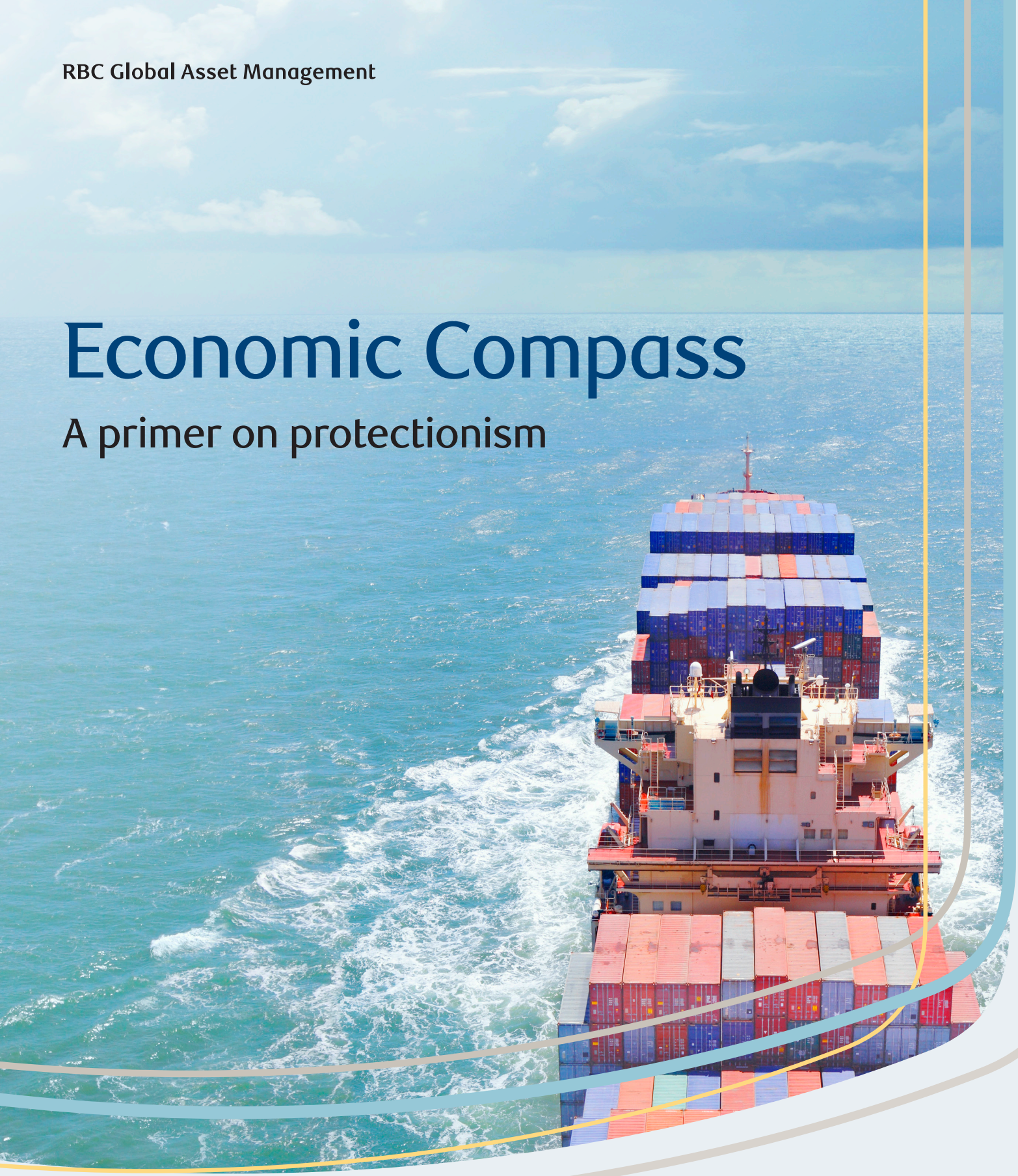
RBC Global Asset Management

Economic Compass

A primer on protectionism



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In this issue

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Among the many macroeconomic issues blowing across the economic landscape, the gusts of protectionism have been especially notable. Reconfiguring the U.S. trading relationship with the world was a key plank in President Trump's campaign platform several years ago, and he has held true to that pledge.

This report lays out the full story of protectionism, beginning with the era of globalization that it has helped to quash, and probing why public and political attitudes have tilted away from free trade, how protectionism works, how protectionism interferes with economic growth, and the likely trajectory for trade and tariffs from here.

Before protectionism: the history of globalization

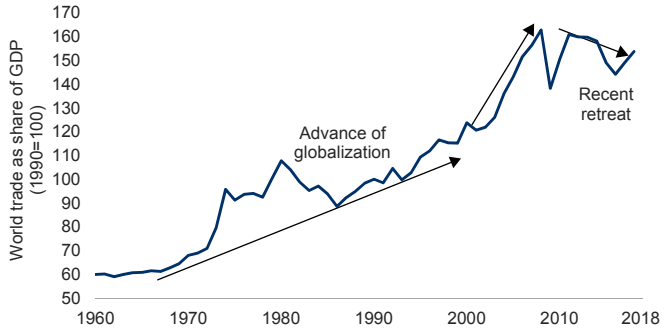
World trade massively outpaced global economic growth over the past 50 years, exploding from just 11% of GDP in the 1960s to roughly 29% today (Exhibit 1). This ascent was the embodiment of globalization: the ever-deeper integration of nations into a single global market in which goods, services, money and people could cross national borders nearly as easily as they circulated within them.

What prompted this explosion of globalization? There were several intermingling catalysts:

1. Tariffs and other trade barriers declined substantially as the liberal economic order came to dominate economic thinking. Principles such as open markets, democracy and multilateral institutions like the International Monetary Fund (IMF), World Bank (WB) and World Trade Organization (WTO) gained nearly universal favour. Big new trade agreements were accordingly struck, including NAFTA in North America and the deepening of the European Union in Europe. With fewer barriers to international commerce, trade soared as companies oriented their supply chains to capitalize on the comparative advantages of different nations.
2. Emerging-market (EM) economies grew rapidly over the past several decades, increasing their thirst for global goods and services, and simultaneously offering an expanding pool of inexpensive labour. This surely contributed to the advance of globalization. While one can debate the causality – part of the rapid EM growth was itself the result of globalization – at least part of the effect runs from fast EM growth to enhanced globalization.
3. The 1990s and early 2000s delivered further major boosts to global trade via the entry of massive new markets into the global economy. The dismantling of the Iron Curtain in the early 1990s unshackled a host of countries from the economic yoke of communism and thrust them into world markets. In the early 2000s, China's ascension to the WTO was an even more momentous development, as the resulting reduction in trade barriers injected more than a billion new consumers and cheap workers into the global system.

This rising trade proved to be an economic positive. Companies were able to achieve better economies of scale by tapping new markets and producing their products more cheaply, EM workers gained more lucrative employment opportunities, consumer choice increased and the cost of goods fell. All of these were powerfully attractive propositions for policymakers, who in turn nurtured the globalization push.

Exhibit 1. Trade growth has receded from its pre-crisis peak



Note: As of 2018. World trade measured as exports of goods and services.
Source: World Bank, Haver Analytics, RBC GAM

Exhibit 2. Globalization in decline

Why weaker globalization?	
Trade is high beta	▪ Weak GDP growth = even weaker trade
Greater competitive parity	▪ U.S. and China no longer have huge labour cost gap ▪ Therefore gains from trade reduced
Prior trade tailwinds have faded	▪ China, Soviet bloc, NAFTA, EU now fully absorbed ▪ Fewer new trade pacts (though still some)
New trade headwinds	▪ Populism ➔ Protectionism

Source: RBC GAM

The decline of globalization

Despite the compelling economic logic backing globalization, the trend of ever-intensifying trade has lately reversed (refer back to Exhibit 1).

There are several reasons why this has happened (Exhibit 2):

First, global trade is a "high beta" economic variable. This means that when economic growth is strong, trade growth is usually even stronger. But the reverse is also true: when economic growth is underwhelming – as it has been for most of the past decade – trade growth is even weaker.

Second, production costs between countries are converging, in part due to all of the globalization that has already

happened. Demonstrating this, U.S. wages have managed only limited growth in recent decades at the same time that Chinese wages have surged. The result is greater competitive parity: the savings from producing something in China and selling it to the U.S. have shrunk. A more homogenous world simply doesn't need to trade as much.

Third, prior trade tailwinds have faded. All of the grand trade achievements of the past several decades – NAFTA, the EU, the opening of ex-Soviet bloc countries and China – have now been mostly absorbed into the global economy. Few major countries remain outside the global economic system, waiting to jolt the world forward with their entry. In turn, there is no reason for trade growth to continue substantially outpacing economic growth. To be sure, there are still a smattering of new free trade agreements being struck, but they are fewer in number, and by definition smaller in achievement given that tariff rates had already been whittled down by prior efforts (Exhibit 3).

Fourth, and finally, there are new trade headwinds now blowing from the spate of populist governments recently installed around the world.

This last drag – populist governments – is worth investigating further.

The rise of populism: a driver of protectionism

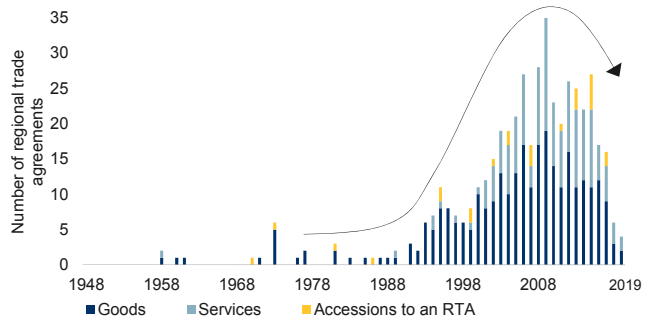
What is populism? Defined most simply, it is a rejection of the technocratic "elite" who have long dominated the political and economic systems, instead endeavoring to return power to "the people." This often leads to the pursuit of superficially logical but ultimately flawed policies like restricting immigration to create more jobs for citizens and limiting imports to create more demand for home-grown production.

Populism has been on the ascent over the past decade, with prominent examples including the Brexit referendum in the U.K., the election of populist governments in Greece (since ousted) and Italy, and – most famously – the U.S. presidential election of 2016.

