Economic Overview for Business Owners

July 2018

What if the US initiates a global trade war?

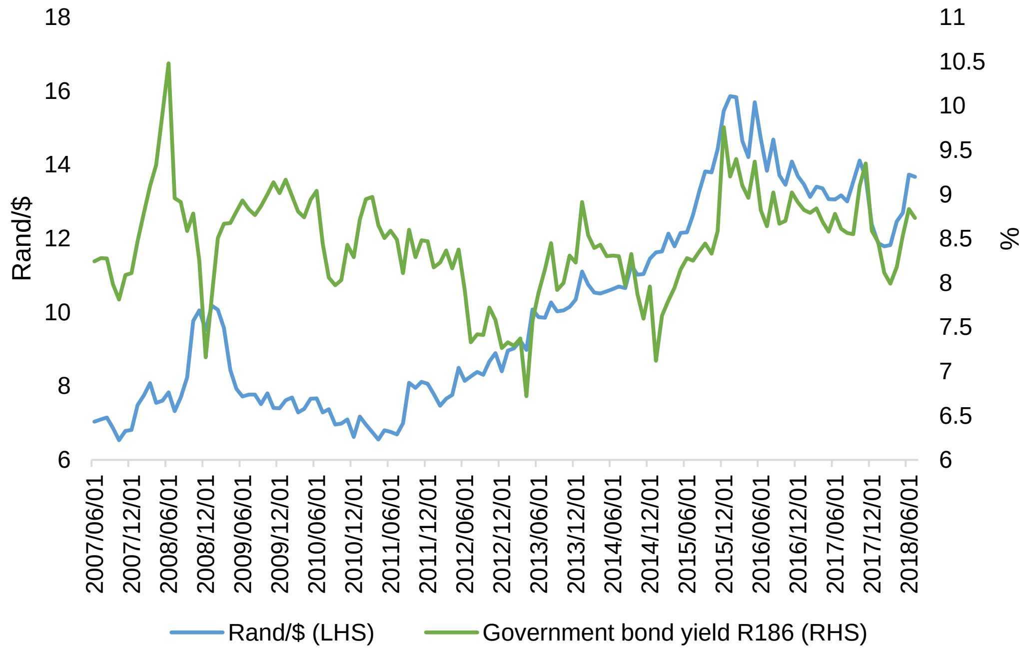
A sharper than expected fall in GDP growth in 1Q18, followed by disappointing production data in the second quarter amidst a softer Rand and higher government bond yields, is challenging the view that the domestic economy is due for a decent recovery.

Expectations for better real GDP growth rest on the tailwind of the global economic expansion and the accompanying increase in commodity prices in recent years. Indeed, supported by relatively low inflation (and the Reserve Bank's interest rate cuts, albeit limited) this backdrop has boosted domestic purchasing power. Accordingly, consumer demand has held up reasonably well – especially considering the increasing individual tax burden.

However, some problems have surfaced. Global real GDP growth has eased, partly due to higher oil prices, which have squeezed real income growth in oil-importing countries. Also, the shift in the US towards trade protectionism has dampened business sentiment. Elsewhere in Europe political uncertainty has re-emerged, notably in Italy and Germany.

Given these developments and the ongoing shift towards less accommodative US monetary policy, global investors adopted a more cautious tone towards emerging markets in the second quarter, as reflected in the depreciation of the Rand and the increase in domestic government bond yields.

