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Will Trump's Trade War Precipitate a Currency War?

3rd in a series on Trump Trade policy

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Last week, mid-July, Trump threatened $500 billion in tariffs on China imports, escalating his prior threat to impose $200 billion on China. He then threatened hundreds of billion in tariffs on world auto parts imports, targeting Europe. But Trump's threats and announcements do not constitute a trade war. Threats and even announcements of tariffs are one thing; the actual implementation of tariffs another. But even the current scope of tariff implementations do not yet represent a trade war. Bona fide trade wars occur when tariff fights spill over to currency devaluations and generate currency wars.

To date, only $34 billion in tariffs on China industrial imports to the US has been actually implemented, plus another $2-$3 billion in intermediate steel and aluminum products. In response, China has so far imposed an equivalent $36 billion in tariffs on imported US agricultural goods, targeting US soybeans, port, cotton and other grains produced in Trump's political base of the US Midwest agricultural belt.

Elsewhere around the globe, earlier in July Trump threatened to escalate a trade conflict with the European Union, threatening to impose $200 billion on Europe and global auto part imports to the US. But to date there's only been US tariffs implemented on Europe steel and aluminum imports. And the response from Europe has been a mere $3 billion in counter tariffs on US imports. Ditto for trade with Mexico-Canada. US steel-aluminum tariffs on imports from Mexico-Canada have elicited a token response of $15.8 billion in Mexican and Canadian tariffs on US imports.

Total actually implemented US import tariffs to date—mostly levied against China—amount to only $72 billion, or 2.3% of a total of $3.06 trillion imports into the US annually. US trading partners have responded measuredly in kind, with their own 2.3% in tariffs on US exports on the total $2.58 trillion US exports worldwide. Tariffs of 2.3% hardly represent a tariff war, let alone a trade war. Bona fide trade wars are never limited to tariffs. Trade wars involve not only tariffs but also non-tariff barriers to trade. Even more important, bona fide trade wars occur when tariff spats escalate and precipitate currency devaluations.

Should Trump follow through with threats of $200-$500 billion more tariffs on China imports, the US and China will likely slip into a currency war as China allows its currency, the Yuan, to devalue further. And that devaluation will almost certainly quickly go global— given the current significant decline in currency exchange rates already taking place throughout various throughout key emerging market economies (Argentina, Turkey, India, etc.). Other emerging market economies will have no choice but to follow China's devaluation lead. Nor will advanced economies like Japan and Europe be immune from having to devalue, as they to offset Trump tariffs in order to maintain their share of global trade that Trump policies are clearly attacking.

Trump's Dual Track Trade War

Trump apparently believes he can control the response of US trading partners to his threats and intimidations, and that he can conclude token trade deals, if necessary, to avoid falling over the trade cliff of currency devaluations. While he might be able to backtrack and quickly close trade deals with NAFTA partners and Europe—just as he settled a quick, token deal with South Korea early this year—the settling of a quick trade deal with China may not prove so easy. And the longer the tariff conflict with China continues, and escalates, as appears likely, the greater the likelihood or the current US-China tariff spat descending into a currency war.

A Trump two track trade policy has been underway since early 2018. One track is with US trading allies. Here Trump will prove flexible and eventually settle for minor adjustments in trade terms, just as he did with the South Korea trade pact earlier this year. Trump will then exaggerate and misrepresent the dimensions of the deals with allies, selling it all as great achievements benefitting his domestic US political base and confirming his US 'economic nationalism' policy that proved so politically valuable to him in the 2016 elections. Much of the trade war with allies is really about US domestic politics and the upcoming US November midterm elections.

