MERatings
Middle East Credit Rating Agency

The Impact of a Trade War on the GCC

Economic Update

October 2018

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1. Background & Overview of the Trade War:

The trade dispute between the US and China began earlier this year, as the US accused China of resorting to unfair tactics to create a large trade surplus with the US, and stealing American technology. The dispute escalated in March 2018, following the conclusion of a United States Trade Representative (USTR) investigation into China's intellectual property and technology transfer practices. As per US accusations, China forces US firms to transfer technology to their Chinese business partners in return for market access.

The trade dispute resulted in the US implementing trade tariffs on China, and the Chinese government took reciprocal measures. The US implemented their first China-specific tariffs on July 6, 2018, with a 25% tariff on Chinese goods valued at US$34Bn. The goods targeted by these tariffs included those which were related to the 'Made in China 2025' initiative, with the majority of products consisting of intermediate goods and capital equipment. China took retaliatory measures and imposed 25% tariff on US goods worth $34Bn. Subsequently, on August 23, 2018, the US implemented 25% tariff on $16Bn worth of goods imported from China. This lead to the announcement of reciprocal tariffs of 25% on US goods worth $16Bn by the Chinese government. The Chinese were not impressed with the actions of the US government and warned that the dispute might lead to the largest trade war in economic history to date. China also cancelled trade talks planned with the US ahead of the impending implementation of US tariffs on US$200 billion worth of Chinese goods. The cancellation of these negotiations prompted the US to implement a third round of tariffs on $200Bn worth of Chinese goods on September 24, 2018, the tariffs carry an initial rate of 10% and will be increased to 25% by January 1, 2019, if negotiations are unsuccessful. China responded by implementing tariffs on US$60 billion worth of US goods on September 24, 2018. Therefore, total tariffs applied by the US to China stands at $250Bn whereas total Chinese tariffs applied to the US aggregate to $110Bn. (Wong & Koty, 2018). The timeline for trade tariff implementation is as follows:

Since Chinese imports less from the US as compared to the amount of goods imported by the US from China, therefore, it is unable to match the dollar value of goods for a retaliatory tariff. However, China has considerable leverage over the US and may resort to non-tariff related actions including restricting market access for US companies operating in China. Moreover, the possibility of a currency war cannot be ruled out as well. The Chinese currency has been weakening since the election of Donald Trump. A weaker Yuan (¥) would be better for Chinese exports and would make US goods expensive.

2. Underlying reasons for the trade dispute:

Initiation of the trade war with China appears to be a calculated strategy on the part of US, with the ultimate objective of containing China's rise as a global power. The gradual ascent of the Chinese economy and the rapid modernisation of its military have created a stir amongst US strategists. China is now viewed as a major challenger to US hegemony, and the US Secretary of State Mike Pompeo has said that the "Chinese government which is aggressive in its military posture with its economic strength, poses a far greater threat to the US than Russia" (China, not Russia a greater threat to US, 2018).

The Chinese economy is in a transition phase, shifting from a manufacturing powerhouse to service industries with the aim of moving up the value chain. China's objective is to pivot away from exporting basic goods such as clothing & consumer electronics to robotics and electric vehicles. US containment strategy and China's aim to move up the value chain have led to competition and friction between the two global powers, and a trade war is one aspect of this global rivalry. Some of the driving factors behind the trade war between the US and China are as follows:

I. Election campaign promise:

President Donald Trump made a string of promises during his election campaign and he wants to be seen as someone who keeps his word, especially close to the mid-term elections in November 2018. The US President promised not to let countries take advantage of US. Therefore, his campaign promise along with overestimation that trade wars are easy to win is one of the reasons for the trade war with China.

II. Disruption of the 'Made in China 2025' plan:

The 'Made in China 2025' plan is a blueprint of China's technology ambitions in the field of information technology, electric cars, pharmaceuticals etc. China's objective is to achieve economic leadership in advanced technology and hence its plan becomes a direct threat to US supremacy in this sector. Because of this, the US is targeting hi-tech manufacturers to disrupt the industrial strategy of 'Made in China 2025', which seeks to make Chinese manufacturing globally competitive by introducing automation and artificial intelligence.

