# STEEL WARS: METHOD IN THE MADNESS?

Op Ed by Dr Rory Knight

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**Dr Rory Knight**, is Chairman of Oxford Metrica and a member of the Board of the Templeton Foundations. He was formerly Dean of Templeton, Oxford University's business college. Prior to that Dr Knight was the vize-direktor at the Schweizerische Nationalbank (SNB) the Swiss central bank.

JOONGANG SUNDAY

**JoongAng Sunday** is the Sunday edition of the leading Korean language daily newspaper JoongAng Ilbo. It is one of the three largest newspapers in South Korea. The paper also publishes an English edition, Korea JoongAng Daily, in alliance with the International New York Times.

Stock markets have had a choppy start to 2018. The swings have been considerably larger than in the calm of 2017. Three concerns in particular have rocked the boat: the geo-political context, especially the tensions on the Korean peninsula, the potential perils inherent in unwinding central bank balance sheets, and the prospect of trade wars.

The year began well with a striking demonstration of Korean harmony at the Winter Olympics in Pyeonchang. Thereafter, the US implemented a highly stimulatory Tax Reform Act, and markets duly soared in January by a staggering 10%. However at his inaugural public meeting the new chairman of the US Federal Reserve raised the chances of a more rapid rise in interest rates and of a speedier unwinding of the balance sheet. This was followed by the US president announcing his intention to impose tariffs on steel and aluminium imports. Between them, these two events wiped out all of January's stock market gains.

The president has now implemented tariffs of 25% and 10% on steel and aluminium respectively. Fortunately this occurred as the break in the *impasse* with North Korea was announced which somewhat eased the pain for the markets.

World reaction has been strident. All the US's major trading partners have objected, threatening strong retaliation. The EU initially struck back with threats of tariffs on a range of such archetypal American products as Levy jeans, Harley Davidson motorcycles and Kentucky bourbon. The Hollywood-like, not to say cartoonish, nature of this list would seem to signal the EU's contempt for Trump's proposals. The media as usual have generally portrayed Trump as a buffoon. Although this is not a difficult argument to make, perhaps the economic effects will not be significant. The tone has changed slightly now that the tariffs are real. Many trading partners are begging for special exemption. Perhaps there is a strategy.

Trump is of course playing to the domestic gallery of his blue-collar constituency, projecting the message that he is protecting jobs and aiming to inject shiny new industries into old rust belt centres like Pittsburgh and Detroit. And in a way - superficially - you can see what is bothering the President. The US has continuously had a trade deficit with the rest of the world. That amounted to $811 billion in 2017. The US is in particular suffering significant trade deficits *vis à vis* its major partners - for instance, $151 billion with the EU and a staggering $376 billion with China.

But with steel and aluminium he is attacking the 'wrong targets" - perhaps intentionally. Admittedly the US is the world's largest importer of steel (some 34.4 million tonnes in 2017) but metals like steel are only minor contributors to the deficit at just over 1% of total imports. The numbers are relatively tiny - EU steel imports to the US are only $6.2 billion, a number which needs to be set against $435 billion of imports from the EU overall. Moreover, if Trump wants to target China he is also gunning for the wrong country, again perhaps intentionally. China, the enemy, only exports a paltry 3% of US steel whereas Canada, the friendly neighbour, by contrast exports some six times that number.

In 2017 the US imported steel from 110 different countries costing $29.1 billion. The top 10 supplier countries, presented in figure 1, supply 73% of all the steel imported by the US. Although China is the world's largest exporter of steel it supplies little more than 3% of US imports with a value just under $1bn. Canada and Mexico which supply over 26% have been exempted. Smaller suppliers such as Australia have likewise been exempted. These exemptions currently leave Korea as the largest non-exempt supplier. Although only around 3% of Korean exports to the US it represents around 10% of its trade surplus with the US.

**Cars next?**

The ominous tweet by the president over the weekend should be worrying for both the EU and Korea "*The European Union, wonderful countries who treat the U.S. very badly on trade, are complaining about the tariffs on Steel & Aluminum. If they drop their horrific barriers & tariffs on U.S. products going in, we will likewise drop ours. Big Deficit. If not, we Tax Cars etc. FAIR!*"

If tariffs are imposed on cars there would be a bigger problem. Think of all those BMWs, Mercedes and VWs speeding along America's highways. The EU's 'automotive products' trading surplus with the US amounts to a whopping 36 billion euros. Germany is of course the main Trumpian 'villain' here, exporting over $20 billion of cars to the US last year.

