Trade at war

By Jean Francois Lambert, founding partner at Lambert Commodities

A complex interplay of trade disputes, sanctions, and tariffs may signal that globalization has turned a corner and we face a more uncertain and harsher world. Jean Francois Lambert explores the shaping of a possible new normal.

2018 may be remembered as the year when trade went to war. Sanctions, tariffs, withdrawals from the nuclear agreement with Iran and the Trans Pacific Partnership, threats to NAFTA, criticism of the WTO… Is this merely a temporary episode caused by a change of administration in the leading world economy, or a harbinger of a new economic (dis)order?

Hopes are for the former, but analysis unfortunately inclines to a more pessimistic stance: we may have turned the page of a prosperous globalisation to enter into a much more uncertain and harsher world.

A tougher world

History has consistently showed us that economic crises take a long time to be overcome. Whilst economies might rebound in a few years only, the negative psychology of societies at large, which suffered during crisis lingers and growing frustration could eventually translate into votes of discontent, and the election of populist leaders, ably surfing of the wave of anger. This was true in the 1930's, and it plunged the world into the darkest possible times.

The good news is that the world has considerably improved during the second part of the 20th century. A new, peaceful, order was built, and thanks to technology, communication and transportation, a truly globalized economic world materialized. New urbanised and educated middle classes emerged from Asia to Latin America, from Eastern Europe to the Middle East. Undeniably, the world has grown wealthier and more prosperous during that period.

However, in the developed economies, the catch up of emerging markets and chiefly China has not always been seen as having such pervasively positive effect: the perception is that income inequality rose, and that in many instances, globalisation opened the door to a new, tougher competition, leading the Western democracies into a painful deindustrialisation process, rising unemployment, unsolicited immigration and stagnation of the middle classes' income.

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The 2008 crisis exacerbated such critics and here we are today: Brexit; political crisis in Italy; a stalled Europe with the French-German engine sputtering; anger in Hungary, Poland, Catalunya; and the election of a new POTUS, whose agenda is to make America great again, even if at the expense of its hitherto allies, shaking the post war world order.

We have entered into a tougher world and this is should not come as a surprise.

De-globalisation? How?

If globalisation is increasingly seen as a threat rather than a blessing, at least in the Western democracies, does it mean this is the end of it? Is our economic ecosystem bound to shrink back to our old nations frontiers? The prospect might tempt several populist regimes, but how is this even possible?

We live through a web of global supply chains, where a product is designed in one country, assembled in three others, with parts coming from ten different places, themselves made of components designed in two or three countries, and made out of raw materials and assembled in another ten… some being already involved in the process at an earlier stage!

The times when one could view trade as 'imports and exports' are over: trade is global and the right question to ask, albeit a much more difficult one to answer is: where is the added value? Are trade deficits such a concern when the purpose is to make use of cheaper production centres worldwide, to make a product that was designed in California and sold all over the places with a

significant profit margin by a top American company?

The dislocation of global supply chains through tariffs defeats its own purpose. It is bound to have several unintended consequences such as the likely rise of the final prices to the consumer, and sooner or later, will trigger a tit-for-tat domino effect which could in no time transform economic bickering into geopolitical tensions.

And when this happens, the weapon of choice is the one everybody forgets, but is yet at the origin of 100 percent of the world's merchandise trade: commodities and raw materials.

Commodities, a weapon of choice

A quick look back will tell us how time and again, commodities have been at the crux of geopolitical tensions[1]:

- In the 30's, when the US, worried about Germany's growing military supremacy, embargoed Helium exports of which it was the sole producer.
- In 1973, when OPEC prohibited exports of crude oil to Israel and its allies in the wake of the Yom Kippur war.
- In 1979, when the US embargoed the exports of 17mio tons of cereals to USSR in retaliation for its military role in Afghanistan.
- In 2010, when China stopped supplying Japan its rare earth upon territorial disputes on Senkaku islands
- In 2014, when Russia used its gas to pressure Ukraine and Poland to endeavour to maintain its challenged influence over Eastern European countries.

2018: The Year of Living Dangerously

This year, commodities are also an important tool of the trade-at-war arsenal, with aluminium, steel, oil, soybeans and sorghum on top of the list. However, where 2018 is in stark contrast with the past, is for the breadth of the decisions taken by the US administration.

