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Asia Economics

Trade Frictions: Broadening Out

The direct impact of the fresh measures announced by the US is small, but the timing and intensity have increased the risks of trade frictions broadening out. The policy imperative within Asia will be to avoid exacerbating trade frictions, and the Asian response will likely be relatively measured.

Rising risk of trade frictions and disputes: While the move to impose tariffs on steel and aluminum products was already in the public domain, the timing (after the action to impose tariffs on washing machines and solar panels in Jan-18) and intensity (the toughest option has reportedly been selected) with which these measures have been taken up is a concern.

Direct impact should be manageable from the trade partners' perspective, as these products account for only 4% of the US import basket and only 0.6-1.1% of China, Japan and Korea's exports. Moreover, our base case view is that the global growth backdrop remains favourable and underlying demand for Asia's exports should remain supported.

Indirect impact of broadening and persistence of protectionism risks: The response of trade partners will be key to watch. If trade frictions do broaden and persist for longer, Asia will be the region most affected via the potential disruption to global supply chains, as companies re-evaluate where to locate their production facilities. From an equity market perspective, increasing trade protectionism has been a concern in general for our equity strategists and in particular a potential negative for markets in North Asia, given the high export revenue sensitivity of South Korea, Japan and Taiwan. In contrast, our strategy team views ASEAN markets and Brazil as relatively defensive in this context.

Response from Asia and signposts to watch for: We think that the policy imperative within the region is to seek to avoid exacerbating trade frictions, and we thus continue to believe that the response from Asia will be relatively measured. Moreover, since tariff actions are not enacted on a bilateral basis, we think this reduces the impetus to respond in a significant manner, and hence the preferred course of action would be to work on a coordinated response with other trade partners and also rely on WTO processes. If, however, trade frictions do rise, the response would probably be in the form of heightened rhetoric, launching of counter investigations of imports from the US, possibly restricting imports of US agricultural products and transportation equipment, and restricting sales of US products.

From the perspective of the US, our public policy strategist, Michael Zezas, highlights that he is watching whether the US will take further action in the form of using Section 301 on intellectual property, or if it moves materially closer to enacting a 'reciprocal tax', as key signals that the US could be moving towards a "protectionist push" (details on the framework and possible scenarios here).

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Asia Economics

Recent developments have meant that the risks of trade frictions broadening out have increased. Indeed, the direct impact of the fresh measures announced by the US is small, but the timing and intensity are a concern. In the near term, the favourable global growth backdrop means that underlying demand for Asia's exports should remain supported. However, if trade frictions do broaden and persist for longer, Asia will be the region most affected via the potential disruption to global supply chains, as companies re-evaluate their decisions on where to locate their production facilities. In this context, the response of trade partners and whether a significant rise in trade tensions can be avoided will be key to watch. We think that the policy imperative within Asia will be to avoid exacerbating trade frictions, and we expect the Asian response to be relatively measured.

What happened

As per published media reports (Wall Street Journal), the US is about to implement tariffs on steel and aluminum imports of 25% and 10%, respectively, after having imposed tariffs on solar panels and washing machines in January 2018.

Assessing the direct impact

At the outset, we would note that collectively steel, aluminum, washing machines and solar panels account for only 4.1% of total US imports -- in other words, the tariffs that have been or are about to be imposed affect only a small proportion of the US trade basket. Putting this in a global context, these items account for only 0.6% of global trade.

Which countries are the major sources of steel and aluminum US imports and hence would be affected? According to the latest US steel import report by the US Department of Commerce (link), Canada is the largest source of steel imports. Within Asia, Korea is currently the third largest US steel import source at 10% as of 3Q17, Japan is the 7th largest at 5%, while China is the 11th largest source. For aluminum and related products, Canada again ranks first, followed by China at 15% of total imports in 2017.

Overall direct impact on Asia from these measures to be limited: From an Asian perspective, the key economies that would be most affected if these tariffs were implemented are China, Japan and Korea. However, from their perspective, the impact would also be relatively muted, considering that the exports of these products (to all destinations) account for only about 6-8% of their total exports. More specifically, their exports of these products to the US are even smaller, accounting for just 0.6-1.1% of their total exports.

Could the impact be farther reaching?

While our assessment is that the direct impact will likely be limited, these actions have been taken up relatively quickly after the imposition of tariffs on solar panels and washing machines in Jan-18. Moreover, the announced measures are the most stringent

option. Hence, the quick succession of adoption of trade measures has meant that the risks of trade frictions broadening out have risen.

