Province of KwaZulu-Natal
Provincial Treasury
Infrastructure Management and Economic Service (IMES) Unit

Trade tensions and its implications to the global trade and economic climate

1. Introduction and background

International trade has strengthened substantially over the past decades as most countries increasingly joined the World Trade Organization (WTO), which promotes trade liberalisation and free trade. Trade liberalisation involves the removal of trade barriers or restrictions in order to ensure free flow of goods amongst countries. The importance of international trade in stimulating economic growth was first suggested by the Mercantilists view and later augmented by Adam Smith and David Ricardo.

These great scholars noted that production costs are relatively different among countries due to uneven distribution of resources and costs of production factors, differences in production technology and efficiency, as well as comparative costs, among others. Adam Smith noted that despite these differences in production costs, countries can benefit from trade by specializing on commodities in which they have absolute advantage and thus exchange with their trading partners. Other trade theories for factor endowment Hecksher-Ohlin (HO Model) and later Samuelson (HOS model) are an improvement on the original work done by the former (Adam Smith and David Ricardo).

The trade patterns are explained primarily by the trade policies, legislative frameworks, and agreements that regulate the flow of goods and services among the countries engaging in trade. The trade policies may differ for each trade relationship depending on the types of goods or services that are being traded. Generally, trade policies should put the interest of the country concerned first while ensuring that trade is balanced, fair and beneficial. If trade policies seem to be unreasonable and undermine national interest or harm domestic industries of other trading partners, it can result in trade restrictions and thus trade conflicts.

Trade conflicts seem to be occurring between the United States (US) and China whereby China's trade policy is unfavourable to the US. Thus, this newsletter discusses the trade tension and its implications to the global trade and economic climate with a particular focus on South Africa (SA) as one of the trading partners of the US and China. Firstly, it provides an economic meaning of trade restrictions and how it causes a trade war. Secondly, it discusses the areas of concern to US policy makers, the trade relationship between the two economies and further looks at how this tension can harm these economies. Thirdly, the analysis proceeds by discussing the effects on Emerging Markets and Developing Economies (EMDEs). Lastly, it narrates the possible implications to the South African economy, particularly the steel industry and equity markets.

2. Trade restrictions

Countries are endowed with different types of natural resources, skills and machines required to add value to their respective abundant resources. Yet, they are used by countries globally either as resources, semi-finished or final products ready for human consumption, irrespective of them available in their geographical countries. They are sourced from countries where they are in abundance at competitive world prices. The sourcing of these products or resources can be done without any restrictive measures when the exporting country makes it available without imposing any trade restrictions, hence free trade.

In order to protect domestic firms or industries, countries put restrictive measures which include import tariffs, import quotas, and subsidies, amongst others. Protectionist policies can impact global economy negatively as it restrict the free movement of goods. Countries normally apply protectionist measures when one or more parties believes that trade is being conducted unfairly in order to protect their respective economies.

2.1 Import tariffs and import quota

There are various protective measures (taxes) used to reduce the inflow of imports to protect domestic industries, which include amongst others import tariffs and import quotas. Import tariffs are charged on imported goods and services in order to restrict imports. Tariffs can be imposed for various reasons such as protecting domestic industries against international competition and increasing government revenues. The effects of imposing tariffs vary with the size of the economy. For example, a small economy in terms of gross domestic product (GDP) per capita cannot influence the world market price. Instead, the price will increase for domestic consumers with no effect to the international market (Lundberg, 1995[1]). However, a large economy has a high probability of influencing the world market price, and thereby foreign exporters' prices.

[1] Lundberg, Lars. (1995). *Internationell handel och industristruktur*. 5th ed. Malmö: Liber-Hermod.

Import quota is another trade protection that restricts import quantity, which is usually enforced through a license system where individuals or firms are regulated in terms of maximum quantity they can import**.** Although import quota has a low possibility to cause global trade conflicts, however, it can result in higher prices domestically due to limited quantity to meet the domestic demands.

3. Trade war

Trade war refers to an intense international conflict where countries interact, bargain and retaliate primarily over economic objectives directly related to the traded goods of their economies. Countries use restrictive policies to block the free flow of goods or services. The most common protectionist policy that countries use during the course of trade conflicts is the import tariffs. As much as the imposition of import tariffs is anticipated to benefit the importing country, however, it can lead to retaliation from the exporting country concerned and thus causing a trade war.