US-Mexico Deal Imminent

Unlike China, where trade negotiations are currently frozen and no discussions are underway, both Europe and Mexico in recent weeks have been signaling they are amenable to a quick deal with Trump if he will settle for relatively minor concessions. Mexico president elect, Lopez Obrador, sent his trade negotiator to Washington DC this past week to explore concessions with Trump. A deal was negotiated last spring by US and Mexican trade representatives but was subsequently scuttled by Trump. Trump introduced a new demand in US-Mexico negotiations that any trade deal would have to 'sunset' and be renegotiated every five years. Trump did not want a deal too early. Trump wants a deal closer to the US November elections so that he can tout it to his domestic political base as proof his 'economic nationalism' policy works. The current differences between the US and Mexican positions in negotiations currently are otherwise not significant; should Trump drop his sunset demand, which he will do when the timing for his domestic politics is appropriate—that is, just before or soon after the US midterm elections—a deal with Mexico (and thereafter similarly with Canada) will be concluded quickly. And according to US Commerce Secretary, Wilbur Ross, just last week, an agreement between the US and Mexico will soon be announced.

Hiatus in Trump 'War of Words' with Europe

The same Trump flexible approach was evident in the just announced 'deal' with European Commission president, Jean-Claude Juncker, who also came to Washington this past week. Juncker's goal was to get Trump to back off his threats to impose tariffs on Europe auto part imports. Not actual tariffs, in other words, but to get Trump to retract his threat to perhaps introduce them. Trump and Juncker then announced a 'deal'. The so-called deal is merely verbal and indicate objectives the parties, US and Europe, hope to maybe achieve, at some point undefined in the future. It was not actually a trade agreement. Just a mutual statement they would negotiate toward a deal. Trump backtracked from his threat to impose tariffs on autos. In exchange, Juncker offered to buy more US soybeans and US natural gas at some point in the future. In terms of actual tariffs, or any other 'trade' measure, the Trump-Juncker announcement was mostly a public relations stunt for both parties designed to placate their domestic critics.

The US trade war with Europe is just a war of words, as it has been thus far with NAFTA. What exists in fact is just a couple billion dollars of actual tariffs on steel and aluminum imposed by the US on Europe and a similar amount of token tariffs implemented by Europe on select US imports to Europe. The so-called trade war with NAFTA and Europe is still phony. Not so the case, however, with China. And while negotiations continue with NAFTA and Europe, no further discussions are underway with China and will likely not occur soon.

What the US Wants from China—And Won't Get

Unlike NAFTA and Europe, a quick settlement with China is not in the works. The US wants concessions from China that it is not demanding from NAFTA, Europe and other allies. The US wants concessions in three areas from China: more access to China markets by US banks and multinational corporations, including 51% and then 100% US corporate ownership of their operations there. Second, the US wants China to purchase at least $100 billion more in US goods, mostly from Midwest US agribusiness and manufacturing. Third, it is demanding stringent limits and reductions in China's current policy requiring US nextgen technology transfer from US businesses operating in China. What has the US defense and intelligence establishment especially worried is China plans to leapfrog the US in nextgen technologies like 5G wireless, Artificial Intelligence, and Cybersecurity. These represent not only the source of industries of the future, but threaten a quantum leap in China military capabilities. The US refers to the nextgen technologies as 'intellectual property' since they are fundamentally software based. But what the US really means is nextgen military-capable software intellectual property.

When negotiations opened with China this past spring, China cleverly offered major concessions to the US. It announced it would grant 51% ownership rights for US multinational corporations doing business in China, and signaled it could agree to 100% as well. That delighted US bankers and multinational corporations. Their representative on the US trade negotiating team, US Treasury Secretary, Steve Mnuchin, publicly declared a deal with China was therefore imminent. China also signaled it could purchase $100 billion more a year in US agricultural products. But it would not budge on the tech transfer issue. A deal was close but was then upended by US defense-intelligence-war industries US negotiating faction. Through their friends in Congress, they aborted any prospective trade deal with China. Trump then followed up by threatening to impose an additional $200 billion of tariffs on China in response to China matching US tariffs on China imports by implementing an equivalent $34 billion on US exports to China, especially targeting US soybeans, pork and other grains. And when China declared it would match the US further threat of another $200 billion in tariffs, Trump doubled down by threatening a further $500 billion on China imports. While Trump's threats of more tariffs and intimidation tactics have proven successful eliciting the response he wants from Europe and NAFTA partners, it has not to date proved similarly effective with China. Nor will it likely.