While the direct impact of these measures will probably be relatively small, the indirect impact will be a broadening and persistence of trade frictions. In this context, the response of trade partners and whether a significant rise in trade tensions can be avoided will be key to watch. Our base case view is that the global growth backdrop remains favourable, and hence underlying demand for Asia's exports should remain supported.

If trade frictions do, however, broaden and persist for longer, Asia (considering its high trade exposure and integration in global supply chains) could be the region most affected via the potential disruption to global supply chains. The impact could linger over the longer term as companies might re-evaluate their decisions on where to locate their production facilities.

Potential impact on equity market

Our Asia / GEMS equity strategist, Jonathan Garner, and his team remain cautious on Asia / EM equities and Japan equities. They have been highlighting consensus earnings expectations, which are significantly elevated versus their own expectations, and valuations in the non-financial sectors that are very high versus history. Increasing trade protectionism has been a concern in general for this team for some time; in particular, they view protectionism as a negative for markets in North Asia with high export revenue sensitivity such as Korea, Japan and Taiwan. In contrast, the team views ASEAN markets and Brazil as relatively defensive to this theme. Sector wise, the team continues to view Information Technology and Autos as most at risk and prefers Financials and upstream Energy exposure.

Response from Asia and signposts to watch for: We think that the policy imperative within the region is to seek to avoid exacerbating trade frictions, and we thus continue to believe that the response from Asia to these actions will be relatively measured. While risks have risen, our base case is still that these measures, by themselves, are not likely to have a significant impact on overall trade growth in Asia unless the situation develops into a full-blown trade conflict.

Moreover, because the tariff actions are not enacted on a bilateral basis (i.e., not levying tariffs on imports from a specific country), we think this reduces the impetus to respond in a significant manner, and hence the preferred course of action would be to work on a coordinated response with other trade partners and also rely on World Trade Organization (WTO) processes to pursue actions against the tariffs. In the event that trade frictions do rise, the response would probably be in the form of heightened rhetoric, launching of counter investigations of imports from the US, possibly restricting imports of US agricultural products and transportation equipment, and restricting sales of US products.

Indeed, the initial response from Asia to the announcement has been measured. Media reports suggest that Japan will be seeking greater clarity as to whether some countries may be exempted, and the Trade Minister has noted that imports from Japan, as an ally, do not affect US national security (WSJ). Korea has indicated that it would actively seek outreach activities with the US until the US government reaches a final decision.

Additionally, recall that negotiations on amendments to the Korea-US Free Trade Agreement are still in the works, and this may also be taken into consideration as policymakers decide how to respond (Reuters).

As regards China, senior officials highlighted cooperation to settle trade disputes, and said the US and China also agreed to talk about related issues in Beijing in the near future, in a bid to create conditions for further cooperation (Xinhua). Moreover, even though China is running a bilateral trade surplus with the US, the size of its overall current account surplus has narrowed significantly in recent years, to 1.8% of GDP in 4Q17 from an average of 5.9% of GDP in 2003-07.

We think China's response will be measured, as (1) the U.S. imposition of tariffs is likely to be on all countries rather than specifically targeting China, and (2) China has continued to advocate free trade and hence would be unlikely to impose meaningful tariffs on selective products (in which the US may have larger market share) and also considering that a disruption to the currently favourable global trade dynamics would lead to some challenges for China in managing its own critical domestic issue of deleveraging.

Underlying demand is holding up, so trade growth will be supported

From a broader perspective, we have highlighted before that Japan's experience in the 1980s should be instructive in understanding the final impact on Asia's trade growth: In the 1980s, trade protectionist measures were imposed on Japan (such as voluntary export restraint and tariffs). Despite these measures, Japan maintained its market share in US imports. Though trade growth in Japan did decelerate during the 1980s, the impact stemmed from the global recession in 1980-1983 rather than the protectionist measures per se.

Underlying demand conditions will be more critical in determining the outlook for trade growth: We believe underlying demand conditions matter more for the trajectory of overall trade growth in Asia. Indeed, with global growth likely to reach close to 4% in 2018 and with the global capex cycle recovering (which tends to exert a stronger influence on global trade), export growth in Asia should remain supported. Hence, we expect that protectionist measures on select sectors would have a manageable impact on Asia's overall trade growth and its trend in market share of global exports.