Populism has grown in popularity for several reasons. The global financial crisis of 2008—2009 was a painful experience for many and spurred discontent with the status-quo economic policies that permitted such a catastrophe to happen. The period of slow economic growth since the crisis similarly disenchanted many voters.

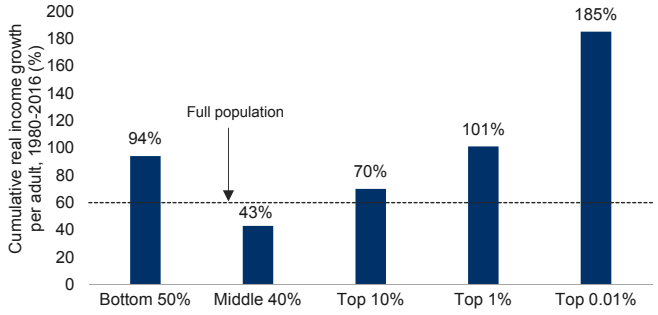
Simultaneously, though not purely the result of the financial crisis, within-country inequality has been rising for decades. This has produced a disenchanted underclass. As Exhibit 4 shows, the middle 40% of global income earners have experienced less income growth than other parts of the income distribution. Most are well aware that the "1%" and their ilk have enjoyed an outsized increase in income. Less appreciated is that the bottom 50% of global income earners have also enjoyed rapid income growth, in sizeable part due to the benefits of globalization accruing to poorer countries like China and India. Those left-behind middle-income earners are not wrong in surmising that globalization itself was at least part of the reason many of them have not prospered. This inequality is the dark underbelly of globalization.

Exhibit 3. Growth of Regional Trade Agreements has dwindled in past few years



Note: As of 2019. Source: WTO Secretariat, RBC GAM

Exhibit 4. Winners and losers from globalization



Note: Cumulative growth of average income of each income group of the world population. Source: World Inequality Database, RBC GAM

Populism, in turn, is associated with a general suspicion toward free trade and immigration, resulting in isolationist policies (Exhibit 5). Some more leftward forms of populism seek to address the aforementioned inequality via a higher minimum wage and a higher top tax rate, though rightward populist movements have so far enjoyed more success and do not usually share this inclination.

These isolationist policies tend to have negative economic implications. Economic growth is usually undercut as diminished immigration impedes population growth and reduced trade hurts commerce and productivity. Inflation also usually rises, in part because reduced immigration increases labour costs, and, in part, because fewer imports increase product costs. In turn, risk assets like equities underperform. These mechanisms have been on display over the past year, as bouts of protectionist concern in late 2018 and May 2019 have aligned with periods of stark stock market underperformance.

U.S. protectionist rationale

Given the many economic negatives associated with protectionism, what has pushed the U.S., in particular, in that direction? The answers fit into five buckets, spanning a mix of illogical and logical justifications (Exhibit 6).

1. Political philosophy

Famously, U.S. President Trump has long espoused isolationist, anti-trade views, dating back many decades to his time as a real-estate developer in 1980s New York City. Whether his underlying views are rational or irrational, he has been consistent in his stance and has accordingly set the tone for the current U.S. administration.

2. Political distortions

As discussed, the rise of populism has distorted public policy, motivating anti-globalization sentiment. While the U.S. is but one of many countries tilting in an anti-trade direction, its enormous economy creates the most noticeable waves.

There are also distortions that arise at the voting level: the rise of populism is a classic case of a relatively small and concentrated group of globalization losers pitted against a much larger – though more diffuse – group of globalization winners. Those that suffer from globalization suffer significantly, and have found in President Trump a political champion to enact changes to their advantage. Conversely, many of the winners from globalization have benefited only slightly and may not even be aware that their increased prosperity was the result of global integration. Thus, it is not a ballot box issue for them.

Exhibit 5. Understanding populism

Why populism?	Policy implications	Economic implications
• Financial crises	• Less free trade	• Less economic growth
• Slow growth era	• Less immigration	• More inflation
• High inequality	• Higher minimum wage?	• More focus on distribution of growth?
• Globalization losers	• Higher top tax rate?	• Worse market returns

Evidence of populist attitudes
• Brexit
• Populist government in Italy, polling elsewhere
• U.S. presidential election
• Rising protectionism, immigration fears

Source: RBC GAM

Exhibit 6. U.S. protectionist rationale

	Why protectionism?
Political philosophy	• Trump has isolationist instincts
Political distortions	• Populist desire to reject traditional economic framework • Concentrated interests of globalization losers beat diffuse interests of globalization winners
Flawed economic rationale	• Mercantilism: to reduce trade deficit • To address domestic competitive shortfall • To reclaim lost manufacturing
Accurate economic rationale	• U.S. has disadvantageous trade arrangements
U.S. exceptionalism	• Tariffs deliver punishment until U.S. gets better deal • U.S. is big, so can demand superior trade terms • U.S. can tolerate tariff pain better than others

Source: RBC GAM

3. Flawed economic rationale

A sizeable part of the U.S. thirst for protectionism is based on flawed economic rationale. There are several sub-elements of this:

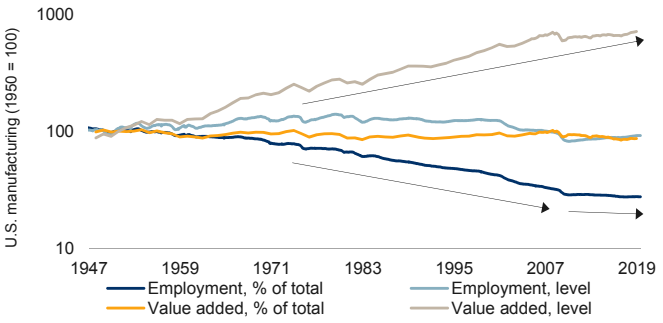
i. The mercantilist approach currently popular in the White House – the notion that exports are good and imports are bad – is deeply flawed. This imagines that an export is something Americans have made whereas an import is something they have failed to produce. But, at a deeper level, trade surpluses and deficits are equally the result of domestic savings decisions. The U.S. economy runs a trade deficit because the country opts to dis-save: to spend more than it produces. It is not economically possible to simply decide to improve one's trade balance, in part because it would require Americans to simultaneously opt to increase their savings rate, in part because with an already low unemployment rate there isn't a large enough pool of untapped labour to make the necessary additional goods, and equally because foreign countries would have to decide they wanted to decrease their own savings rate to absorb the additional goods.

ii. In actual fact, a significant part of the U.S. current account deficit (a measure similar to, but technically broader than, the trade deficit) is the result of the U.S. enjoying the privilege of being the world's reserve currency. Because the entire world wants the safety and liquidity of dollars, there is a surplus of available capital in the U.S. In turn, this depresses U.S. interest rates and thereby encourages the world's reserve nation – the U.S. – to borrow more. Almost by definition, a current account deficit results. Despite occasional speculation about the ascent of the Chinese renminbi and prior to that, the euro, the U.S. dollar is nowhere near losing its so-called "exorbitant privilege" of being the world's reserve currency. By extension, efforts to balance America's exports and imports are likely to be thwarted.

iii. To the extent the U.S. trade deficit is the result of an American competitiveness shortfall – which is oft-claimed but far from clear given the admirable U.S. competitive position versus many of its developed-world peers at the same time that those peers themselves have achieved balanced trade – it would make more sense to resolve any such shortfall via a better tax and regulatory environment, and via improvements in human capital, as opposed to building a moat around the country.

iv. The loss of U.S. manufacturing clout is a sore point that has undeniable linkages to China's ascent. However, this erosion has more to do with automation than with cheap foreign labour (Exhibit 7). Contrary to popular belief, the valued-added of the U.S. manufacturing sector is miles ahead of where it was in past decades (up 709% between 1947 and 2018), and has only slightly declined as a share of GDP over the same period. What has fallen aggressively is manufacturing's employment share. But this employment underperformance is primarily the result of more productive American manufacturers requiring fewer workers per unit of output rather than that jobs have shifted abroad. Automation is not something that tariffs can fix. To the contrary, tariffs may even accelerate the automation process.

Exhibit 7. U.S. manufacturing employment down but output up



Note: Employment as of Jun 2019, value added as of Q4 2018. Data displayed in base-10 log scale. Source: BEA, BLS, Haver Analytics, RBC GAM

4. Accurate economic rationale

Despite some of the flawed foundations of the U.S. globalization backlash, there are nevertheless three legitimate complaints that warrant tabling.

First, even if globalization is a net positive for economic growth, it is indisputable that not everyone wins. While new sectors have sprung up as a result of globalization, some industries have indeed abandoned the developed world. Whereas economists anticipated that negatively affected regions and workers would prove capable of retooling and retraining, achieving a comparable or even superior economic standard of living over time, the reality is that certain parts of the U.S. have remained economically depressed long after the forecasted rebound was supposed to have kicked in. The reasons behind this are multifaceted, including what appears to be a diminished inclination for workers to relocate to stronger labour markets.

Second, the U.S. was indeed getting a slightly raw deal when it came to trade deals (Exhibit 8). More often than not, domestic producers were forced to pay a higher tariff rate when selling into foreign markets than when foreign producers sold into the U.S. This was disproportionately a function of the agricultural sector, but not exclusively. In other words, the basic premise that the U.S. should renegotiate its trade deals to secure a more symmetrical arrangement is a valid one.

Third, and most starkly, the Chinese economy functions in a manner that creates many asymmetries to its advantage that don't appear on a tariff schedule, including capital controls that shield the country from foreign investors, extensive government support for massive state-owned corporate champions, aggressive intellectual property acquisition practices, and joint-venture requirements for foreign firms wishing to enter the country's domestic market. All of this gives Chinese companies a considerable advantage. Much of the U.S. push to redraw the trade playing field concerns entirely legitimate concerns such as these.

5. U.S. exceptionalism

U.S. trade decisions are also motivated in part by a sense of U.S. exceptionalism – that the U.S. is special and can therefore play by its own set of rules. Setting aside the morality of the approach, the U.S. is probably right.

Tariffs are being used not so much as a permanent tool for impeding foreign competition, but as a stick designed to hurt foreign economies until they bow down to U.S. demands, at which point the tariffs can presumably be removed.

