlation between global growth and trade volumes.”

He expressed the vain hope, articulated by the EU and other major trading partners of the US, that Washington would act in a way consistent with the rules of the World Trade Organisation.

Australian capitalism is dependent on the growth of the Chinese economy for its key exports of iron ore, coal and other raw materials.

In a report issued last week, Morgan Stanley issued a warning particularly relevant for Australia and other raw material exporters, saying that rising trade tensions “bring the risk of demand destruction across commodity markets.”

The former trade minister in the Australian government, Andrew Robb, entered the fray in a speech last night. Speaking at the annual dinner of the Mineral Council of Australia, he said US efforts to contain the rise of China were “futile” and “counter-productive.” China and India were emerging as major players in Asia and would “share” power with the US over the course of the next century.

“Unfortunately, the United States appears yet to accept this inevitability, with both sides of the political aisle in Washington endlessly focusing on ‘containment’ of China,” Robb stated.

Robb said the mining industry was most exposed to the changing geo-political environment and should try to navigate “this increasingly tense power struggle.”

“The alternative of leaving two bulls in a paddock to fight it out is no answer,” he said.

But neither is the perspective advanced by Robb that countries such as Australia should try to navigate their way through the conflict until the US accepts the “inevitability” of the rise of China or any other power that in any way challenges its dominance.

The growth of China, as Robb pointed out, is regarded by both sides of the political establishment in the US as an existential threat to its position. It is determined to counter that threat by trade war and other economic measures, and, if necessary, by resorting to military means.