Current conditions are still favourable: In early 2018, trade growth in Asia has remained relatively robust. Indeed, for Jan-Feb combined, Korea's exports have grown by 13% YoY, while the US manufacturing ISM (Institute for Supply Management) report has shown a further increase in Feb-18. With the US non-oil trade deficit widening and the enactment of fiscal stimulus, demand growth should be supported.

What to watch for

At the time of writing, the tariffs on steel and aluminium products have been announced but not implemented. In this context, the most important signpost would be the details around the implementation -- particularly around the exact quantum of tariffs and potential exemptions.

As discussed earlier, the key is to assess whether trade frictions escalate. In this context,

the response or comments from policy makers in Asia would remain a key to watch, as would the upcoming decisions to be taken on other trade-related investigations. The separate investigation into the issue of China's intellectual property rights would be another key decision to watch. This is likely to be released in summer 2018.

What to watch for from the US perspective: Our US public policy strategist, Michael Zezas, highlights that he is watching the following four potential developments (while not comprehensive) that could escalate the situation to a 'protectionist push':

1) The international reaction is more severe than expected. This could take the form of a broad-based tariff response and/or rolling back foreign investment or limiting imports.

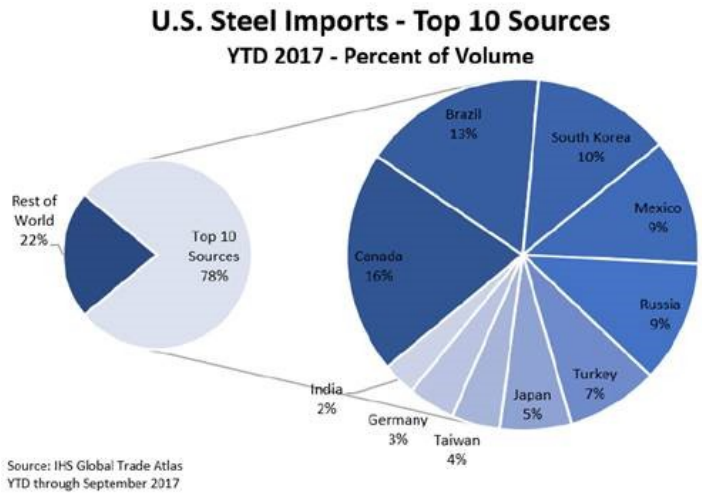
2) The US uses Section 301 to act on intellectual property.

3) The US does not exempt Canada and Mexico from tariff actions, calling the current NAFTA negotiations into question. If tariffs are announced but keep NAFTA partners in scope, this would break with recent precedent, as the steel tariffs under President Bush did not apply to Canada and Mexico.

4) The US moves materially closer to enacting a 'reciprocal tax'. While the administration has not yet fully detailed what such a tax would look like, based on public comments, we take it to be an effort to 'level the playing field' by taxing imports near or equal to the difference between the exporting country's VAT and US state and local sales taxes, thus attempting to equate the US consumption tax charged on goods imported with the consumption tax of the exporting country. It is not clear to us that the President has the authority to enact something this broad within the existing set of laws, but we can't dismiss such a move outright, either.

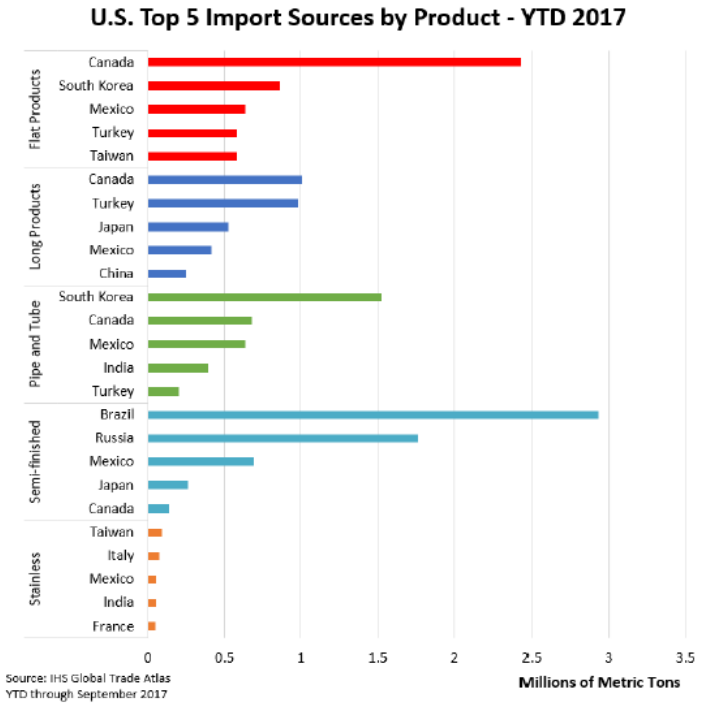
For more details on Michael's framework and the possible scenarios for US trade policy, see US Public Policy: Trade Policy: Beyond the Hypothetical (23 Jan 2018).