The U.S. is capable of pursuing this strategy for a few reasons.

First, the U.S. economy is less trade-oriented than most, meaning it suffers less economic damage from tariffs. Thus, the U.S. can tolerate a high tariff environment for longer than other countries, incenting or even obliging other countries to bend to U.S. demands.

Second, the U.S. has a hugely attractive domestic market (the proverbial carrot) and an even bigger military (the proverbial stick) relative to the rest of the world. This gives it greater negotiating clout, with the implication that it is capable of securing not just balanced trade deals with other countries, but arrangements that tilt asymmetrically to its own advantage.

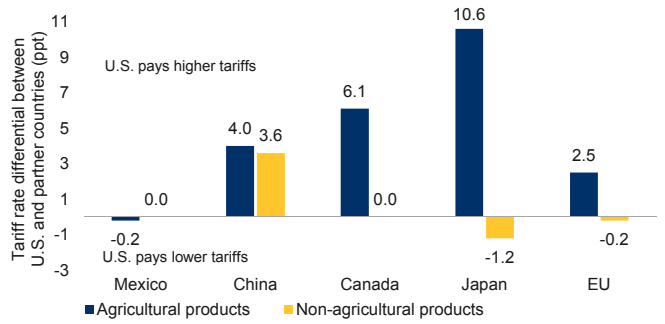
Who is the U.S. targeting?

With a mercantilist mindset that views exports as good and imports as bad, the U.S. has naturally aimed its tariff threats at the countries that sport the largest trade surpluses with the U.S. Four countries have drawn particular attention (Exhibit 9).

China is responsible for a startling 61% of the U.S. trade deficit, making it more relevant than all of the other countries combined. This is why China has been and will likely remain the main focus of U.S. trade actions.

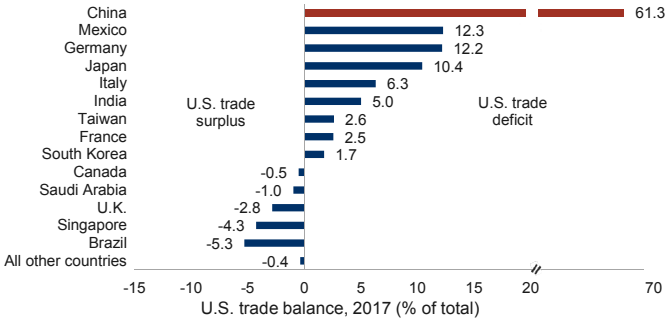
The other three countries lag well behind, with Mexico capturing 12% of the U.S. trade deficit, Germany representing a similar 12%, and Japan responsible for 10%. To this end, the U.S. has also focused on NAFTA renegotiations (with relevance to Mexico) and has threatened auto tariffs as a means of putting pressure on Germany and Japan.

Exhibit 8. U.S. gets bad tariff deal versus partners



Note: Difference between tariff rates U.S. pays on its exports to partner countries and rates partner countries pay on exports to U.S. Source: WTO/ITC/UNCTAD World Tariff Profiles 2018, RBC GAM

Exhibit 9. U.S. trade deficit with China tops the list



Source: Census Bureau, Haver Analytics, RBC GAM

Interestingly, Canada is not responsible for any of the U.S. trade deficit, but has instead been snared in the U.S. trade web primarily because of its membership in the same trade accord as Mexico – NAFTA. In fairness to the U.S., Canada does apply somewhat higher agricultural tariffs to the U.S. than the reverse (refer back to Exhibit 8), but this does not translate into an outright surplus.

Tariff increases in context

The average U.S. tariff rate has nearly tripled since 2017 (Exhibit 10). With this change, the U.S. has gone from being one of the lowest-tariff countries in the developed world to one with tariffs that are among the highest.

However, some longer-term historical context is useful. The tariff rate has merely gone from around 1.5% of the value of goods imported in 2017 to 4.3% as of mid-2019. This is still quite low compared to much of history (Exhibit 11). The tariffs that contributed to the Great Depression were far higher, above 20%. And the 19th century was riddled with tariff rates that ventured even beyond 50%. Of course, there is far more international trade occurring today than in centuries past, so the recent increase in tariffs is not trivial.

Three protectionist vectors

U.S. protectionist efforts have focused on three items: renegotiating NAFTA, levying a variety of blanket tariffs on products such as steel, aluminum and (threatened on) autos, and reforming the U.S.-China relationship (Exhibit 12).

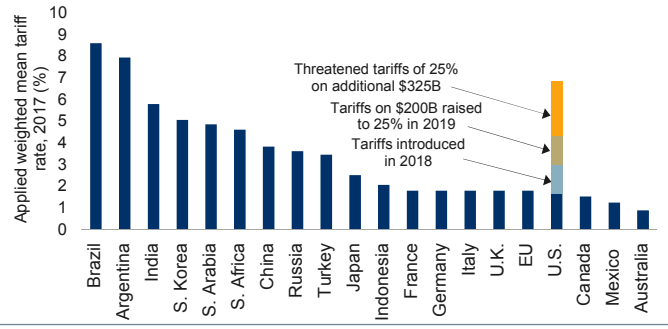
NAFTA/USMCA

After nearly a year of U.S.-instigated negotiations in pursuit of a replacement for the North American Free Trade Agreement (NAFTA), a tentative deal was struck in the autumn of 2018, called the U.S.-Mexico-Canada Agreement (USMCA).

The new deal has been subjected to conflicting critiques (Exhibit 13). On the one hand, it is arguably less conducive to the free flow of goods and services than the NAFTA accord it is set to replace, in that it adds new restrictions to the auto sector, inserts a sunset clause and restricts the ability of Canada and Mexico to negotiate side deals with China. Some wags have taken to describing the USMCA not so much as NAFTA 2.0 but as NAFTA 0.9.

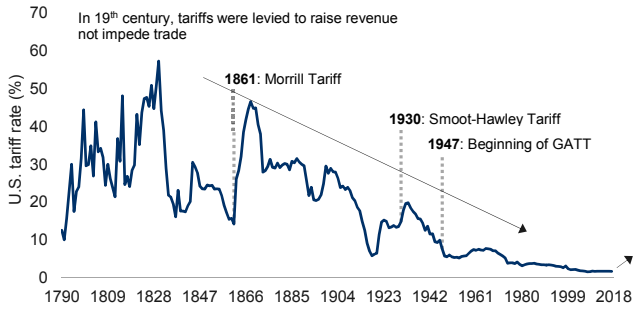
However, context is everything. There was the very real chance that efforts to secure a deal would fail given a gaping divide between initial U.S. demands and the positions of the two other countries. Thus, a deal of any description is at least a small victory relative to the alternative of torching the pre-existing framework and reverting to the relatively

Exhibit 10. U.S. tariff rate now substantially higher



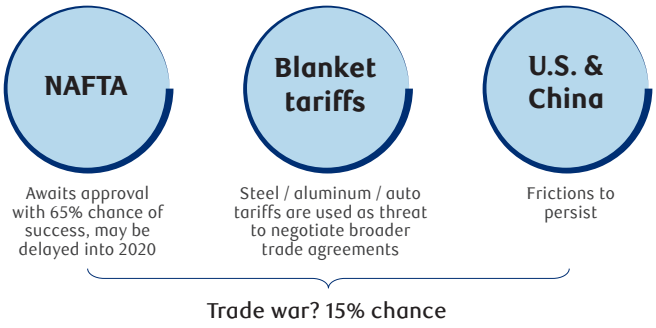
Note: Applied weighted mean tariff rates for all products. Estimates of U.S. tariffs introduced in 2018 and after based on additional tariffs announced up to end of May 2019. Source: Deutsche Bank, World Bank, Haver Analytics, RBC GAM

Exhibit 11. U.S. tariff rate was declining until recently



Note: As of 2017. Source: Historical Statistics of the United States, World Bank, RBC GAM

Exhibit 12. Key protectionist issues



Source: RBC GAM

Exhibit 13. NAFTA negotiators reached tentative deal

Scenario	Odds	
New USMCA deal	65%	• **Bad deal? USMCA deal slightly weakens trade** • **Good deal? But better deal than feared** • Auto sector: quotas, 75% domestic content minimum, higher sector wages • Sunset clause, but 16 year minimum • Harder to negotiate China trade deal • Trade dispute tribunals mostly unaltered • Unchanged cultural exemptions • Unchanged gov't procurement rules • Stronger IP rights • Canadian dairy sector partially opened • Higher cross-border shopping limits • Modernization
Prior NAFTA remains	30%	• If Democratic House fails to approve
NAFTA terminated	5%	• If Democratic House fails to approve and Trump reacts badly • Revert to WTO rules?

Source: RBC GAM

thin gruel of WTO rules. Moreover, in achieving a deal, the U.S. ultimately watered down its more extreme demands, increasing the length of time between pact renewals, scaling back restrictions on the auto sector relative to initial demands, and leaving two of the three trade dispute mechanisms in place despite initial threats to eliminate them all. The new deal also managed to reduce certain barriers to agricultural trade and cross-border shopping, and modernized the arrangement in a variety of subtle ways including with regard to intellectual property.

With the new deal, the North American economy might grow a little bit less quickly than under NAFTA, but only by a slight margin. And the trade outcome was better than many, including financial markets, were expecting just a year ago.

However, the matter is not yet completely resolved. The deal has only been tentatively agreed upon by heads of state. Politicians still need to formally vote on and ratify the deal. Mexico has already accomplished this, and Canada has expressed a willingness to do so now that steel and aluminum tariffs have been lifted. But it could yet be a tricky affair in the U.S. The primary challenge is that Republicans no longer control both chambers of Congress, meaning that Democrats in the House of Representatives will be asked to vote for legislation spearheaded by their nemesis in the White House. Even the Republican Party had expressed misgivings about the deal, though those have recently quieted as the U.S. scaled back steel and aluminum tariffs on Canada and Mexico. Given that the deal is better for the economy than reverting to WTO rules, we think Congress will ultimately (and grudgingly) approve it, with a 65% likelihood.