It is much more likely that an economically powerful country facing a developing country will improve its income with an optimal tariff, even if a developing country retaliates (Conybeare, 1987[2]). However, if both countries are economically strong, the effect of these trade conflicts can cause other countries to be affected as far as the value chain is concerned. Evidence has been recently realised between the US and China's trade war which has affected most of the emerging market economies including SA.

4. Emerging trade tensions between the US and China

The risk to the global economic environment has intensified as the trade tensions between the US and China continues. The trade disagreements emanated from concerns raised by US's policymakers regarding the imbalance, unfair and China's damaging trade policies towards the US economy. In this regard, the US policymakers believe that other countries' policies especially China, impede US economic interests and result in job shedding in some sectors. Further, the criticism relates largely to a huge trade deficit in the US that has cumulatively widened over the past decades.

The US policy makers argue that the deficit reflects shift in global production and the emergence of complex supply chains, where China is often the final point of assembly for export-oriented multinational firms that source goods from different countries. The major areas of concern raised by these policymakers and stakeholders include the following: China's alleged widespread cyber economic espionage against US firms; relatively ineffective record of enforcing intellectual property rights; discriminatory innovation policies; mixed record on implementing its World Trade Organisation (WTO) obligations; extensive use of industrial policies to promote and protect industries favoured by the government and interventionist policies to influence the value of its currency.

5. Trade and economic relations

The US-China economic and trade ties began to grow in the late 1970s when both countries formally established diplomatic relations[3] through entering into bilateral agreements. In 1980, total trade between these economies was US$4.9 billion, whereby China was the 24th largest US's trading partner, 16th largest export market, and 36th largest source of imports (Morrison, 2018[4]). Trade ties between the two countries strengthened substantially over the past decades, following China's agreement to join the World Trade Organization (WTO) in 2001. China is currently the largest trading partners of the US, while the US is China's second largest trading partner after the European Union (EU).

5.1 United States (US) merchandise trade with China

Table 1 displays the US merchandise trade with China from 1980 to 2017. The table shows that US merchandise exports[5] to China have grown significantly from US$3.8 billion in 1980 to US$130.4 billion in 2017. This growth rate of exports by the US to China is faster than that of the US exports to any of its top 10 export markets in the same period[6]. Despite the substantial growth on exports from US to China, it is noted that imports from China to the US outweigh the exports and thus translate into a huge deficit that has contributed immensely to the ongoing trade disagreements between the two countries.

[2] Conybeare, John A.C. (1987). *Trade wars: The theory and practice of international commercial rivalry*. New York: Columbia University Press.

[3] In 1979, China and the US formally established diplomatic relations at ambassadorial level. The US announced the severance of its so-called diplomatic ties with Taiwan, the withdrawal of its troops from Taiwan and the ceasing of the US-Taiwan Joint Defense Treaty.

[4] Morrison, W. M. (2018). China-U.S. Trade Issues. Congressional Research Services. Available online: https://fas.org/sgp/crs/row/RL33536.pdf. Accessed on: [11 July 2918]

[5] The top five US goods exports to China in 2017 included the following, aerospace products (mainly civilian aircraft and parts); oil seeds and grains (mainly soybeans); motor vehicles; semiconductors and electronic components; and waste and scrap.

[6] Major US merchandise export markets (2002-2017): Canada (75.7%), Mexico (149.1%), China (491.3%), Japan (31.6%), United Kingdom (69.4%), Germany (100.9%), Korea (113.7%), Netherlands (130.3%), Hong Kong (217.4%), Brazil (198.8%).

Table 1: US merchandise trade with China from 1980 to 2017

Year	US Exports	US Imports	US Trade Balance
		US$ Billion	
1980	3.8	1.1	2.7
1990	4.8	15.2	-10.4
2000	16.3	100.1	-83.8
2010	91.9	365.0	-273.0
2011	104.1	399.4	-295.3
2012	110.5	425.6	-315.1
2013	121.7	440.4	-318.7
2014	123.7	468.5	-344.8
2015	115.9	483.2	-367.3
2016	155.6	462.6	-347.0
2017	130.4	505.6	-375.2

Source: US International Trade Commission (USITC) Data-Web

The US's trade deficit with China is larger than that of its five largest trading partners, namely Mexico (-$71 billion), Japan (-$69 billion), German (-$64 billion), and Vietnam (-$38 billion). The deficit increased from approximately US$10.4 billion in 1990 to US$367 billion in 2015. It plunged moderately to US$347.0 billion in 2016, before increasing further to US$375.2 billion in 2017 (Table 1). As argued by the US policymakers, the deficit reflects the imbalance in trade policies whereby China benefits more than the US. The cumulative increase in the trade imbalance emanated from the US companies relocating to China for cheap labour.