Exhibit 1: US steel imports: Canada, Brazil and South Korea are the top three sources



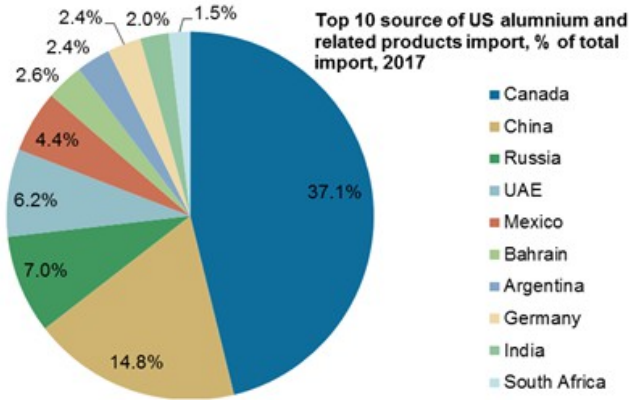
Source: US International Trade Administration

Exhibit 2: Top 5 import sources of various steel products



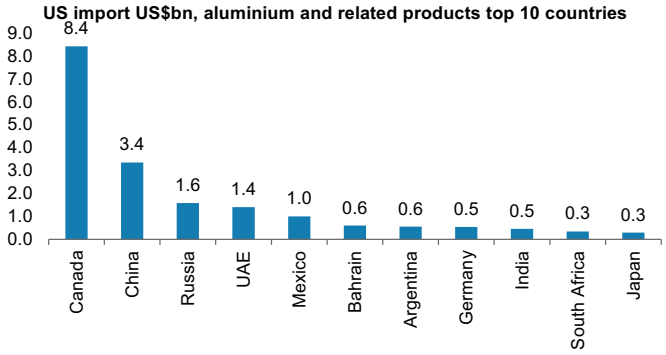
Source: US International Trade Administration

Exhibit 3: Canada and China account for around half of US imports of aluminum and related products, ...



Source: US Department of Commerce TPIS Database, Morgan Stanley Research

Exhibit 4: ... which totaled about $12bn in 2017



Source: US Department of Commerce TPIS Database, Morgan Stanley Research

Exhibit 5: Exports of steel, aluminum, washing machines, solar panels and related products account for 6-8% of total exports from China, Japan and Korea

2016, % of Total Exports	China	Japan	Korea
Iron and steel	2.1%	3.8%	3.8%
Iron and steel products	2.5%	1.5%	2.2%
Aluminium and products	1.0%	0.3%	0.5%
Washing machine	0.2%	0.0%	0.2%
Solar panel	0.8%	0.6%	0.8%
Sum	6.5%	6.2%	7.6%

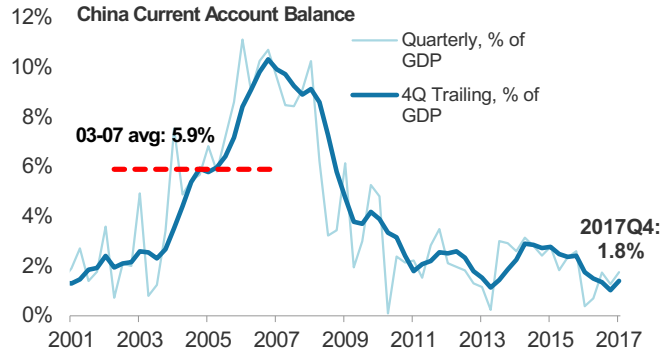
Source: UN Comtrade Database, Morgan Stanley Research

Exhibit 6: Exports of these products to US account for only 0.6-1.1% of the countries' total exports

Exports to US as % of Total Exports	China	Japan	Korea
Iron and steel	0.03%	0.2%	0.3%
Iron and steel products	0.4%	0.3%	0.4%
Aluminium and products	0.1%	0.03%	0.04%
Washing machine	0.03%	0.00%	0.04%
Solar panel	0.1%	0.1%	0.3%
Sum	0.7%	0.6%	1.1%

Source: UN Comtrade Database, Morgan Stanley Research

Exhibit 7: China's current account surplus has declined in recent years compared with 2003-07 levels



Source: CEIC, Morgan Stanley Research.