From a timing perspective, it may prove difficult to approve the deal before the fall. The Democrat-controlled House Ways and Means Committee can delay a vote for up to 45 days in which Congress is in session. The action may heat up later in 2019, as the USMCA could be approved as a bargaining chip in budget negotiations this fall. Democratic House Speaker Nancy Pelosi has indicated that she has the votes to approve the deal once Republican offerings are sufficiently enticing.

Should the approval effort drag into 2020, its fate would become more complicated and politicized given the approaching U.S. election. Fortunately, failure to approve the USMCA would not necessarily be an economic problem so long as the pre-existing NAFTA rules remained in place. The real risk would be if the White House responded to failure with the scorched-earth tactic of scuttling NAFTA, in which case the economic damage would be considerable (though, equally, Democrats might finally be convinced to approve the USMCA in that scenario). We assign only a 5% probability to this worst-case scenario.

Mexico was briefly threatened with further U.S. tariffs in the late spring of 2019 as a means of forcing additional Mexican border controls, though a resolution has since been secured (Textbox A).

Textbox A: Mexican tariff threat

The U.S. briefly threatened to levy additional tariffs on Mexico in the spring of 2019, but these were ultimately avoided just before a June 10, 2019 deadline.

We are not entirely surprised by the last-minute resolution. Unlike the rather trickier negotiations underway between the U.S. and China over the very structure of the Chinese economy, U.S.-Mexico frictions were more superficial.

The U.S. had demanded tighter border controls from Mexico – a central component of President Trump's 2016 campaign platform. Mexico ultimately complied, committing more National Guard troops to the border and promising to process rejected migrants returned by the U.S. more quickly.

President Trump has also reported that Mexico will buy more American agricultural products, but this does not appear to be a formal part of the deal.

To some extent, these Mexican concessions simply represent a return to vigilance after an easing of border security under relatively new Mexican President Obrador.

So long as the flow of illegal immigrants from Mexico and Central America (via Mexico) slows into the U.S, that should be the end of the story.

However, we flag the chance that the threat of Mexican tariffs could return, for any of several reasons:

- The U.S. has not been shy to again threaten a country with trade sanctions despite striking an earlier deal. Mexico is in fact the poster child for this, having signed the USMCA and then hit by this very tariff threat mere months later. As a result, one has to imagine that additional U.S. threats are possible against Mexico, whether on further immigration-related concerns, when the auto sector enters the crosshairs this fall, as a bargaining ploy to extract further USMCA concessions as a means of achieving the support of House Democrats, or for more foundational reasons relating to Mexico's superior competitiveness and/or the country's trade surplus with the U.S.
- The definition of success in the new agreement is poorly defined. To our knowledge, there is neither a specific number of troops that Mexico must install on the border, nor a particular reduction in illegal immigrants that must be achieved. It may thus be hard for Mexico and the U.S. to see eye to eye on whether the Mexican response has been successful.
- Mexican measures are unlikely to entirely halt illegal immigration into the U.S. The U.S. could use this as an excuse to extract a fervently-desired concession: having Mexico sign a safe third-country agreement with the U.S., with the implication that Central American refugees would be compelled to claim asylum in Mexico rather than continue on to the U.S.

For context, the number of illegal immigrants entering the U.S. reached a 46-year low in 2017. This was for three reasons. The first is that inward illegal border crossings have been down ever since the financial crisis as the U.S. became a less attractive destination from an economic standpoint.

Second, the number of deportations of illegal immigrants from the U.S. has been rising for many years, making the U.S. a less attractive destination. This actually began under President Obama, wherein illegal immigrants found guilty of other crimes began to be deported in sizeable numbers. This has since ratcheted even higher under President Trump after a zero tolerance policy was implemented.

Third, President Trump's tighter physical security at the actual border combined with harsher treatment of illegal immigrants prevented some and discouraged others from traversing the border.

However, despite these actions and at least in part because of lighter controls in Mexico, illegal immigration rebounded in 2018, returning the subject to political prominence.

The bottom line is that, from an economic standpoint, the decision not to levy tariffs on Mexico is clearly positive and has been interpreted by financial markets as such. But be warned that the threat could yet return, and it is disconcerting that the U.S. would come close to levying a new tariff on a country with which it had already struck a major new trade deal. This reduces U.S. credibility as other trade deals are pursued.

Blanket tariffs

The U.S. has also introduced a variety of blanket tariffs, described as such because they generally blanket an entire product or commodity regardless of origin, rather than focusing on specific trading partners.

The motivation for these tariffs is twofold. First, to benefit a particular domestic sector by hobbling foreign competition, and second, to gain negotiating leverage over foreign countries in an effort to force them to re-open a wider range of trade issues.

Targeted products have included softwood lumber, solar panels, washing machines, steel and aluminum. The steel and aluminum tariffs have since been lifted for certain allies, including Canada, Mexico, South Korea, Argentina and Brazil after those countries made various concessions on other fronts.

Auto tariffs would be the most consequential blanket tariff, but these have only been threatened rather than implemented thus far. Motor vehicles and parts are responsible for 13.2% of U.S. imports and exports, making it the single most important sector for American trade. Given the specialized nature of the industry – it is difficult to substitute supply from one country for another – any disruption would inflict considerable economic damage.

The main motivation for the auto threat is to get Europe and Japan to the negotiating table, as they are responsible for sizeable chunks of the U.S. trade deficit, and their corporate champions reside disproportionately in the auto sector. The U.S. seeks a variety of changes to its trading relationship with the two regions, but central among them are rebalancing the flow of motor vehicles (potentially via a mix of import quotas and reduced foreign tariffs on American vehicles) and pruning agricultural trade barriers.

Originally, these auto tariffs were scheduled to arrive in the spring of 2019, but that deadline has since been extended until the fall. We expect auto tariffs to return as a prominent threat, but ultimately to be avoided or prove extremely short-lived as Europe and Japan make certain trade concessions under U.S. pressure.

U.S.-China trade

China is the main focus of the U.S. protectionist push, for several reasons.

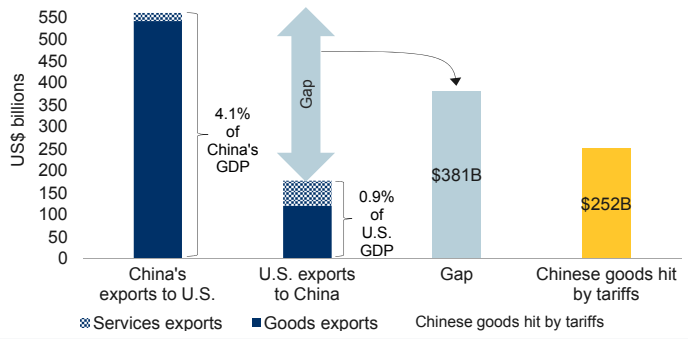
First, China's economy has become so massive that it represents a threat to U.S. economic hegemony. To the extent that a fair portion of China's prosperity has come from its status as the ultimate low-cost manufacturer of U.S. consumer goods, this represents an opportunity to slow the country's ascension.

Second, China exports far more to the U.S. than the U.S. exports to China (Exhibit 14). The resulting trade deficit is arguably the prime motivation for targeting China.

Third, China's economic model is radically different than nearly everyone else's – combining capitalism with powerful state controls – a combination that appears to accord the country significant competitive advantages. A large part of the U.S. push for a new trade deal with China is motivated by a more fundamental desire to balance the playing field with China, with tariffs simply a pressure tactic to achieve that aim.

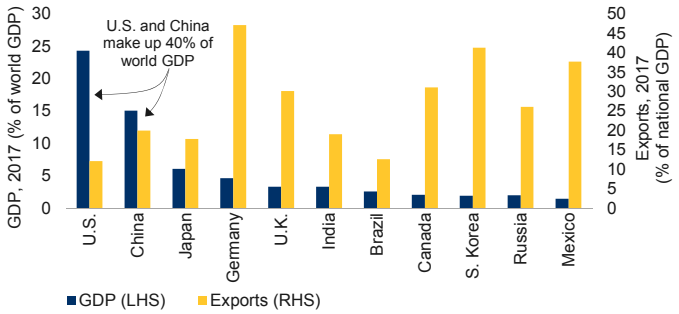
The U.S-China trade dispute matters to the world, as the two countries collectively generate a remarkable 40% of global economic output (Exhibit 15). Not only would any further slowdown significantly damage the profit of multinational corporations, but there would be spillover effects for the rest of the world. Canada is particularly exposed, given its exceedingly close economic relationship with the U.S. and

Exhibit 14. U.S. slaps tariffs on imports from China



Note: 2018 exports shown in chart. Tariffs on China include tariffs on washing machines, steel and aluminum products and 25% tariffs in effect on $250B of goods. Source: U.S. Census Bureau, Haver Analytics, RBC GAM

Exhibit 15. U.S.-China trade war is consequential



Source: Haver Analytics, RBC GAM

the outsized role that Chinese demand has in determining commodity prices.

Looking beyond tariffs

While tariffs represent the most obvious way in which countries are pursuing protectionism, they are far from the only tool available, or in use (Exhibit 16).

Non-tariff barriers to trade – policy measures that impede trade without explicitly imposing a tax on the flow of goods like a tariff does – include quite a range of strategies:

- The U.S. recently applied an import quota on motor vehicles from Mexico and Canada, limiting the number of cars that can flow across the border.[1]
- Most countries provide some measure of indirect subsidy to their corporate champions, but China is particularly aggressive on this front with its state-owned enterprises and capital controls.
- Countries can also manipulate the thickness of their border: the cost to cross it, how much time this takes, and how much paperwork is involved. Anecdotally, it has recently become more laborious to transport items between the U.S. and China, even setting aside the impact of tariffs.
- Technical barriers can create a subtle barrier to trade. As an example, Canadian products require different labelling than the U.S. to accommodate the country's two official languages. This is not an intentional trade barrier, but it does increase the cost to companies seeking to expand their operations into the other country.
- The U.S. has dragged its heels when asked to approve judicial appointments to the World Trade Organization (WTO). This has limited the speed at which that body can resolve international trade disputes.

[1] Note that the auto quota as proposed in USMCA is currently above actual vehicle shipments – it will only begin to bind in several years' time.