6. Rationale for US's restrictive trade measures

The US undertook trade investigations to determine whether certain imports had exerted adverse impact on the US economy. One of the investigations was based on Section 301 of the Trade Act of 1974, which sought to determine whether China's policies and practices related to technology transfer, intellectual property, and innovation are unreasonable and restrict the US commerce. Findings of these investigations showed that China's policies and practices definitely cause technology transfer burden and also restrict US commerce. Consequently, the US took actions against China in line with these findings by:

6.1 Imposing restrictive measures (tariffs)

In 2018, the US announced its decision to impose tariffs on steel (25%) and aluminium (10%) imports globally[7]. Although the imposition of tariffs spread to other US's trading partners, it is believed that Chinese products are the major target as the US primarily aims to shrink the trade deficit. Initially, the US published a list of products that are subjected to additional tariffs[8], which includes 1 102 product lines[9].

In response to China's retaliation, the US announced a second list of Chinese products that will be subjected to additional tariffs amounting to US$100 billion. Further, it pursued a WTO dispute settlement to address China's discriminatory technology licensing practices[10]. Lastly, the US will implement specific investment restrictions and enhanced export controls for Chinese persons and entities related to the acquisition of industrially significant technology to protect national security.

6.2 China's counter trade measures

The trade restrictions enforced by the US on Chinese imports saw a quick retaliation initiative by China. In its statement, China's ministry of commerce (MOFCOM) stated that "*the US has ignored the consensus already reached and capriciously initiate the trade war. It has impaired the interest of both sides, and destroyed the world trade order*". It will, in response to this, impose tariffs with the same size and further invalidate all the trade and economic achievements reached by the two economies.

6.2.1 China retaliation process

In response to the US restrictive measures based on section 232 investigation findings, the Customs Tariff Commission of the State Council (CTCSC) announced that in order to offset the losses brought about by the US imposed tariffs, it will levy additional tariffs (ranging from 15% to 25%) on 128 product lines valued approximately US$3 billion on various imports[11] from the US.

China also responded to restrictive measures related to section 301, it indicated that 25% additional tariffs will be applied on 659 items of US products worth about US$50 billion[12]. The first set of products which covers 545 of the product items, worth about US$34 billion, was officially subjected to tariffs in June 2018. The second set which includes 114

[7] Section 232 Investigation focuses on whether the importation of the article in question is in such quantities or under such circumstances as to threaten to impair the national security.

[8] The first list include industries of aerospace, information and communications technology, robotics, industrial machinery, new materials, and automobiles.

[9] Tariffs on listed products are imposed on two sets, the first set comprises of 818 product lines (medical-related apparatus, motor vehicles, airplanes and related parts) worth approximately US$34 billion of imports from China and is charged 25% tariff. The second set contains 284 product lines (lubricating oils, plastic tubes and pipes, and engines for industrial equipment) worth approximately US$16 billion.

[10] Under the WTO dispute settlement framework, there are three main stages of the dispute settlement process: (a) consultations between the parties; (b) adjudication by panels and, if applicable, by the Appellate Body of WTO; and (c) the implementation of the ruling, which includes the possibility of countermeasures in the event of failure by the losing party to implement the ruling.

[11] The products affected include pork products, aluminium waste and scrap, and selected fruits and nuts

[12] Tariffs on 659 items of US products worth about US$50 billion including agricultural products, automobiles, chemical products and airplanes

items valued at about US$16 billion remained pending for implementation on a later stage.

7. Is there any winner?

Given the historical data portrayed in Table 1 which showed a huge merchandise trade deficit between the US and China, it is reasonable to agree that China has engaged in trade practices that unfairly harm US companies. However, there are other trade restrictive measures that are less aggressive than import tariffs, which could have been applied by the US. For example, it could have engaged in diplomatic negotiations and thus apply voluntary export restraints[13] or domestic content requirements, which are less aggressive measures.