Never in peace-time have so many measures been taken simultaneously; shaking the post-war order where multilateralism was formed as a way to turn the page on two world wars. America was the promotor and architect of this construction. It seems it has now turned to be its nemesis: UN, WTO, trade agreements… nothing holds against America's focus, now uniquely centred around its immediate self-interests.

'Making America great again' but at all costs. Allies are no more: only competitors. And, naturally, the biggest threat to America's leadership is China.

Thucydides' Trap ?

The "Thucydides' Trap" is how Graham Allison[2] described the inevitable confrontation between a rising power and an already dominant one. Could a trade war be the harbinger of such fate? Well, if tensions between dominant America and rising China, are inevitable, a fully-fledged conflict, even if around trade, is fortunately very unlikely.

Granted, China's geopolitical influence has become palpable beyond its sheer economic power, and this challenges America's supremacy but – and at least for four reasons – US and China will have to maintain a good relationship:

First and foremost, because their economies are closely intertwined through trade; the chief concern of the US administration today. However, China is also a prime creditor of the US, being by far, the first holder of US Treasuries at $1.18tn.

Second, the US has grown overly dependent on China through the global supply chains, notably in the technology sector. A link which would prove unrealistic to severe.

Third, the often-disregarded fact that China has today a quasi-monopole in the production of rare metals and rare earth, without which most electronic devices (including military equipment's) would simply not work, and strategic alternative energy development would prove simply impossible outside China.

Interestingly, and we should pay attention, China unlike any other country has endeavoured to lower its reliance over US technology companies (Google, Facebook etc) in the new economy which are absolutely dominant elsewhere and notably in Europe, by nursing its own juggernauts such as Baidu, Alibaba, and Tencent or Huawei.

The US is not Athens, and China is not Sparta. The economic ties that have been weaved are such that they are bound to come to terms. Besides, it is rather easy for China, a centralised economy, to open up without putting much at risk, thus taking a few good-gesture decisions to assuage the US administration and save both parties' faces. China is therefore probably safe. But is Europe?

Venus without Mars?

As Robert Kagan put it: America is from Mars and Europe from Venus[3]. For European countries, Mr Trump's wake-up call is ominous and happening at the worst possible time, when Germany and France struggle to articulate a common project for the future. The European Union is entirely focussed on the daunting task of finalising a decent Brexit accord with UK, whilst being challenged at its Eastern borders by Hungarian and Polish governments, and potentially destabilized by an improbable Italian coalition.

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Furthermore, its dependency on the US is much larger than it looks: The US is the primary destination of EU Exports of goods with $435bn in 2017, leaving a surplus of $139bn. The balance of services - what Europe sells and gets is more or less even, at circa $250bn on both sides[4]. But the real magnitude of the intricacy of the relationship is measured through the size of Foreign Direct Investment: European companies' total stock of investment in the US up to 2016 reached $3,180bn leaving, when offsetting US interests in EU, a positive balance of $409bn. A web of interest rather difficult to disentangle.

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On top of this, two major dependencies are worth highlighting. First, the obvious one: besides France and the UK, European defence hinges quasi exclusively on NATO. The other Achilles' heel is the over reliance of all European countries on US companies, to cater for electronic communication tools and systems (Internet, Google, Apple, Microsoft, Facebook and Twitter).

Does this mean that the EU cannot react to tariffs implemented by America? No, but it is realistically left with limited capabilities for retaliation.

America too big to shun?

Tariffs call for tariffs. Tit for tat. Canada will strike first; Europe will take more time because of its sheer complexity, but eventually will react in the same fashion against tariffs on aluminium and steel. Such is the implacable logic of protectionism: a game of chicken. To achieve what? This is altogether another issue: very little and a lot of harm, unless one of the opponents has the means to hurt the other one significantly more than it is affected itself. Between the US and Europe, who has the upper hand?

The outcome is rather uncertain, but a tariff war will primarily hurt the country which does not produce alternative products, and this is where Europe may prevail over time: US buyers of European steel and aluminium are looking for high quality specs which are simply not available in the States. This is the supply chain effect where indirectly tariffs are eventually tantamount to self-inflicted pain.

A re-balancing act of alliances is another temptation for European countries. As China's dominance develops, it might be of mutual interest to form a special bond between the EU and China. Already, China's Belt and Road strategy aims at tightening links with Eastern and Western Europe. However, re-balancing takes a long time and will certainly not solve the short-term problems. Besides, whether Western democracies will be willing to shift their dependence from the US to an autocratic nation like China (with Russia in the way) is far from certain. History tells otherwise.