Exhibit 16. Trade war ammunition extends well beyond tariffs

Tariffs:

- Universal
- Geographic filter
- Product filter

Non-tariff barriers:

- Import quota
- Domestic subsidy
- Border thickness
- Technical barrier
- U.S. blocking WTO judge appointments

Investments:

- Restrict inward capital flows
- Restrict inward corporate acquisitions
- Sell foreign holdings (China: U.S. bonds)

Export restrictions:

- Access to Chinese "rare earths"
- Access to advanced U.S. tech

Other pressure points:

- Immigration restrictions
- Constrain individual firms (ZTE, Huawei, Qualcomm, Micron, Apple)
- Access to $ clearance system
- Gov't procurement contracts
- Exchange rate manipulation
- Universal Postal Union
- Inflame public sentiment (boycott, tourism)
- Military posturing

Source: RBC GAM

These non-tariff barriers have become more widely deployed in recent years, nowhere more enthusiastically than in the U.S. (Exhibit 17).

Furthermore, the tools of economic warfare extend beyond trade-specific measures. After all, globalization is not just about the flow of goods and services, but also about the flow of people and money. Regarding the former, the U.S. has tightened its visa requirements for Chinese students. Regarding the latter, China has long restricted the flow of investments into and out of its economy and the U.S. is now starting to respond in kind, rejecting Chinese attempts to acquire U.S. firms.

The possible sale of China's large holdings of U.S. Treasury bonds is viewed by some as a genuine threat to the U.S. economy, though it seems unlikely to happen on a large scale as China's bilateral trade surplus means that it must continue accumulating dollars in one fashion or another; the bonds would be difficult to dispose of in large quantities; any sale would have a smaller than imagined effect on U.S. borrowing costs; and the act would hurt Chinese competiveness via a stronger renminbi.

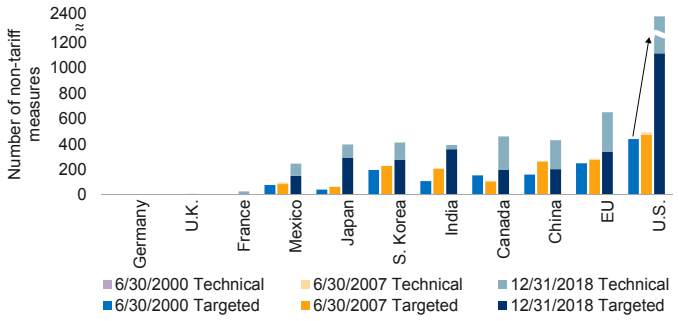
The U.S. is now restricting certain of its technological exports to China on the grounds of national security, and China has for its part threatened to restrict its sale of rare earths – key compounds necessary for modern-day electronics – of which it produces the majority of the world's supply (Textbox B).

The list of non-tariff threats goes on and on. Other pressure points include inflaming public sentiment, military posturing, and, used to the greatest effect so far, hobbling foreign corporations. Both the U.S and China have been active on this last front. The U.S. first hit Chinese telecommunications company ZTE in 2018, and more recently tech giant Huawei in 2019 (Textbox C). For its part, China has blocked an attempted Qualcomm merger, levelled anti-trust allegations against Micron, and limited the sale of certain Apple iPhones within China. Google has long been restricted in the country.

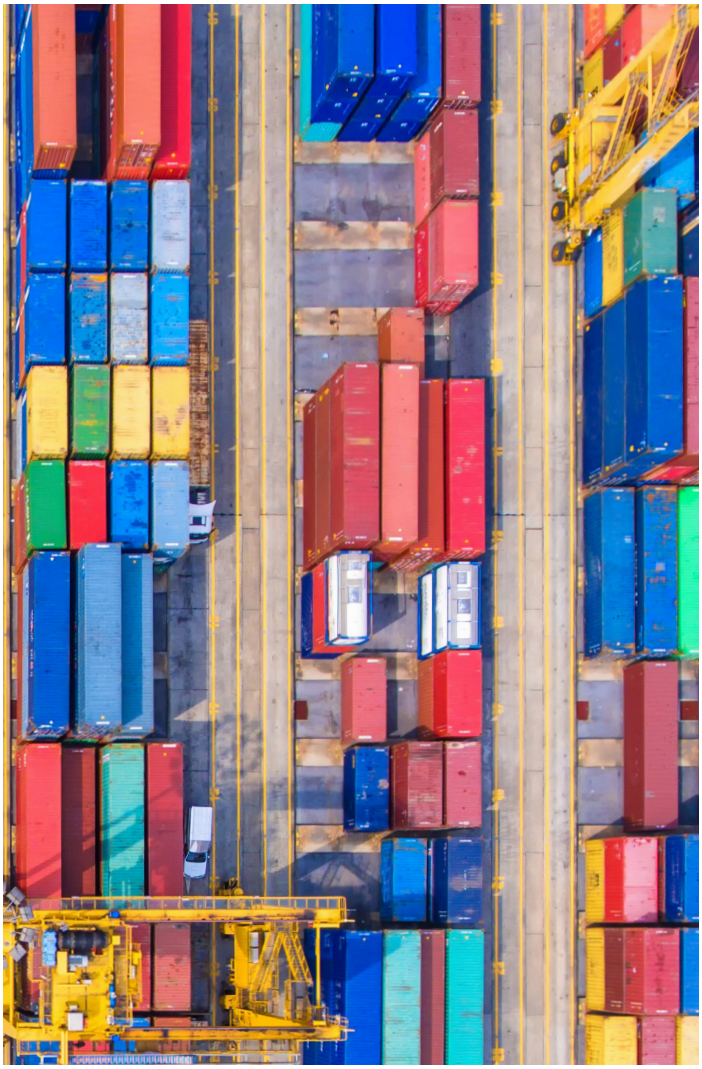
China is also cobbling together a so-called unreliable entities list: a blacklist of foreign companies that cannot be counted upon to provide their wares to China. Presumably, this will include the many U.S. companies currently being instructed not to sell their technologies to Huawei.

The U.S. recently insisted that Chinese packages pay full freight rather than be subsidized as per Universal Postal Union convention.

Exhibit 17. Non-tariff trade barriers growing everywhere



Note: Targeted barriers include anti-dumping, countervailing, safeguards and special safeguards, tariff-rate quotas, export subsidies, quantitative restrictions and state trading enterprises. Source: World Trade Organization, RBC GAM



Textbox B: The rare earth threat

China's domination of the rare earths industry has attracted considerable attention given its potential as a pinch point that the country could leverage. Furthering such speculation, China recently made explicit reference to possibly withholding its vast supply of the materials.

The country currently produces 70% of the global supply of 17 exotic elements that are used in the creation of many magnets, alloys and electronics. Disk drives, microphones, speakers and screens all rely upon rare earths in one capacity or another. Gasoline refining also traditionally uses a rare earth catalyst.

Consequently, any curtailment of Chinese rare earths could create a pinch point in the U.S. and global hardware sectors, hurting the economy. The U.S. is even more reliant on China's supply than the global average, with 80% originating from China.

However, we do not see the threat of a Chinese rare earths embargo as overly dangerous:

- First, the industry is fairly small. The U.S. only imports $160 million worth per year, a pittance in the context of a $20 trillion economy. This means that even if supply shortages increased the prices significantly, the economic hit would still be minimal.
- Second, China only leads the world in rare earths production because of its lax pollution controls and thus lower costs. In actual fact, the elements are plentiful around the world. One – cerium – is more common than copper. Granted, rare earths are more dispersed than base metals, such that it can be hard to find the substance in sufficient concentration to be economic. But the point is that every country has some, unlike with a commodity like oil.
- Third, China's last attempt to pinch the market in 2010 backfired badly. Prior to its efforts to block Japan from buying its rare earths, it had been producing nearly 100% of the global supply. Afterwards, motivated by higher prices and chastened by the unreliability of China's production, other countries re-opened previously mothballed mines and China's production share fell to the aforementioned 70%. As a result, China may be reluctant to actually cut off the world again.
- Fourth, other countries are already being incented to increase their production. Companies that produce rare earths have seen their stock valuations rise by nearly 50% since trade relations deteriorated in early May. Australia has a significant mine and projects are being pursued in the U.S. and Canada.
- Fifth, companies can, to an extent, find their way around a rare earth blockade. In 2010, gasoline refiners were able to continue refining by substituting other catalysts for rare earths. Screen-makers were similarly able to pivot.

In summary, any Chinese decision to halt the export of rare earths might be consequential, but not an economy-killer. Furthermore, the risk to China's market position in the sector is significant, so it will be loath to pursue the tactic.

Textbox C: Corporate actions

Huawei finds itself at the very centre of firm-level protectionist developments. Not only has its CFO been charged by U.S. courts and its 5G products blocked in the U.S. and several other developed nations, but American companies must now obtain government permission to sell key technologies to the company on the basis of national security concerns. This means Huawei can suddenly no longer source many American technologies already embedded in the company's products.

Furthermore, the company has been blocked from future participation in two standards organizations that negotiate universal protocols for such technologies as Wi-Fi and SD memory cards.

So far, Huawei has not been blacklisted on the dollar-clearance system – a step that nearly bankrupted Chinese peer ZTE in 2018 before the U.S. hastily reversed its heavy-handed edict. But the potential for more aggressive action certainly exists.

Huawei has likely been targeted for a mix of reasons:

- The country is leading the 5G charge, with no U.S. competitor in sight. As such, part of the U.S. effort may be simply to limit the extent of China's technological lead.
- Huawei is alleged to have acquired a significant fraction of its foundational intellectual property in questionable ways, often at the expense of leading developed-world firms.
- The U.S. accuses Huawei of violating U.S. sanctions on Iran.
- The U.S. worries that Huawei's proximity to the Chinese state could result in espionage should Western countries place the company's 5G products at the heart of their telecommunications networks.

Huawei's restrictions could well be resolved by any trade pact between the two countries. Setting a precedent, ZTE's limitations were eventually lightened as a favour to the Chinese president – an entirely political decision rather than a legal one. The intensity of Huawei's restrictions were also recently lightened slightly after a meeting between Trump and Xi at the June G20 meeting.

U.S. corporate-level targeting risks backfiring if implemented for too long, as the longer China loses access to U.S. technologies, the more likely it is to replicate such technologies itself. Similarly, any loss of access to the U.S. dollar clearance system would serve to accelerate the creation of a competing Chinese clearance system, undermining America's ability to exert the same clout in the future.