The Rand and long-term government bond yield

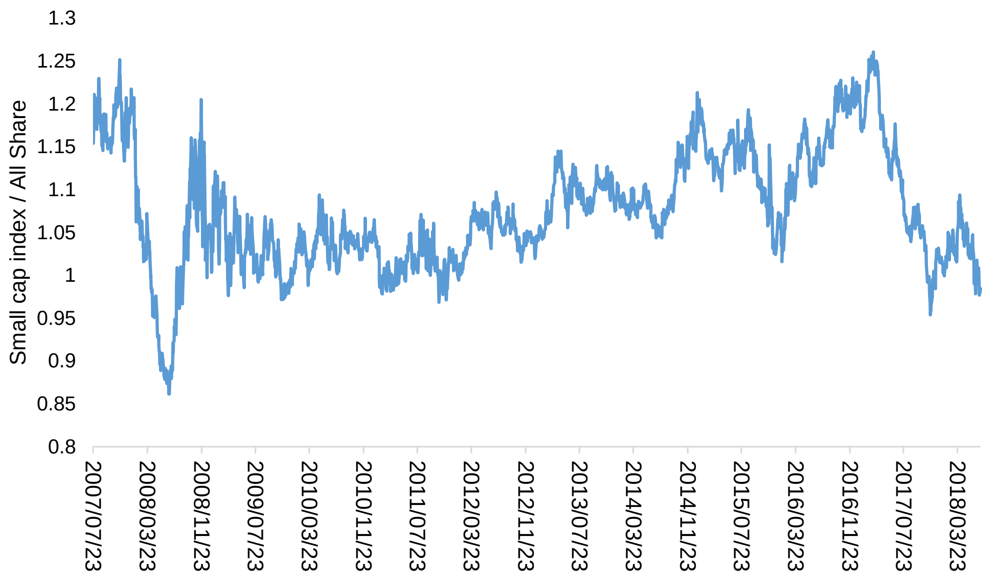


Source: I RESS

At the same time, the JSE Small Cap Index, which outperformed earlier in the year, lost ground relative to the JSE All Share Index.

It still, nonetheless, seems reasonable to argue the South African economic expansion should resume following the disappointment of the first quarter. Not only has global final demand improved in recent months, which should help stabilise global manufacturing production, but the historically reliable leading real economic activity indicator of the South African Reserve Bank suggests domestic growth should be firmer than the depressed outcomes recorded of late. Although average growth of just 1.25% is expected for 2018, a growth rate of around 2% in 2019 should not be too much to ask for if global growth holds up. This remains our base case scenario, whereby firmer domestic demand should lend support to small businesses.

JSE Small Cap Index relative to JSE All Share Index



Source: I RESS

But, we know there are risks. One of these, other than any unexpected acceleration in US monetary policy tightening, is the potential escalation of that country's hitherto modest shift towards trade protectionism into a full-blown trade war. Import tariffs implemented *to date* by the Trump-led administration are modest and should not exert a material impact on the global economy. However, China has retaliated to the announced implementation of a 25% import tariff on $34 billion worth of Chinese imports into the US in early July 2018 (with another $16 billion expected to follow early in the third quarter). This increases the risk of a trade war, since, the US has threatened to respond to China's retaliation by, possibly, imposing a 10% import tariff on an additional $200 billion worth of Chinese imports, with further tariff hikes on even more goods imports possible if China continues to retaliate.

In addition, the US administration is investigating whether automotive industry imports into the US pose a threat to its national security. If such a threat is confirmed, the US is expected to impose a 25% tariff on automotive industry imports, which amounted to almost $360 billion in 2017 (vehicles plus parts and accessories).

It must be stressed that that a fully-fledged trade war may not unfold. Indeed, the US president does not have universal support for his trade policy and resistance is to be expected.

But what would the impact be if trade tensions continue to escalate? An IMF working paper released in July 2017[1] estimates that a 10% increase in import tariffs in the US, accompanied by retaliatory action of the same magnitude by its trading partners, would decrease global trade and GDP by 1% and 0.5% respectively (assuming tariff increases are limited to direct trade with the US and are not increased between the non-US trading partners themselves). The effective aggregate increase in tariffs threatened so far, if implemented, falls short of an increase of 10%, implying a materially smaller impact on the global economy than indicated here – although the complex integrated nature of global supply chains and the uncertain impact on asset prices and sentiment implies some risk to the estimated outcome.

In essence, we should not make light of these potential developments. If the implementation of a 25% tariff covers South African auto industry exports to the US, it should be remembered it follows the implementation of import tariffs on aluminium and steel exports to the US, despite the AGOA Extension and Enhancement Act (which runs to 2025). In addition, for reference, according to the 2018 Automotive Export Manual (Automotive Industry Export Council) total domestic auto industry exports to the US amounted to R18.8 billion in 2017 (most of which reflected vehicles). Although this amounts to just 1.5% of total SA exports in the year (0.4% of GDP), it would be a material development for the domestic auto industry and its suppliers.

Further, it is also possible the impact will not be limited to direct exports to the US, since domestic producers form an integral part of the global auto industry supply chain.

Moreover, one of the factors which have attracted foreign investment into the domestic auto industry, according to the Automotive Export Manual, is South Africa's favourable trade arrangement with the US.

On balance, even if the global impact of any potential escalation in trade protectionism is contained, its potential impact on specific industries is significant. And, in tandem with tighter global financial conditions, it does imply capital hungry economies such as South Africa will continue to be carefully scrutinised for fault lines in their macroeconomic policies and growth prospects by suppliers of capital, underlining the importance of pressing ahead with economic reform to lift South Africa's potential growth rate.

Written by Arthur Kamp, Investment Economist, Sanlam Investment Management

[1] Lindé, J and Pescatori, A.: "The Macroeconomic Effects of Trade Tariffs: Revisiting the Lerner Symmetry Result", IMF Working Paper 17/151, July 2017.