Car tariffs could also hit Korea hard. In 2016 it exported some $15.7 billion of cars to the US – a number that has ballooned up by 50% over the last six years. Korea also supplies some 10% of the US steel market. It is currently the sixth largest exporter of goods to the US, not just materials but increasingly high spec products, mainly cars but also products like TVs, fridges, computers and other machinery. Its trading surplus with the US is $23 billion – small in comparison to China but nonetheless not insignificant. Korea would be well advised to keep a sharp eye on developments in Washington.

**Trade not everything**

Trump's interpretation of a trade deficit as lost money has been ridiculed, if only because deficits are of course value for money for US consumers. However there are consequences for running trade deficits, foreign reserves diminish. Table 1 reports the top 10 countries (and the US) by foreign reserves. The data speak for themselves. Trade surplus countries build reserves, trade deficit countries lose reserves. China has the largest absolute reserves at over $3 trillion which enables it to bankroll the US as discussed below. Hong Kong has the largest foreign reserves relative to GDP at 130%. Korea weighs in at a creditable 9th with foreign reserves of $395 billion which has a ratio to GDP of 26%, the same as China. The US as a net importer has negligible reserves equal to just over half of one percent of GDP. Not surprisingly there are real issues for the president.

Actually Trump's obsession with trade and tariffs obscures a salient feature of the US economy – that it is in fact far less dependent on its trade balances than many of its major competitors. According to recent OECD numbers, US exports and imports represent only 8% and 12% of national GDP respectively. The corresponding numbers for the Eurozone are 46% and 41%, and for Germany, with its healthier exporting record, 46% and 35%. The Korean ratios to GDP for exports and imports are 38% and 32% respectively.

## "Big deficit..we tax cars etc. FAIR!"

China, incidentally, provides an interesting parallel. Twelve years ago Chinese exports and imports respectively represented 36% and 28% of Chinese GDP, similar to the current levels in Korea. Now they have fallen to 18% and 14%. True, the volumes remain vast but these numbers nevertheless indicate a massive turn-around. China is busily transforming itself from an export-led economy to a domestic consumer-based one while at the same time shifting from basic outsourced production and, like Korea, into more sophisticated manufacturing. In a sense the US and increasingly China in their different ways both benefit from economic autarchy.

Trump might point to the US's domestic economic strengths as evidence that trade wars are easy wins, but trade wars are by no means the only game in town. In fact they are a surface-level problem and deflect attention from far more serious and deep-seated issues – particularly that of the US's spiraling indebtedness and, related to that, the foreign ownership of that indebtedness and the potential stranglehold it implies. The US treasury currently has $16 trillion in securities (notes, bills and bonds) in issue. Of these the Federal Reserve holds $2.5 trillion and China $1.2 trillion. Jay Powell the new chairman of the Federal Reserve must have noticed that China could have as much impact on the markets as the Fed itself. China is well on the way to becoming America's foreign paymaster. Sticking duties on largely irrelevant trading products is likely to madden and further goad an already mighty opponent. Wang Yi, China's foreign minister promised "a justified and necessary response".

**Heed history's lessons**

We have been here before. Many have forgotten George W Bush's 2002 steel tariffs which most economists agree (a rare event) did more harm than good. It is estimated that 200,000 jobs were lost with the attendant higher steel prices. But even were Trump attacking real problems and were his remedies to have short-term effectiveness, still he would be wrong. His threats fly in the face of all that was learned in the last century about the value of free trade and of open, liberal global markets. Free trade, unhampered by heavy tariffs, is a mighty global engine, enhancing efficiency and productivity, spurring innovation, increasing availability and lowering costs – and in all these ways making a profound contribution to human well-being throughout the world.

To realise this you have only to look back ninety years to the trade wars which broke out on the heels of the Great Depression. In 1930, despite the objections of such opposed political figures as Hoover and Roosevelt and resistance from bankers and businessmen like the CEO of Morgan Grenfell and Henry Ford (who allegedly went down on his knees to plead against it), Congress passed the Smoot-Hawley Tariff Act slapping tariffs on over 20,000 imported products. Other countries promptly responded in kind, and in the aftermath world GDP fell by 17%. Revisionist economists, as is their wont, are divided on the precise proportion of this collapse for which tariffs are responsible but all agree it was a crucial factor. We must never again take steps down that road, however small and tentative.