How tariffs do economic damage

Tariffs are usually bad for economic growth. This is the net result of the complicated interplay of various competing economic channels (Exhibit 18).

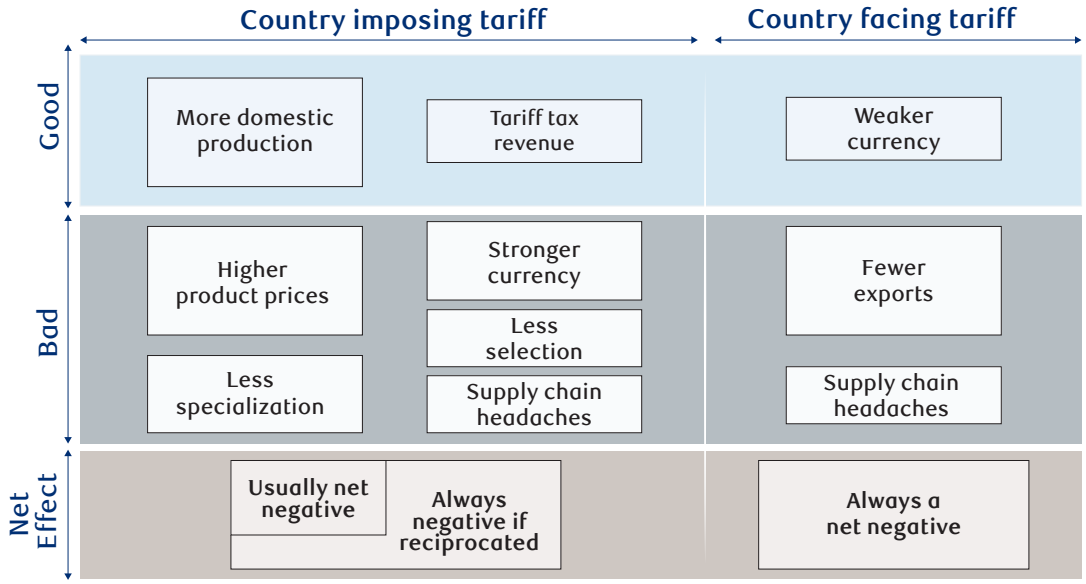
There are admittedly some superficially positive things that happen when a country puts tariffs on foreign imports. A tariff is essentially a tax applied to foreigners, and so at least initially a tariff increases government revenue without impoverishing domestic households or companies. Furthermore, domestic companies capture a larger share of production with foreigners squeezed out, and for the same reason can also charge a higher price on the products they sell.

However, this glimmer of good is easily outweighed by the bad. The main negative of protectionism is that products become more expensive to buy, in part because foreign products become by necessity more expensive due to the cost of the tariff they pay, and in part because domestic producers can get away with a higher price (because of less competition / because ramping up production is not costless). More expensive products increase the rate of inflation, making consumers poorer.

There are also four other economic detriments associated with protectionism:

- **Less selection:** With fewer products coming from abroad, the selection available to domestic consumers usually diminishes. And with less competition, domestic companies are themselves less inclined to innovate.
- **Less specialization:** Because domestic companies endeavor to fill the product void left by foreign companies shut out of the market, domestic firms are less able to specialize in what they are truly good at, hurting productivity.
- **Stronger currency:** Traditionally, the country imposing tariffs on its trading partners ends up with a stronger currency, hurting domestic growth. The currency movement occurs because exchange rates act as shock absorbers, and so when one country suddenly develops a competitive advantage over another, the exchange rate can be counted upon to reallocate relative competitiveness between the two nations until the first nation's initial advantage has been substantially diminished.
- **Supply chains:** Finally, in the modern era, international supply chains have become so far-reaching that it is genuinely difficult to argue that domestic companies stand to even superficially benefit from tariffs. The auto sector is a classic example: in the U.S. context, American companies produce a great deal of their wares abroad, foreign firms produce a sizeable fraction of their motor vehicles domestically, and all transfer inputs back and forth across the border many times before the final product rolls into the showroom. Tariffs badly gum up such supply chains, hurting everyone.

Exhibit 18. Theoretical tariff considerations



Source: RBC GAM

Even the aforementioned tariff positives don't always last. In particular, governments usually start to bleed revenue as their economies begin to stumble, reducing the initial tariff windfall. Similarly, many domestic firms are hurt more than they are helped as the cost of their own foreign-sourced inputs goes up and the wealth of their customers goes down.

Furthermore, when a country applies tariffs on a foreign nation, the other country usually reciprocates in kind. This tit-for-tat then hurts the original country in the form of additional taxes paid to a foreign government, diminished foreign demand and yet more supply-chain headaches. As a result, tariffs are virtually always an economic negative once both countries have landed blows.

Observing initial effects

Tariffs are theoretically bad news, but can we actually see any damage being done? The answer is "yes." One such piece of evidence is that the rate of global trade growth is slowing, both in nominal and inflation-adjusted terms (Exhibit 19). Tariffs are like sand in the gears of trade.

Evidence of protectionism's damage is just as clear elsewhere. For instance, the cost of items subjected to tariffs has gone up by far more than has the cost of other goods (Exhibit 20). Illustrating this, the cost of washers and dryers in the U.S. has increased by 9.2% since end of 2017, compared to a 0.2% drop in the price of overall consumer goods. The costs of steel and aluminum have also risen much faster than normal.

Higher prices are the main way that tariffs damage an economy. And that primary channel is very much in operation.

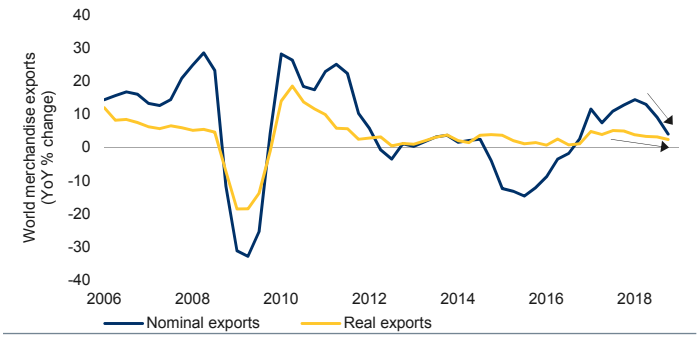
We can also observe damage being done to the most trade-oriented sector – manufacturing – as evidenced by the fact that the U.S. manufacturing leading indicator has fallen more aggressively than have other sectors (Exhibit 21).

Estimating economic damage

Any effort to quantify the economic damage delivered by protectionism first requires a solid understanding of the current tariff landscape and a view on how it is likely to evolve.

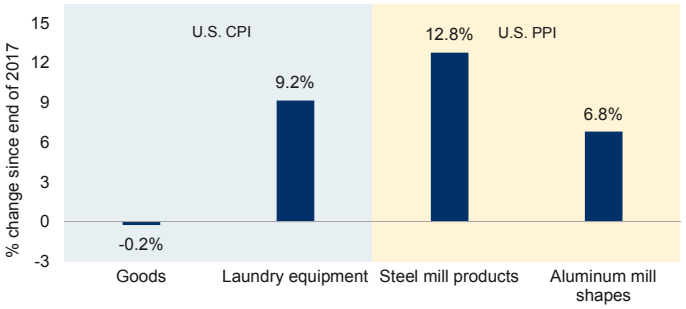
The U.S. has already imposed several rounds of tariffs on China, including tariffs on $50 billion of imports in August 2018 and on another $200 billion at a 10% rate in September 2018. China has mostly responded proportionately to

Exhibit 19. Global trade has slowed significantly



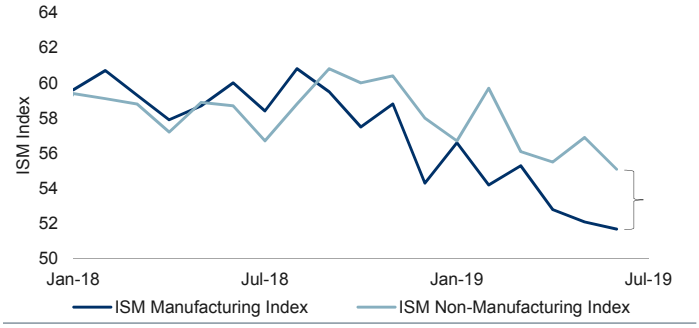
Note: As of Q4 2018. Nominal exports in U.S. dollars. Source: WTO, RBC GAM

Exhibit 20. Trump tariffs feed into inflation



Note: As of May 2019. Source: Bureau of Labor Statistics, Haver Analytics, RBC GAM

Exhibit 21. U.S. manufacturing and non-manufacturing diverge recently



Note: As of Jun 2019. Source: ISM, Haver Analytics, RBC GAM

these actions, hitting U.S. exporters with tariffs of a similar magnitude, though strategically targeted at different sectors to inflict maximum political damage.

The U.S. originally imposed a deadline of December 31, 2018 for China to comply with its demands, after which the tariff rate on the $200B of imports would increase from 10% to 25%. However, this deadline was subsequently delayed to allow further negotiations.

The U.S. motivation for all of this tariff pressure is only secondarily to discourage Chinese imports. Its main purpose is to apply pressure on China in an effort to guide it toward a more symmetrical economic structure with the rest of the world, one that reduces the extent of China's capital controls, halts the country's pattern of forced technological transfers from western companies to their Chinese partners, and limits the special governmental help enjoyed by China's many state-owned enterprises.

In the spring of 2019, these negotiations were beginning to look quite promising, culminating in what was said to be a 150-page deal filled with Chinese pledges to refashion its system of state-owned enterprises, intellectual property practices, joint-venture requirements and capital controls.

Accordingly, we briefly upgraded our odds of success and began highlighting the prospect of a "slightly negative" tariff scenario rather than our prior base case of a "negative" scenario.

However, when negotiators put the document in front of Chinese President Xi, he reportedly chopped 45 pages from the proposed pact, including the great bulk of the commitments to enshrine the proposed changes into Chinese law. Without these, the proposed trade accord was not only substantially reduced but lacking teeth.