The trade war between the world's largest economies will have dire consequences for both countries and for global trade climate. However, the negative effects might be severe for the US as a consumption-led economy especially on both domestic producers and consumers alike. Firstly, retailers in the US such as Walmart and Target rely heavily on products manufactured in China and thus would undoubtedly be affected.

Secondly, the technological companies such as Apple depends on Chinese employees to assemble iPhones, which means that trade tensions could block the accessibility of Chinese labour markets. As a result, the production costs for the companies could rise significantly, ultimately negatively affecting consumers.

Another important consequence of the ongoing trade conflicts is a loss of US jobs and decline in corporate profits on goods that are included in the Chinese retaliation strategy. This includes aircraft and heavy machinery, agricultural commodities such as soybeans. The imposition of tariffs on these products will reduce the demand and thus cost the US jobs and corporate profits.

Lastly, the trade war could also fuel inflationary pressures in the US, potentially causing the Federal Reserve (Fed) to raise interest rates, which would put further downward pressure on equity markets more especially in emerging markets and developing economies (EMDEs) as it has showed massive decline since the beginning of 2018.

7.1 Lessons from past experience

The use of protectionist measures by the US are certainly not new, as it applied restrictive trade policies during the Great Depression. In 1930, then US president Hoover signed the Smoot-Hawley Tariff Act as domestic businesses were experiencing increased international competition and declining prices due to overproduction. The businesses began to support trade protectionism after the stock market crashed in 1929.

The Smoot-Hawley Act aimed to decrease US imports, which it accomplished. The US imports from Europe fell by approximately 66 % between 1929 and 1932. Further, the measure set off a chain reaction of protectionism around the globe, causing more than 20 other nations to enact retaliatory measures. This greatly harmed US exports as they plummeted from $5.2 billion in 1929 to $1.7 billion in 1933, thereby showing a staggering loss. The act affected largely the agricultural sector, of which it was originally designed to protect. Although it was designed to benefit the US, however, it ultimately worsened the severe economic crisis of the Great Depression. This emanated mainly from the retaliatory barriers enforced by countries in other parts of the world as a means to compensate for higher tariffs on imported goods. The World Trade Organisation (WTO) was formed to regulate international trade, with the hope to avert the repetition of the global trade war of the 1930s.

This scenario highlights an important point that a tariff implementing country may end-up losing and worsen the situation by using trade restrictive trade measures.

8. Implications to emerging markets and developing economies

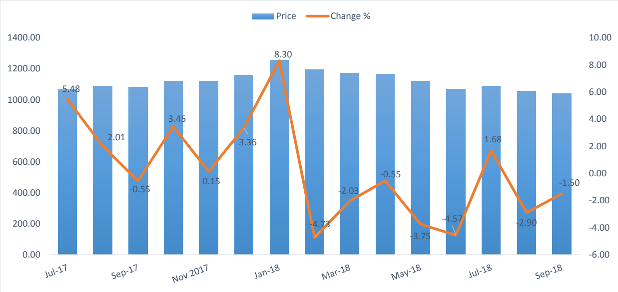
8.1 Emerging markets sell-off

The trade tensions between the largest economies (China and US) have far-reaching implications to other economies especially the emerging market and developing economies. The collateral damage has been evident in emerging markets as investors pull out their assets and move to the safe havens.

This puts pressure on emerging markets currencies, increasing inflation and thus leads to interest rate hikes. Another important factor that contributes to the risk to emerging markets has been the strong dollar, which raises the cost of the foreign currency denominated debt in developing countries, making less money available for government spending.

[13] Voluntary export restraints (VER) are arrangements between exporting and importing countries in which the exporting country agrees to limit the quantity of specific exports below a certain level in order to avoid imposition of mandatory restrictions by the importing country. The arrangement may be concluded either at the industry or government level.

Figure 1: Emerging market index from July 2017 to September 2018



Source: Investing.com

In addition, the stronger dollar encourages emerging market sell-off by investors for better returns in the US. The decline in the emerging markets is reflected in the emerging market index above which represents 24 countries[14]. The emerging market index performed well in 2017 as reflected in the figure above. Since February 2018 it started to show a downward trend and realised negative growth.