III. Redirection of supply chains:

The Trade War is a part of US strategy to redirect supply chains to favor American manufacturers. From a US point of view, tariff implementation on imports from China would force firms to look for alternative supply chain arrangements, preferably within the US. This is one of the reasons as to why tariffs implement on US$200Bn worth of Chinese goods carry an initial rate of 10% and will be increased to 25% by January 2019. It will provide time for US firms to adjust their supply chain and minimise losses caused due to supply chain disruptions. However, it would be easier said than done as China has successfully inserted itself into the supply chains of numerous multinational organisations with the help of the 'Belt and Road Initiative'. Therefore, redirection of the supply chain in favor of American manufactures will be challenging and most likely will not be achieved.

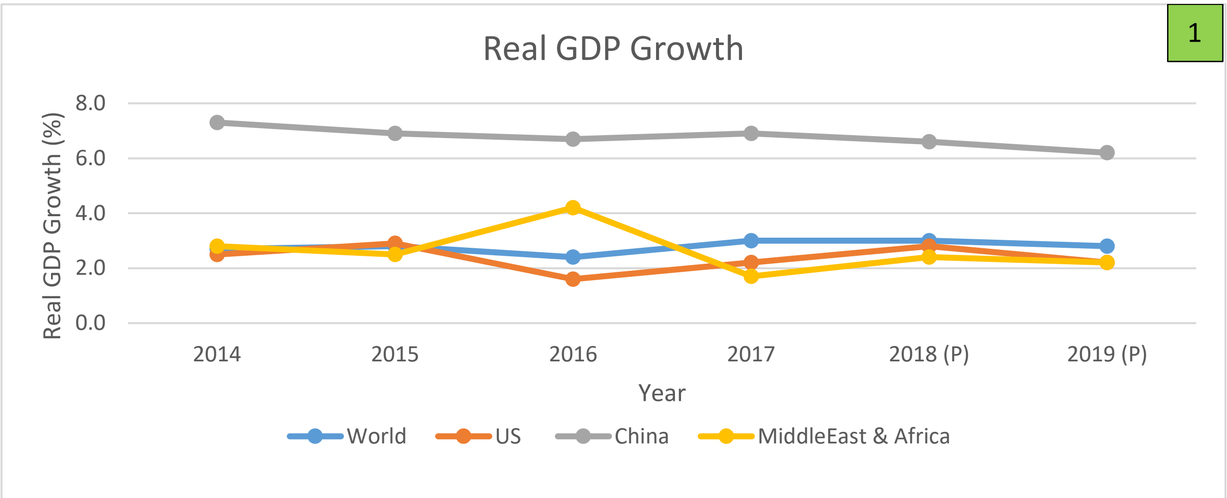
IV. Pressure tactic:

Pressurising countries to accept US demands is a trademark strategy of the present US government. A similar approach was applied against Canada during the NAFTA renegotiation. An argument can be made that the US is using this trade war as a leveraging tool to pressurise China to open its domestic market to US companies.

3. Impact of the Trade War

I. Impact on the Global Economy:

The trade war between the US & China will have negative consequences for global growth and the dispute between the two largest economies are showing signs of escalation. A trade war will diminish growth in both economies and will adversely impact the global economy. According to the Economist Global Forecasting Service, global growth is expected to slow to 2.8% in 2019 from 3% in 2018 (Global Outlook Summary, 2018). Graph 1 below depicts the projected real GDP growth of the world along with other major economies. A major impact of the trade war is expected to be felt in 2019 and drag on global growth will be felt due to a decline in GDP growth rates of the US as well as China.



Data source: (Global Forecasting Service, The Economist)

In addition to adversely impacting global growth, the trade war will also lead to supply chain disruption, trigger inflation and capital outflows from emerging markets (as US Federal Reserve would increase the interest rate to counter rising inflation), thereby negatively impacting the growth in the US. Therefore, the impact of a trade war would not be restricted to the US or China only but the overall global economy would suffer. Reduction in global growth would directly impact the demand for oil with GCC countries also affected.