China's reluctance to sign onto a new deal is understandable in that the document was primarily one of Chinese concessions, with few American ones. Why would China sign onto something like this?

Of course, the opposite perspective is that China's current trade model affords it significant advantages over the rest of the world, and the rest of the world is simply asking that China operate in a more symmetrical fashion. That requires changes from China.

The two countries are at loggerheads again. We have always been of the opinion that any deal if achieved would be fairly superficial and fail to fully address underlying frictions between the world's two economic superpowers. But even that half-victory now seems elusive.

The U.S. has now followed up on its long-delayed threat, raising its tariff rate on the $200 billion of Chinese products

Exhibit 22. U.S. trade scenarios: negative is most likely

Scenario	Likelihood	Detail	Economic effect
Worst case	15%	Trade war	US: -2.1% CN: -2.5% CA: -2.0%
Negative	40%	Substantial tariffs	US: -0.3 to -0.6% CN: -0.4 to -0.8% CA: -0.2 to -0.4%
Slightly negative	25%	Small tariffs	US: -0.1 to -0.2% CN: -0.2 to -0.5% CA: -0.1%
Neutral	10%	Trump tariffs unwind	US: 0.0% CN: 0.0% CA: 0.0%
Best case	10%	Foreign barriers fall to pressure	US: positive CN: ? CA: ?

Source: RBC GAM, Oxford, Bloomberg, OECD, Nomura, Goldman Sachs, UBS, Barclays, Fajgelbaum et al

from 10% to 25%. It has also threatened a further set of tariffs on another $325 billion of imports from China (at a rate between 10% and 25%), potentially doubling the net impact again. China has retaliated, with new tariffs of its own on another $60 billion of imports from the U.S. (also at a rate between 10% and 25%).

Markets are naturally displeased with all of this, and have only been soothed by a concerted shift toward more dovish monetary policy.

While many scenarios exist, ranging from a knock-em-down drag-em-out global trade war at a 15% chance (the only scenario in which a recession could realistically occur solely due to protectionism) to a world in which Trump succeeds in forcing other countries to reduce their own barriers, resulting in fewer trade barriers than before, the most likely outcome is somewhere in the middle.

We have reverted back to the opinion that the "negative" scenario is most likely (Exhibit 22). This assumes that existing tariffs remain in place, with the risks tilting toward a slight further intensification.

While June 2019 G20 negotiations unlocked some mild concessions on both sides of the table – China has promised (yet again) to purchase more U.S. agricultural products and the U.S. has slightly eased its restrictions on Huawei – this is not so much a truce as a return to the negotiating table. The two countries are still quite far apart on important issues, and existing trade barriers are mostly still in effect.

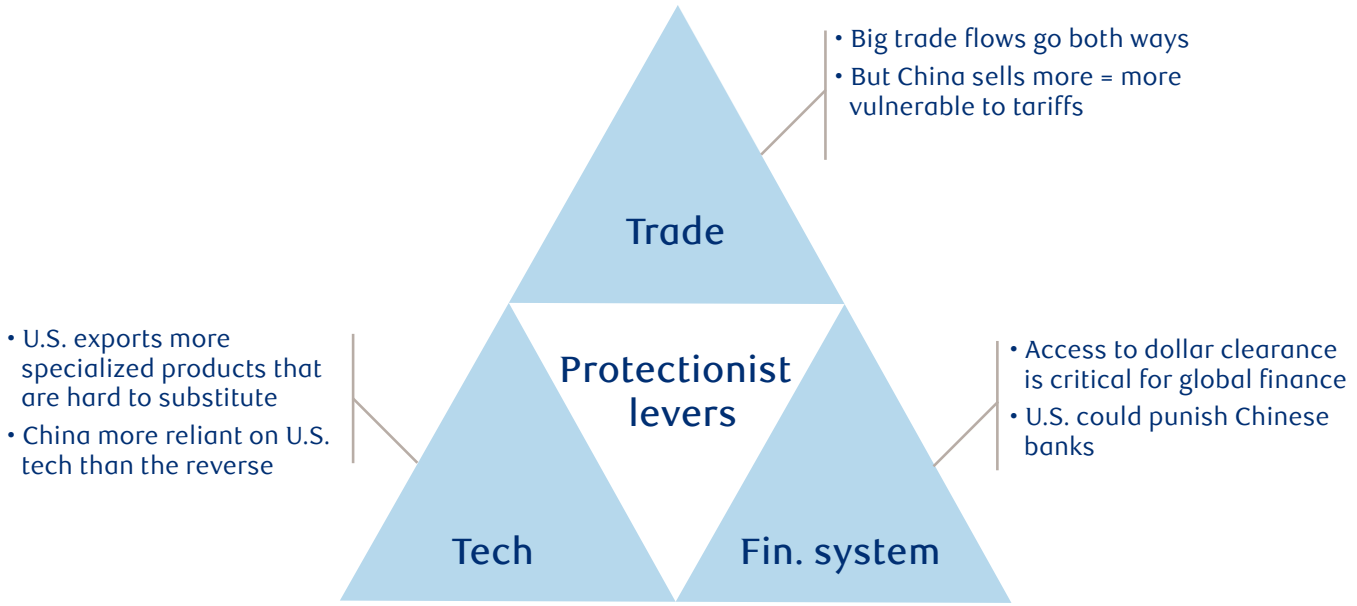
It is not impossible that the two countries will pragmatically gloss over their differences and find their way to a superficial détente given the desire to revive Chinese growth and for the U.S. economy to make a good showing in the lead up to the U.S. 2020 elections. But more likely is that existing tariffs persist.

We combine the output of our own large-scale econometric model with other published estimates to approximate the economic damage that arises under our base-case negative scenario (and other possibilities).

The negative scenario implies economic damage of around 0.3% to 0.6% of GDP to the U.S., and 0.4% to 0.8% to China. By way of comparison, this is around twice the damage relative to if the tariff rate hadn't gone up in the spring of 2019. Conversely, it is about half the damage relative to if the U.S. delivers on its threat of tariffs on another $325B worth of Chinese imports. We assume no lasting auto tariffs.

The damage to China's economy is somewhat greater than to the U.S., despite the presumption of roughly proportionate tariffs, because China sells more to the U.S. than the U.S. sells to China, because the restriction of technological

Exhibit 23. U.S. versus China: China more vulnerable



Source: RBC GAM

exports would hurt China more than the U.S., and because the U.S. continues to wield much more control over the global financial system than does China (Exhibit 23).

Perspective on the economic damage

In our base-case scenario, the GDP impact estimates are not enough by themselves to drive the U.S. or China into recession, and it should be further noted that the aforementioned damage is spread over a multi-year period rather than all accruing right away. Recessions rarely happen from protectionism alone. They usually require a confluence of factors. That could yet occur given simultaneous worries about the business cycle and geopolitical tensions with Iran, but it is not pre-ordained.

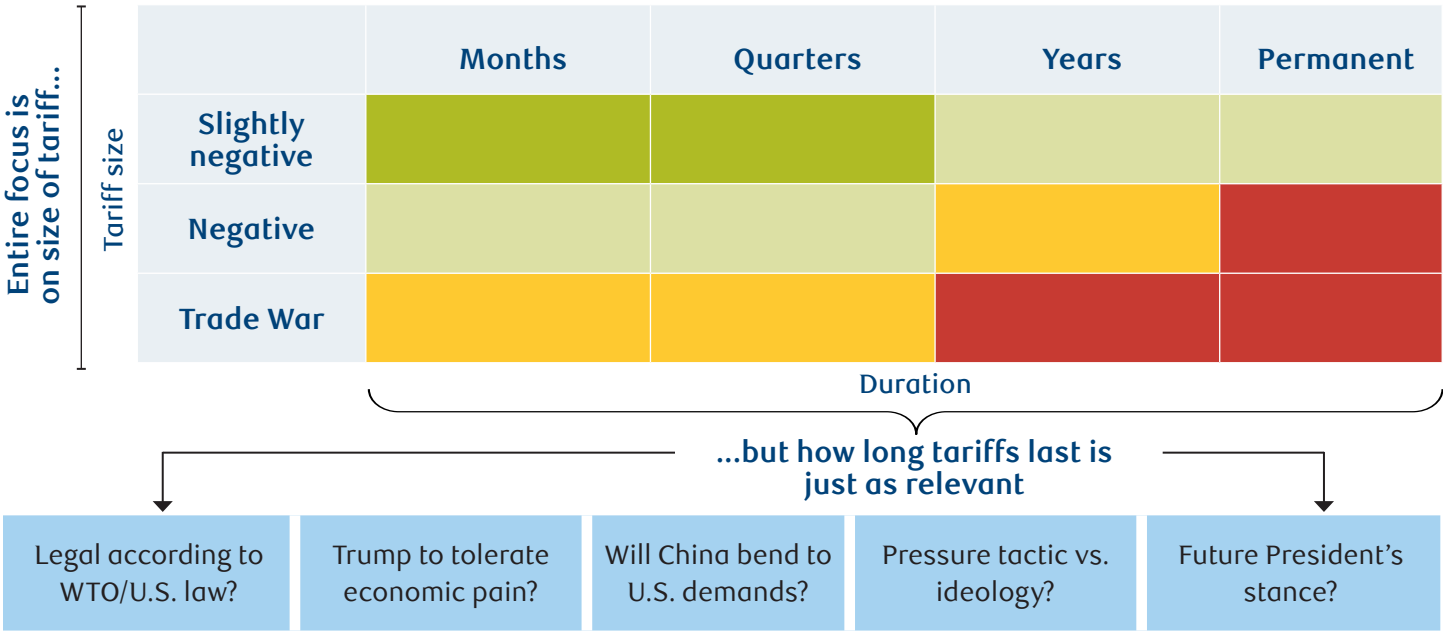
If the economic damage estimates from tariffs seem surprisingly small, it is useful to recognize several supporting considerations:

- First, it is the very nature of businesses to profit maximize. They will only continue to import a product subjected to a pricey tariff if they cannot find a cheaper substitute at home, find an alternate foreign supplier, or find a way to function without the product altogether. Not infrequently, one of those options proves feasible.
- Second, if U.S. businesses can prove that no alternative domestic supplier exists, they can in many cases qualify for a tariff waiver. A remarkable 80,000 such requests have been submitted with regard to steel and aluminum tariffs alone (processing them expeditiously has proven a problem, however).
- Third, governments frequently assist affected industries. The U.S. has directed billions of dollars to help its agricultural sector survive Chinese tariffs, as an example. This reduces some of the economic damage, in exchange for a higher public debt.