## Method in the madness?

The imposition of trade tariffs is not a good idea for anyone. At the very least they punish domestic consumers and foreign trading partners, at worst they could lead to a global trade war with dire economic and political consequences. So how could this action by Trump be rational? Well, there may be some method in Trump's madness. As a strategic signalling exercise it may make sense - and of course to be credible it must be costly. Trump is right to call out unfair trade practices where he specifically cites the EU. The EU for all its pompous rhetoric about free trade is a major impediment to free trade with a massive set of barriers around its "single market". Its protestations about the US tariffs would be more credible if it took a long look at its own protectionist policies.

If Trump is operating strategically he could not have picked a better commodity than steel. It makes good on his campaign promises, and, as pointed out, it will do the least damage in terms of scale, especially as the major suppliers are exempt. Perhaps the best response would be to ride with the punches, hoping the largest economies in the world do no more than signal their concern. The president may then find something else to tweet about and sidestep the tit for tat spiral into a trade war.

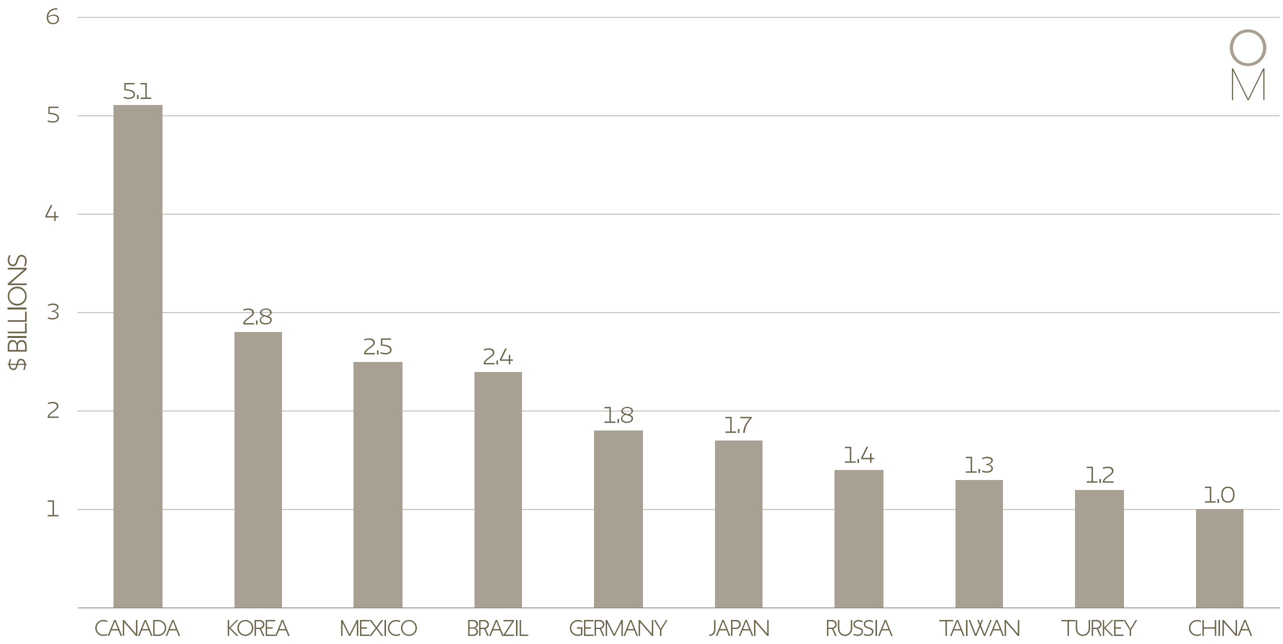


FIGURE 1. Provenance of US steel imports in 2017

US Steel Imports 2017

SOURCE: United States Census Bureau

| Rank | Country | Foreign reserves $bn | Foreign reserves % of GDP |
|---|---|---|---|
| 1 | China | 3,236 | 27% |
| 2 | Japan | 1,264 | 26% |
| 3 | Switzerland | 795 | 121% |
| 4 | Saudi Arabia | 488 | 69% |
| 5 | Russia | 454 | 29% |
| 6 | Taiwan | 451 | 80% |
| 7 | Hong Kong | 431 | 130% |
| 8 | India | 420 | 17% |
| 9 | Korea | 395 | 26% |
| 10 | Brazil | 381 | 18% |
| 21 | United States | 123 | 0.6% |

TABLE 1. Top 10 countries by foreign reserves (December 2017)

SOURCE: Government statistics

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