9. Is South Africa affected?

The South African economy is an open economy, which strengthened markedly since the first democratic transition in 1994. The major step undertaken by the democratic government was to end trade sanctions and open the economy to international trade, investment and economic relations. The country has made significant progress towards improving international trade since the adoption of trade liberalization in 1995. This includes participating in different trade organizations such as the World Trade Organization (WTO).

It has also diversified and reinforced relationship with other regions by engaging in regional trade agreements and trade blocs such as the Southern African Customs Union (SACU) and Southern African Development Community (SADC). These trade blocs facilitate all forms of trade efficiently, especially the flow of goods between partner countries. Further, the country has developed strong partnership with various nations such as China, USA and Germany which currently constitute key trading partners (SARS, 2018). SA has also strengthened relations with the Brazil, Russia, India and China (BRICS). The formulation of Africa Agenda 2063 strategic framework for the socio-economic transformation of the continent over the next 50 years is also a great initiative. This framework builds on, and seeks to accelerate the implementation of past and existing continental initiatives for growth and sustainable development.

Given the trade relations that SA holds with the rest of the world, particularly the US and China, the trade conflicts have spill-over effects to the domestic economy through the value chain. The negative effects associated with the trade war include deteriorating export volumes, high import prices, exchange rate volatility and capital outflows, among others.

9.1 SA's trade relations with US and China

According to the South African Revenue Service (SARS) (2018), China and the US are the largest trading partners for SA. China is the first largest export market for SA as it constitutes 9.2 % of total exports, followed by the US at 7.4 %[15]. As indicated above, the import tariffs are directed at steel products, which indicates a risk to the national economy as an exporter of steel. SARS (2018) showed that products such as iron and steel exports to the US amounted to R10.2 billion whilst exports to China was R9.3 billion during the first half of 2018.

China is the largest imports market for South Africa at 17.1 %, whereby machinery was the largest imported products at R58.5 billion. The US, on the other hand, is the fifth largest source of imports for the national economy at 5.4 %[16]. Machinery was the largest merchandise imports from the US at R11.2 billion from January to July 2018. Therefore, trade conflicts between these economies has a spill-over effect to SA.

9.2 South African steel and aluminium industry at risk

According to the African proverb, if two elephants are fighting, it is the grass that suffers. This implies that small economies globally, including SA, could suffer most from the trade conflict between the US and global largest economies like China or the EU. The domestic economy, through the benefits of the African Growth and Opportunity Act (AGOA), is the most African important exporter of steel to the US[17].

[14] Emerging Market countries include: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

[15] The largest products that South Africa export to China include mineral products, products iron & steel and textiles whilst largest imported products include machinery, textiles, products iron & steel, chemicals, and plastics & rubber. The largest products that South Africa export to US include precious metals, products iron & steel and vehicles aircraft $ vessels whilst largest imported products include machinery, chemicals, and vehicles aircraft & vessels.

[16] South African Revenue Services (2018). Merchandise trade statistics. Available online: http://www.sars.gov.za/ClientSegments/Customs-Excise/Trade Statistics/Pages/default.aspx Accessed on: [29 August 2018]

[17] AGOA was introduced in 2000 by the Clinton administration to boost trade and investment in granting Africa duty-free access to 6,500 exported products. The purpose of this legislation was "to assist the economies of sub-Saharan Africa and to improve economic relations between the United States and the region. After completing its initial 15-year period of validity, the AGOA legislation was extended on 29 June 2015 by a further 10 years, to 2025" (African Growth and Opportunity Act, Wikipedia)

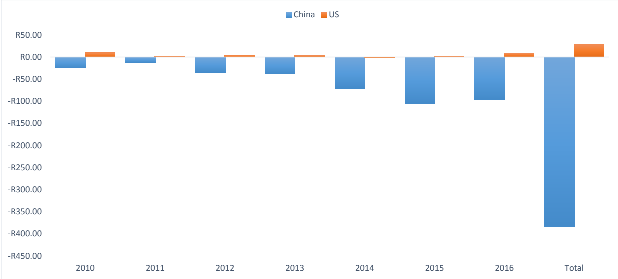
It is estimated that South African steel imports to the US amounted to approximately US$ 950 million, which is a quarter of all South African US exports in 2017. Further, the national economy imported aluminium products valued at US$375 million, which accounts for 1.6 % of US imports over the same period[18] (Kohnert, 2018).