China: Direct Impact Limited, Watching for Potential Risks

The combined likely direct impact on China's export growth of recent US tariff hikes on steel, aluminum, solar panels and washing machines appears manageable at -0.1ppt. However, the US government's recent moves on trade suggest rising risks of trade frictions broadening out, and potential risk events such as penalties stemming from the US Section 301 investigation of intellectual property rights may drag down China's exports by an additional 1.1ppt. We believe China will remain measured in its response as it deals with rising trade tensions, and our base case is that large-scale trade friction is unlikely.

Relatively limited impact of US tariff hikes on China thus far: The 25% tariff on steel imports and 10% tariff on aluminum imports (announced by the US on March 1st) might translate into merely a 0.04ppt drag on China's export growth, since these products combined represent only ~1% of China's exports to the US. Meanwhile, the US tariff hikes on solar panels and washing machines (announced on January 22nd) may drag down China's export growth by 0.07ppt.

However, risk of rising trade frictions bears watching: We believe the US government's recent moves suggest a rising risk of trade frictions broadening out. The key risk event we are watching is the US Section 301 investigation of intellectual property policy, with a decision expected by August. The potential penalties may affect areas such as semiconductors, computers and telecommunication devices. Moreover, risks could come from a universal tariff hike in autos and auto parts, as well as a spillover effect from disruption in the Asia production chain.

Measuring the potential impact if trade frictions broaden out and persist: Taking into account the existing and potential US tariff hikes/quota cuts, we estimate the drag on China's export growth could be as large as 1.2ppt (Exhibit 8), and the net drag on China's GDP growth would be ~0.1ppt.

- **Telecommunications and semiconductors:** These sectors could be the primary target in US investigations into intellectual property issues. Combined, they make up 23% of China's exports to the US and 4.4% of China's total exports. According to China's Ministry of Commerce, foreign enterprises in China contribute around 59% of China's goods trade surplus. We thus assume that 40% of these two sectors could be subject to a hypothetical tariff rate of 30% by the US, translating into a 0.8ppt decline in China's total export growth.

- **Automobiles:** If the US were to raise import tariff to 30% for all countries, this could translate into a 0.3ppt decline in China's total export growth, since China's exports to the US in this sector account for 0.7% of its total exports. That said, we see a relatively low probability of a US tariff hike on China in this sector, as China accounts for only 5% of total US road vehicle imports (with more than two-thirds being parts and accessories) while China takes 10% of total US road vehicle exports (with 81% in passenger cars).

Our base case assumes measured response from China: We believe China will remain pragmatic in dealing with rising trade tensions, as the impact from new US tariff hikes on

China has been small. Indeed, the initial response from China to the announcement has been measured. Media reports suggest that Chinese senior officials highlighted cooperation to settle trade disputes, and said the US and China agreed to talk about related issues in Beijing in the near future, in a bid to create conditions for further cooperation (Xinhua). We think that if trade frictions should rise, China's near-term response could be to turn to WTO processes and launch counter investigations in select sectors (for instance, China launched an anti-dumping probe into US sorghum imports in early February). Meanwhile, as China is not the only country to be affected by the US tariff hikes, its policymakers may prefer to craft a coordinated response with other countries. We think China and the US could conduct further negotiations and possibly reach trade and investment deals that are mutually beneficial.

That said, China may consider a more meaningful response should trade frictions continue to rise in a persistent manner. The list of potential actions could include: reducing imports of US agricultural products and transportation equipment, restricting sales of some US products, and increasing tariffs on US goods.

Exhibit 8: Potential Impact on China's Export Growth if Trade Frictions Broaden Out and Persist

Existing US tariff hikes	
30% tariff on solar panel and 20-50% tariff on washing machine	-0.07%
25% tariff on steel and 10% tariff on aluminum	-0.04%
Sub-total	***-0.1%***
Potential risk events	
A 30% tariff rate on part of China's semi-conductor and telecommunication devices	-0.8%
A universal 30% tariff rate on autos & auto parts	-0.3%
Sub-total	***-1.1%***
Total possible impact	**-1.2%**

Source: CEIC, Morgan Stanley Research estimates

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