II. Impact on the US

The economy continues to grow with stellar performance expected in the third quarter after growth hit a near four-year high in the second quarter. Industrial production and ISM survey data for July and August show the manufacturing sector kept running at full capacity, with large order books poised to maintain strong activity in the coming months. Job creation also remained robust in the same two months, while wage growth accelerated and consumer confidence hit an 18-year high in August, boding well for private consumption. (US Economic Outlook, 2018)

The US economy continues to receive support from the Trump administration's fiscal policies, as well as the ongoing strength in the labour market. The economy has added an average of over 200,000 jobs in January-August 2018, and year-on-year wage growth reached 2.9% in August. However, the escalating trade dispute with China will start to weigh on growth later in 2018 and into 2019. The US manufacturing and agricultural sectors will be hit by the trade dispute, and rising interest rates will cause private consumption to slow (Global Outlook Summary, 2018). Growth is likely to dampen in 2019 as inflation increases and interest rates continue to rise, which would contribute to diminishing consumer spending and adversely affect the business environment.

Moreover, the time period provided by the US government to Businesses to adjust their supply chain is inadequate, leading to further confusion and uncertainty. Supply chain disruption of US companies might also force them to reconsider expansion plans and as these businesses focus on mitigating the impacts of a trade war. This would eventually lead to higher cost of business for US firms and could make them less competitive globally thereby, adversely affecting US exports.

III. Impact on China:

The impact of a US-China trade war would be much more pronounced on China as the US is its top trading partner and Chinese exports to the US far exceed its imports from the US. In 2017, the US imported US$431.7Bn worth of goods, that's 19% of total Chinese exports followed Hong Kong (US$281Bn) and Japan (US$137.4Bn). (Workman, 2018). Already, there are signs that China's manufacturing sector is slowing down. The China official manufacturing purchasing manager's index fell to a seven-month low of 50.8 in September 2018 from 51.3 in August 2018, lower than the median estimate of 51.2 in a Bloomberg survey of economists.

Meanwhile, the Caixin manufacturing PMI, which better reflects sentiment among smaller, private firms, declined to 50 from 50.6, the lowest since May 2017. A reading of 50 is the dividing line between expansion and contraction. Furthermore, new export orders, an indicator of future activity shrank at the fastest pace since February 2016, contracted for a fourth straight month, with the index falling to 48 from 49 in August 2018 (Boesler, Han, Hamlin, 2018).

The slowing down of the Chinese economy would have a ripple effect as several Asian economies including those of Japan, South Korea, Vietnam etc. are interlinked and dependent on China's growth. According to China's customs, over 30 per cent of the country's total exports in 2017 were processed and assembled products that incorporated other countries' inputs and components. This means that even though the final goods were labelled "Made in China", the profits were not made by Chinese producers alone (Yao, 2018). Therefore, as China's exports to the US decline, its import of components and inputs from other partners will drop too, adversely affecting their global production lines.

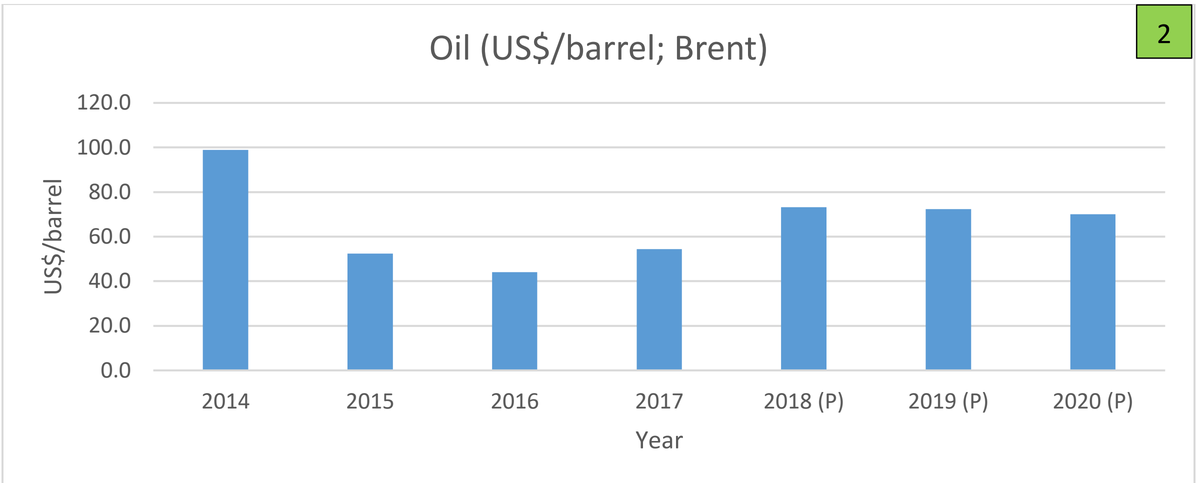
The Chinese government will respond by applying measures to support growth including tax cuts and infrastructure spending. China's central bank will continue topping up liquidity in the financial system to promote economic growth, bring financing cost down, boost lending to smaller businesses, fast-track infrastructure projects (resulting in an improvement in construction activity & services industry) and cut reserve requirements ratios for banks. Lowering the required amount will increase the supply of money that a bank can lend to businesses and individuals, therefore reducing borrowing costs.