This indicates that if SA would not be granted exemption on the increased steel and aluminium tariffs from across-the-board 25% steel and 10% aluminium tariffs, the local industry might experience job losses. For example, if the domestic economy loses the US export market, there is a high possibility that roughly 300 000 tons of steel production, along with some 7 500 jobs in the steel and manufacturing supply chain would be at risk (Kohnert, 2018[19]).

9.3 SA's trade balance with the US and China

Figure 2 depicts SA's trade balance with US and China for the period 2010 to 2016. The figure shows that trade deficit between SA and China has been widening over the period. It increased from R24.8 billion in 2010 to approximately R96 billion in 2016, thereby amounting to R384.1 billion in total.

Figure 2: SA merchandise trade with US and China from 2010 to 2016



Source: South African Market Insight, 2018

A trade deficit indicates that imports exceed the exports between countries, whereby SA purchases more goods from China but export less. The trade deficit is large on machinery products as it stood at R452.1 billion from 2010 to 2016. However, the trade balance is positive on mineral products at R430.6 billion over the same period.

The trade balance has been positive between SA and the US, indicating that exports are more than imports (Figure 2). The trade surplus is estimated at R28.3 billion for the period 2010 to 2016. The largest products exported included precious metals at R109.7 billion and iron and steel at R63.5 billion over the same period. It is worrying that these resources are major exports for the South African economy. Though these resources are abundant domestically, there is lack of resources beneficiation. They are exported at low value as primary products and imported back after beneficiation internationally and become expensive.

9.4 Exchange rate volatility and capital outflows

Similar to most EMDEs, the domestic currency (Rand) is highly responsive to domestic and global economic and political developments. It has depreciated markedly following the ongoing trade conflicts involving the two largest economies. The major reason being that investors fear high risks in EMDEs and thus sell-off their investments. The rand depreciated to the highest level of R15.69 against the dollar in September 2018 as the trade tensions intensified and the Turkish Lira crisis become evident.

This was a substantial depreciation of the domestic currency when compared to R11.53 observed earlier this year when the optimism was high among the investors over political transitions[20]. There are numerous risks associated with a depreciating currency such as high import prices and second round effects to consumers in terms of inflation. Over and above, the domestic economy loses significantly with capital outflows.

10. Conclusion

The ongoing trade war between the US and China is affecting the global economy. The main reason for this trade war emanates from the imbalance of trade between these two countries which favours China. The trade imbalance is also evident between China and SA, because of the AGOA agreement, SA is able to maintain a positive trade balance with the US.

[18] Creamer Terence (2018): South Africa to make tariffs submission as Trump leaves door open for exclusions.. Creamer Media Engineering News, 9th March 2018

[19] Dirk Kohnert (2018). Trump's tariff's impact on Africa and the ambiguous role of African agency. GIGA - German Institute of Global and Area Studies, Institute of African Affairs, Hamburg. Available online: https://mpra.ub.uni-muenchen.de/87647/1/MPRA_paper_87647.pdf Accessed on: [14 August 2018]

[20] Trading economies exchange rate historical data. Available online: https://za.investing.com/currencies/usd-zar-historical-data. Accessed on: [10 September 2018]

When large economies in terms of GDP are engaged in a trade war, there is a high probability that the global economy, more especially the EMDEs are going to be affected. This is evident in the emerging markets index which include 24 countries showing significant decline from February 2018 to date due to emerging markets sell-off. This has affected the Johannesburg Stock Exchange (JSE) All Share Index as it has shown volatility. The spill-over effect is through the value chain in the production process as well the fact that Naspers (multinational internet and media group headquartered in SA) which has around 31% stake in China-based internet giant, Tencent makes approximately 25% of the JSE top 40 index and 21% of the JSE all share index. Hence the movement of Tencent share price due to jitters over the Chinese economy's vulnerability to a trade war affects Naspers share price which then affects the whole JSE index.

The trade war has a negative effect on the macroeconomics variables such as the exchange rate, inflation and the interest rates amongst others. Negotiations with the WTO facilitating the discussion to reach an amicable solution in the interest of the global economy is paramount between these two countries.

Province of KwaZulu-Natal

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