That said, the estimated tariff damage – while strictly correct and indeed fairly small – may undersell the broader impact of protectionism:

- First, even the econometric models acknowledge that the damage to households and businesses is worse than the damage to the overall economy. This is because the government sector frequently comes out ahead thanks to extra tax revenue. For investors, it is the corporate impact that matters most.
- Second, some domestic companies and workers benefit when foreign competitors are blocked from the market. But, by definition, that means that other companies and

Exhibit 24. A second dimension to protectionist math: duration
Heat map of cumulative tariff pain



Source: RBC GAM

workers with an international orientation, not to mention consumers, are hurt by more than the average figure.

- Third, and most importantly, the models completely miss the fact that governments are also engaging in protectionism via the non-tariff means discussed earlier. This damage goes unquantified in most models, but is very real. It remains something of a dark art to try and map these corporate impingements and other non-tariff actions onto economic damage.
- Fourth, the stock market tends to respond to economic shocks by a multiple of the hit to the economy itself. As such, a multi-percentage point reaction from the stock market is perfectly normal in response to a protectionist shock that only knocks half a percentage point off economic growth.

Duration of damage

Discussions about tariffs tend to venture in great detail into the specific tariffs at play, but neglect an equally important dimension: how long will the tariffs remain in place? A huge tariff won't do much damage if it only lasts a month or two. Conversely, a much smaller tariff can prove punishing if permanent (Exhibit 24).

For our part, we don't expect the bulk of the tariffs to prove permanent. The U.S. views most as a pressure tactic to achieve other trade goals – securing the updated NAFTA accord, negotiating new trade deals with Europe and Japan, and refashioning its relationship with China. Most countries are bending to U.S. demands, however reluctantly.

All the same, existing tariffs have already lasted for more than just a few months.

This argues we should budget for tariffs and trade barriers lasting for several quarters to several years, but not necessarily longer (or shorter) than that.

That said, the "x-factor" is China, which is an economic superpower in its own right and is being asked to change the very foundation of its economic model. It is less certain to bend than other nations, leaving the possibility of some tariffs proving quite long-lasting.

Long-term frictions

We budget for sustained friction between the U.S. and China for many years, if not decades, to come. This does not necessarily mean that existing tariffs will prove permanent, but simply that across various axes – economic, values, political, military – the two countries will often find themselves in conflict.

A key reason for this is that each country has complaints about the other (Exhibit 25). U.S. criticisms of China include:

- The benefits accorded to Chinese state-owned enterprises, such as lower borrowing costs and explicit government support.

Exhibit 25. Hard to resolve underlying U.S.-China frictions

Sources of friction			
U.S. complaints about China		China complaints about U.S.	
Trade surplus	Capital controls	Tariffs	Control of global order *(WB/WTO/UN/ IMF/G7, etc.)*
State-owned enterprises	FX manipulation	Pacific clout	
Joint venture requirements	Challenging global order *(One Belt One Road/ AIIB/ South China Sea)*		
IP theft			

Source: RBC GAM

- Joint-venture requirements that oblige American firms to partner with Chinese firms for access to the Chinese market (in the process, yielding intellectual property to the partner).
- Intellectual property theft from U.S. firms via cyber-espionage and embedded employees.
- Capital controls that limit the flow of money into and out of China.
- Currency manipulation that has often allowed the Chinese renminbi to be strategically weaker than fair value (though not obviously at present).
- China's challenge to the global order via its more assertive military, territorial disputes in the South China Sea and the East China Sea, its deep engagement with Africa, the One Belt-One Road plan, and energy deals with Russia.

China, for its part, complains about U.S. tariffs, the U.S. influence in the Pacific (military and otherwise) and American control of the global order (U.S. privileges include appointing the World Bank head, enjoying a large vote at the IMF, hosting the United Nations in New York City, and its membership in the G7).

None of these disagreements are easy to resolve. U.S. complaints about China, in particular, relate to the very structure of the Chinese economic model. Meanwhile, just over a year ago, the Chinese president was advocating a greater emphasis on state-owned enterprises. As such, it seems unlikely China will be willing to substantially comply.

While the conflict is particularly intense at the moment due to the aggressive tactics of President Trump, attitudes have shifted on both sides of the American partisan divide (and indeed, around the world) such that one cannot presume these issues will disappear after Trump's time in the Oval Office comes to an end. Simultaneously, changes in rules governing leadership succession in China mean that President Xi could well lead the country for decades to come, reducing the probability of a significant about-face from that quarter.

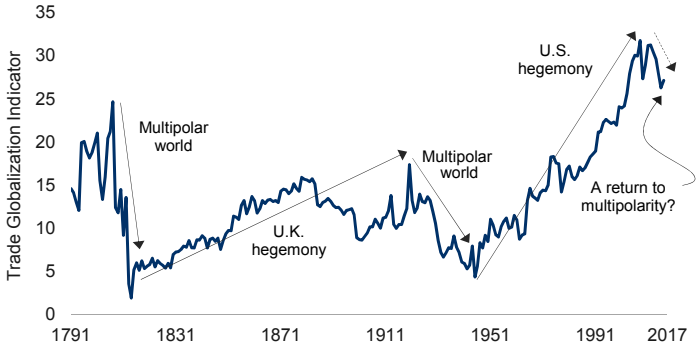
Return to a multipolar world

Turning in a more theoretical direction, hegemonic eras – periods when one country is the undisputed economic leader – have traditionally supported globalization (Exhibit 26). Global institutions facilitating trade and commerce tend to strengthen in such periods, and trade barriers accordingly fall.

For the past several decades, the U.S. (and to an extent, the world) enjoyed the fruits of its economic hegemony. However, with China's ascent, the world is now returning to a more multipolar era. As the U.S. and China grapple for influence, history shows that these eras are associated with less globalization. Traditionally, each powerhouse develops its own sphere of satellite nations, with the by-product of reduced interaction between the two sets of countries. This hints of diminished economic growth. Already, there is evidence of some amount of supply chain realignment (Textbox D). In this context, the recent implementation of tariffs between the U.S. and China can be thought of as representing the opening shots of a new era.

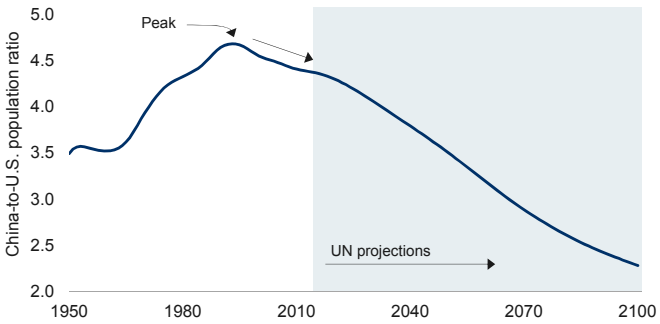
Finally, as China closes in on the U.S. for the title of world's largest economy, perhaps the ultimate question is whether China will eventually outrun the U.S. altogether, eventually achieving economic hegemony of its own. Much depends

Exhibit 26. Multipolar eras are bad for global trade



Note: As of 2017. Measured as average of imports as % of GDP weighted by population. 148 countries used for 1791 to 1995, 126 countries after 1995.
Source: Chase-Dunn, C., Kawano, Y., Brewer, B., "Trade Globalization Since 1975: Waves of Integration in the World System," American Sociological Review, 2000, Haver Analytics, RBC GAM

Exhibit 27. China's population advantage already shrinking



Note: Data based on World Population Prospects: The 2017 revision.
Source: United Nations, Macrobond, RBC GAM

on how quickly Chinese productivity growth can continue to converge upon U.S. levels. But from a purely demographic perspective, the answer is "probably not": the Chinese outlook is actually rather challenging (Exhibit 27).

With a fertility rate of just 1.1 children per woman and net outward migration, the UN projects that China's population will fall from 1.4 billion today to just 1.0 billion by the end of the century. Conversely, by virtue of a higher fertility rate and positive immigration, the U.S. population should rise from around 330 million to 450 million. The net result still leaves China well ahead from a population perspective, but with a substantially reduced advantage relative to today. This argues that the multipolar era will likely persist for a long time, and that – if anything – the U.S. could enjoy something of a second wind as the coming century unfolds.

Textbox D: Supply chain realignment

To what extent will multinationals move their production out of China now that trade with the U.S. has been impeded by tariffs and frictions seem likely to persist into the future?

Before the trade dispute began, companies were mostly content with their Chinese production, with 88% planning to continue sourcing from China – substantially in excess of any other country.

However, companies are more than capable of changing their sourcing in fairly short order. The average supplier turnover is 27% per year, meaning that more than a quarter of production jumps from one factory to another in the average year. The figure is even higher among large companies. Of course, it is presumably much easier to shift the manufacturing of commoditized items like textiles than auto assembly or highly specialized electronics.

Now that a tangle of tariffs has been erected, companies are thinking seriously about shifting their sourcing. A significant 35% of producers indicate they will adapt should foreign markets prove difficult to access from China, pivoting their Chinese factories to focus more on producing for the country's enormous domestic market. However, 40% say they are considering or have already relocated production outside of China, with South-East Asia and Mexico as popular alternatives.

Of course, let us not expect a wholesale exodus from China: Most other nations are too small to seriously supplant China; China still possesses an attractive domestic market; and China long ago lost its pure cost competitiveness, instead enjoying advantages related to multinationals' pre-existing factories in the area, familiarity with the country's rules, good infrastructure and decent governance.

What about moving production (back) to the U.S.? After all, the U.S. labour cost disadvantage has significantly shrunk versus China, and the U.S. enjoys low energy costs, low tax rates and has recently engaged in a deregulation push. There are slivers of this happening, including a new Foxconn headquarters and plant in the U.S. The advance of automation further increases the allure of factories close to the markets they serve. However, in the same survey that found 35% of producers planning to diversify outside of China, a mere 6% indicated they have moved or are considering moving their factories to the U.S.

Disclosure

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