IV. Impact on GCC

There would be no immediate effect of a US-China trade war on the GCC as the region is not directly involved. The GCC is primarily an import driven region with large trade deficit outside crude oil; therefore, other countries cannot impose a tariff on its exports. Moreover, the GCC region is not a part of China's production line in a way South Korea or Japan is positioned. Although, the GCC region may not be directly affected by a trade war, however, indirectly it will be affected. Here are some of the ways in which trade war will indirectly impact the GCC:

a. Crude Oil Prices:

Currently, crude oil prices are hovering around US$70-80 per barrel. However, prices will decline in response to a lower demand for crude oil resulting from the weakening of global economic growth. Gulf economics relies heavily on Asian oil consumption, particularly by China. Asian Oil consumption is crucial to Saudi Aramco and Abu Dhabi National Oil Company (ADNOC). The escalation of a trade war, the rise of protectionism in international trade along with increased petroleum exports by the US would further increase competition. All of these factors will put downward pressure on crude oil prices. Presently, crude oil prices are supported by turmoil in Venezuela and the threat of sanctions on export of crude oil by Iran. Without these factors, crude oil prices would have dipped sharply in response to the ongoing trade war. Graph 2 below shows the projected crude oil prices. If sanctions on export of crude oil from Iran are not effectively implemented, the projected crude oil prices will dip further.



Data source: (Global Forecasting Service, The Economist)

b. Economic diversification plan:

The economic diversification plan initiated by some of the GCC countries including Saudi Arabia and Qatar will be delayed as a result of a trade war. Saudi Vision 2030 and Qatar National Vision 2030 plan to reduce oil dependence and diversification of economy would be adversely affected in the face of slowing global economic growth and heightened uncertainty in international trade as these plans are dependent on foreign investments and stability in world economic order.

c. GCC equity markets:

The impact of a trade war in the GCC would be felt on the economic growth and performance of equity markets of the GCC. As most of the GCC markets are either classified as frontier or emerging, capital outflows from the region is expected in response to rising interest rates in the US. Investors are also expected to sell equities for a flight to safety given heightened uncertainty in global equity markets.

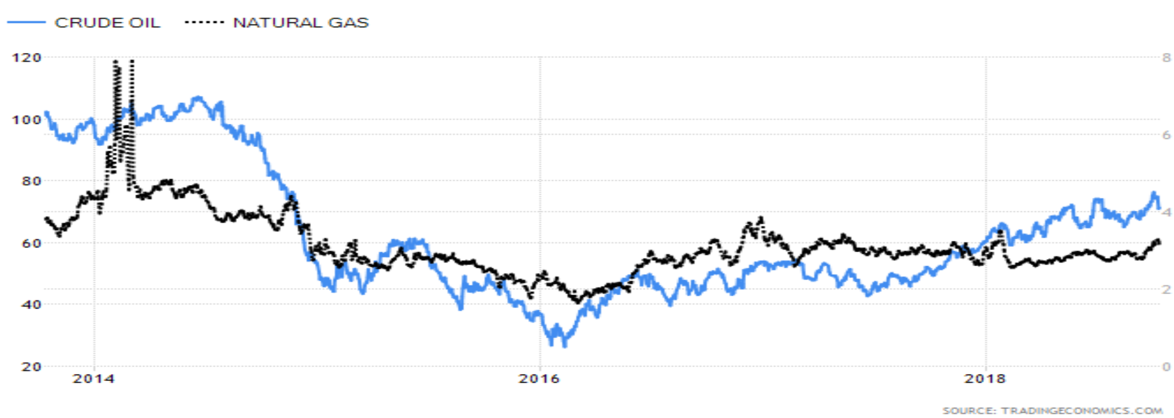
d. Economic growth:

Gulf countries import most of their goods, and their currencies are pegged to the US dollar. Imposition of tariffs by the US & China is likely to increase the cost of production, which would translate into higher prices to be paid by the end consumer. Therefore, a trade war will trigger inflation. Since Gulf countries' currencies are pegged to the dollar, inflation will pass through, and this will necessitate restrictive policies on the part of the GCC region and is likely to hamper economic growth.