While China will allow significant US corporate access to its markets, and will agree to purchase hundreds of billions more of US exports, especially agricultural, China shows no signs of bending on its technology development objectives. And while US bankers, multinational corporations, and agribusiness-farmers appear willing to cut a trade deal on market access and US exports purchases, it appears that the US defense establishment

(Pentagon, Intelligence agencies, defense contractors), together with its friends in Congress, will not allow a deal with China without major concessions by China on technology.

From Tariff Spats to Currency Wars

Trump believes his intimidation tactics—thus far proving successful with NAFTA and Europe—will work as well with China. He believes he can close token deals quickly when he chooses with the former two, which is true. But he can't do so similarly with China. And the longer the tariff spat with China drags on, and deteriorates, the more likely a US-China tariff war will escalate into a bona fide trade war involving currencies and US dollar-Yuan exchange rates. And that is the prospect US and global business interests are particularly worried about.

A currency war between the US and China will reverberate across the global economy that already shows signs of slowing and, in some key sectors, is already descending into recession. Tariff spats involve two trading partners and may affect their mutual economies, but currency wars quickly spread across all economies in a chain-like contagion of devaluations.

This potential scenario is approaching, as Europe's economy is slowing rapidly and tending toward stagnation once again. Japan is already in another recession. A growing number of emerging market economies are contracting—the worst case scenarios being Argentina, now in a 5.8% economic contraction, but Brazil, South Africa, and others are continuing to slip further deeper into recession. Turkey's currency is now collapsing rapidly, a harbinger of real economic contraction on the near horizon. Meanwhile, India and other south Asian currencies and economies are also growing more unstable. In short, the global economy is growing more fragile in terms of both trade and production. A trade war involving currency instability between China and US will almost certainly tip the balance.

But Trump clearly believes China's economy can be destabilized by the US trade offensive. That China has more to lose than the US, since it has benefitted from US trade more than the US has from China trade. But this is a naïve and simplistic analysis, typical of Trump and his advisors. Typical of a financial speculator mentality, Trump believes that so long as the US stock markets are doing well, the real economy is strong and can weather an intensification of a tariff war. For Trump, 'tariffs are great'. Just raise them further to intimidate trading partners and force concessions from them to the benefit of US corporate interests and the economies of his domestic political US base.

China has already begun to 'dig in', however, in anticipation of a longer, protracted contest with the US over tariffs and their economics effects, and US demands to restrict China technology development. It has just announced another major fiscal-monetary stimulus to its economy this past week, in anticipation of slower growth from exports and trade with the US. A massive money injection to spur bank lending, tax cuts, and more government investment are planned to offset any export slowdown. It is also aggressively pursuing other trade deals with Europe and other economies to offset any decline in US trade. China also has various measures it can employ in a Trump trade war escalation. It can slow its purchase of US Treasury bonds. It can impose more non-tariff administrative barriers on US companies in China and those exporting to China. It can launch a boycott of US made goods among China consumers. These are likely measures of last resort, however. More likely is China may allow its currency, the Yuan, to devalue against the dollar—thus even offsetting any Trump tariff effects. And ironically somewhat, the devaluation of China's currency will be allowed to occur due to market forces, not any China official declaration of devaluation, since the US policy is already causing a devaluation of the Yuan.

Trump's trillion dollar annual US budget deficits have resulted in the US Federal Reserve central bank raising interest rates. The Fed must raise rates to finance Trump's now estimated annual trillion dollar deficits for the next decade (caused by Trump's $3 trillion in tax cuts and trillion dollar hikes in defense spending; with trillions more tax cuts and defense spending in the Congressional pipeline before year end 2018).