Meanwhile lets' brace for probable escalation, hoping it will not get out of hand. Of a bigger concern though is how the dollar has become the biggest problem for Europe and why this situation is not going to improve anytime soon, as neither Euro - nor renminbi offer compelling alternatives.

Our currency, your problem

When John Connally, President Nixon's Treasury Secretary proclaimed to the G-10 in 1971 "the dollar is our currency, but it's your problem", he did not have in mind the absolute weapon of 'secondary sanctions' which was deployed at the eve of the 21st century.

Simply put, secondary sanctions would allow the US to penalise non-US financial institutions or corporations which would go against American interests in dealing with a sanctioned company or individual. They would be able to prevent any US citizen or US institutions from dealing with the contravening party. In effect, if penalized, such party would be unable to do business in the United States or to deal in US dollars.

When Europe and the US are in agreement to implement sanctions against a country or any private individual or corporate, there is obviously no issue. However, if there is dissensus between the US and EU on the course of action to follow, the leeway of European counterparts is therefore extremely limited.

Promoting the use of the Euro instead of the dollar is a logical step to take for European counterparties – and Europe should have done so for a long time. Yet, in dealing with US sanctioned parties, this would only help counterparties (corporates, financial institutions and their staff, potentially) without any activity in the US or in dollar. When 83 percent of world trade is denominated in dollars[5], and when European companies have such huge investments in America, one can measure the challenge and understand why already large groups such as Total have made clear that if sanctions are reinstated against Iran, they will have no choice but to halt their investment program there.

The banking industry is not in a position to take any chance either and even if the EU puts a protective program in place allowing European parties to keep their dealings with a country despite being sanctioned by the US, it is rather unlikely they will make use of it.

Between the rock and the hard place

Banks are indeed in a very difficult position. Losing their banking licence in America or being unable to deal with any US bank is simply not an option. This explains why, often frustrating their clients in the process, they have become docile and zealous enforcers of any US sanctions, however tight the relation with their customers is: non-compliance risk has become as critical - some will say more critical- than credit risk in banks' business assessment.

The tragedy of this situation is that it induces a very risk adverse culture which means that in case of any doubts, banks will often err on the side of caution. In other words, banks, because of the severity of the non-compliance risk are, de facto, amplifying rather than moderating the effects of sanctions.

Let us think about the consequences of the sanctions taken against Mr Deripaska: it is highly probable that most international institutions are preventively reviewing their exposures on Mr Deripaska's companies thus indirectly creating even more pressure for the Oligarch to relinquish his ownership in the various companies he controlled. Going one step further, many institutions are probably already revisiting their outright exposure on Russia amid worries over the possibility further tensions.

New dis-order, New Normality

The picture is bleak arguably. Maybe – hopefully- tensions are simply the manifestation of POTUS' new diplomatic tactics and will abate. Maybe when national security is invoked as a rationale for tariffs and sanctions, this is just rhetoric and easily challengeable at multilateral institutions like the WTO.

Yet the current tensions have roots in an economic crisis we thought we escaped relatively unscathed. When the bad genie of protectionism is out of the bottle, it takes a while to put it back in. If this is correct, then we should brace for further turmoil and trade is likely to be at war for a while longer.

With what effect on the business? All this is obviously not good but let's not underestimate the resilience of the global supply chains. Trade will certainly keep flowing but the question is how is it to be supported by nervous financial institutions?

A flight to quality and safety is likely, as banks will probably prioritize more self-liquidating, short term exposures than longer tenors. As to big strategic shifts (from dollar to Renminbi to Euro, isolation of the US, stronger partnership between China, Russia, Europe), they will not happen overnight.

Venus and Mars need each other anyway and divorce is an unlikely option. That leaves both parties to define new rules of engagement and all of us to muddle through in the meantime. ■

Notes

1. See Guillaume Pitron's La Guerre des Métaux Rares, p124.
2. Foreign Policy June 2017 – The Thucydides' Trap by Graham Allison.
3. 'Of Paradise and Power', Robert Kagan, July 2004.
4. Figures 2017 Source European Union Directorate General for Trade Apr 2018 – converted to dollar at 1.16.
5. Source Swift Trade Traffic 2017 as reported in ICC Global Trade 2018.