V. Impact on Qatar

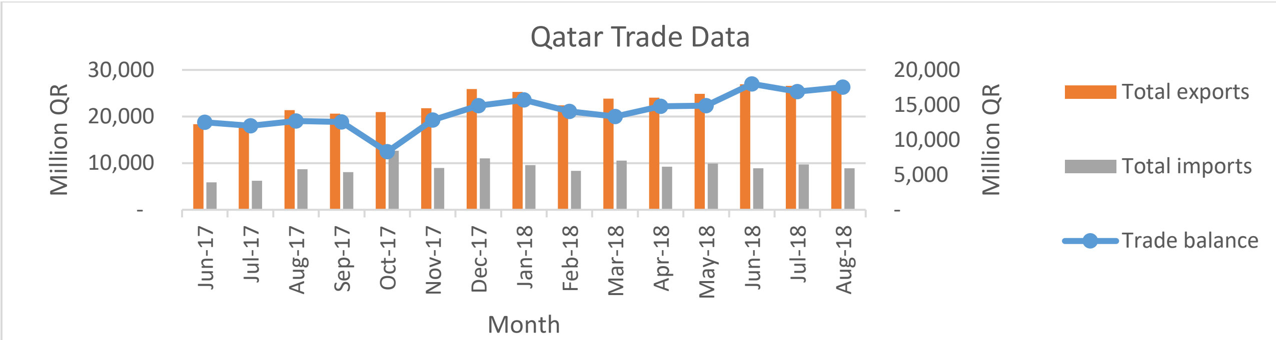
The impact of a trade war between the US and China would have a limited effect on Qatar mainly because of two reasons:

1. The Qatari economy is heavily dependent upon energy exports (primarily gas), and tariffs applied by the US or China are not related to energy exports.
2. Indirect impact on the GCC would be visible in the form of downward pressure on crude oil prices, resulting from a lower demand for crude oil, owing to slow down in global growth. However, the impact of lower crude oil prices would be muted as Qatar is primarily a gas exporter and gas prices are weakly correlated with crude oil prices (as shown in graph 3 below).



(Source: Tradingeconomics.com)

Graph 4 shows the trade balance and imports/exports of Qatar, before and after the escalation of the trade war between the US & China. The trade dispute escalated in March 2018. The graph depicts that the imports/exports remained largely unaffected. In fact, trade balance started to show a rising trend post-March 2018 mainly due to volumetric increase in gas exports.



Although the trade of Qatar would largely remain unaffected, some effects of the trade war on the country's economy would still be felt in the form of declining foreign investments due to heightened uncertainty and an expected rise in interest rates to counter inflation & prevent capital outflows.

Declining foreign investments would impact the realisation of the economic development goals of Qatar's National Vision 2030 as attracting investments and growth stimulation would become challenging given the uncertain global economic outlook.

A rise in interest rates will adversely impact growth rate, particularly at a time when the country is looking inwards for the development of SME industry to achieve sustainable growth and economic diversification. Moreover, Qatar will need to raise interest rates faster than the US rate hikes to attract capital, which will act as a drag on economic growth.

VI. The Way Forward?

The progression and ultimate outcome of the trade war is highly dependent on the domestic politics of the US. As US businesses start to feel the pain of supply chain disruptions caused by the trade war, pressure will mount on Donald Trump. Furthermore, House of Representatives mid-term elections in November will also determine the trajectory of a trade war. Two scenarios are possible:

Scenario A: The Trump administration comes under increasing pressure to refrain from further escalation of the trade war. This political pressure, combined with the Republicans' loss of the House of Representatives in the November mid-term elections will cause Donald Trump to rethink his trade strategy. (Global Economic Outlook, 2018)

Scenario B: The Trump administration withstands domestic pressure and is also successful in mid-term elections. This will provide a vote of confidence and encourage him to continue a policy of trade confrontation with China, further accelerating the trade war and even expanding hostility towards China in other domains as well, e.g. currency war, sanctions on certain military purchases etc.

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