To pay for the multi-trillion dollar deficits, the US central bank, the Fed, is rapidly raising interest rates. Rising interest rates are driving up the value of the US dollar. That dollar appreciation in turn is causing an inverse decline in the value of emerging market economy currencies—and that includes China's Yuan currency. The Yuan has devalued by 10% since the US tax cuts, deficits, and interest rate hikes in 2018. A seven percent Yuan devaluation in just the last three months. The Yuan is now at the edge of its trading band at 6.8 to the dollar. Should it slip further, which is inevitable as US interest rates and the dollar continue to rise, a devaluing Yuan will set off a chain reaction of devaluations throughout the global economy—i.e. a currency war will have arrived. And as currencies devalue, Trump's tariffs will have been offset, neutralized, negated.

Trump has declared 'tariffs are great'. But Trump's tariffs will have been negated in turn by a currency war set in motion by Trump's own domestic fiscal and monetary policies that are causing the US dollar to rapidly appreciate worldwide. Trump is betting his intimidation approach can produce quick results before his tariff war precipitates a currency war and a severe global economic contraction. He is rolling the economic dice. He and his advisors clearly believe if it gets too serious, he can call off the tariff disputes with NAFTA, Europe and other trading allies quickly. He probably can, by backing off and getting token agreements which he'll misrepresent and exaggerate. But the scenario for a quick resolution is quite different with China. It will not back off so easily. The US-China dispute is far different than the US-trading allies (NAFTA, Europe) trade war of words.

Some Conclusions

Thus far, Trump's trade wars with allies are phony. A NAFTA deal is imminent. A hiatus even in the trade war of words with Europe has been declared. And a further escalation with China has not yet occurred. Trump will announce token and fake deals with Mexico and Canada before the US November elections for purposes of touting the success of his 'economic nationalism' to his US domestic political base. He will likely make more outrageous threats to China while perhaps trying to lure them back to negotiations with sweet-talk about China President, Xi, and possibilities of a deal . But China knows his game by now, and most likely will not negotiate until it sees what happens with the US November elections and the Mueller investigation of Trump.

At some point China and the US will negotiate. When they do, the key to whether a real trade war emerges thereafter—and that will only be with China—will depend whether Trump follows through with his threats to impose another $200 billion in tariffs on China imports to the US and whether the Pentagon and US defense industry lobby agrees to soften its demands on US technology transfer. US-China negotiations have already reached tacit agreement on China purchases of US exports and more US banker-corporate access to China markets in the future. How China will respond to more US tariffs and technology transfer is the crux of any US-China trade agreement—or trade war.

Trump and his advisors believe China cannot match tit-for-tat an equal $200 billion since it doesn't import that magnitude of goods from the US. They think therefore they have the advantage in a dispute with China. The US has a bigger 'tariff stick' than China has is the thinking. But that view is naïve. China has other measures, which it has signaled it is prepared to employ (without yet revealing the details). A devaluation of its currency would be high on its agenda of possible responses should Trump implement $200 billion more in tariffs. China's currency is already pushing the edge of its band, at 6.8 to 6.9 to the dollar. China thus far has been intervening in money markets to keep it there. All it needs to do, however, is stop intervening and let the Yuan devalue beyond the band, driven by market forces. It doesn't even need to declare a devaluation. As the dollar rise, as it will continue to do so as the Fed raises interest rates further, the Yuan will devalue without China intervening to prevent it. (In other words, US policy is ultimately driving the Yuan devaluation). A Yuan devaluation will allow China to offset Trump tariff costs by an equivalent amount, thus negating Trump's tariff actions. Contrary to Trump's bombast, of 'Tariffs Are Great', he will find that tariff wars typically fail.

At that point the skirmish on tariffs between the US and China will morph into a currency war and signal that a true trade war will have begun. It will be a China-US trade war—with significant repercussions for other global currencies as a contagion effect of currency devaluations follow. Global currency exchange rates will adjust downward even lower than they have to date already throughout emerging markets, as well as in Europe and Japan. The general competitive devaluations will sharply slow global trade and, in turn, global economic growth.

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