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WEEKLY ECONOMIC COMMENTARY

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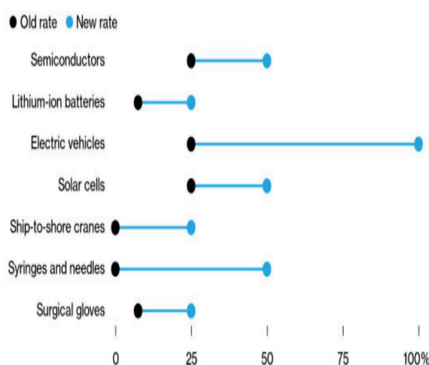
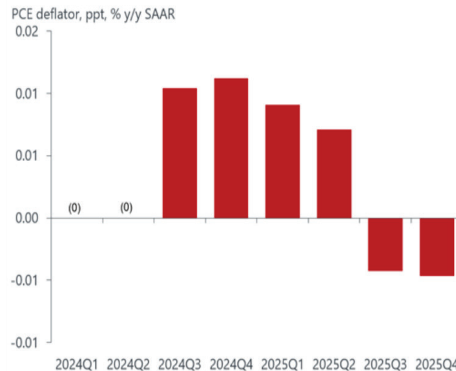
The word "tariff" is descended from an Arabic word meaning "notification." Last week, the United States placed China on notice with a new round of punitive tariffs. The near-term impact of the new measures is likely to be limited, but they raise a host of long-term concerns.

Across the world, a handful of major themes are driving economic strategy. Designing an energy transition to alleviate the consequences of climate change and developing artificial intelligence (AI) to enhance productivity are two of them. Many nations desire to be world leaders in these areas, and their governments have been increasingly engaged in industrial policy in an effort to come out on top.

For China, primacy on these two fronts is not only a long term objective. In the near term, improved exports are key to overcoming a series of economic headwinds that are hindering growth. Beijing has long sought to establish champion firms who can dominate global markets, but this effort has taken on additional urgency amid weak domestic demand and strong international competition.

American trade policy seeks to limit China's advances in critical industries. The view in Washington is that Chinese sponsorship of production places U.S. providers at a disadvantage, which tariffs are intended to remedy. And having native capacity to produce strategic goods is important to national security. The United States does not want to become overly dependent on Chinese semiconductors or batteries.





Sources: Bloomberg, White House, Oxford Economics

In announcing the new tariffs, the Biden administration extended a strategy that had been used extensively by its predecessor. All of the restrictions placed on China since 2018 remain in place, and the list is likely to get longer in the years ahead. Trade control,

especially aimed at Beijing, is one of the very few areas where the Republican and Democratic parties are somewhat aligned.

The announcement of heightened tariffs on electric vehicles (EVs) is unlikely to have much of an impact. U.S. sales of EVs last year totaled 1.6 million units, less than 7% of total vehicle sales. Virtually none of those were Chinese imports. Europe is a much bigger market for Chinese EVs, and so the European Commission's current review of trade fairness in this space has the potential to be more significant.

New tariffs will raise trade tensions.

The increased levy on batteries is another story. More than 70% of lithium-ion cells used in the United States are sourced from China. These components are central not only to EVs, but also to a range of consumer electronics and the transmission of alternative energy. Apart from lithium, China dominates control of the global reserves of other raw materials that are critical to manufacturing long-life batteries. It will therefore be very challenging for the U.S. to develop domestic capacity that would replace Chinese supplies, even in the presence of higher tariffs.

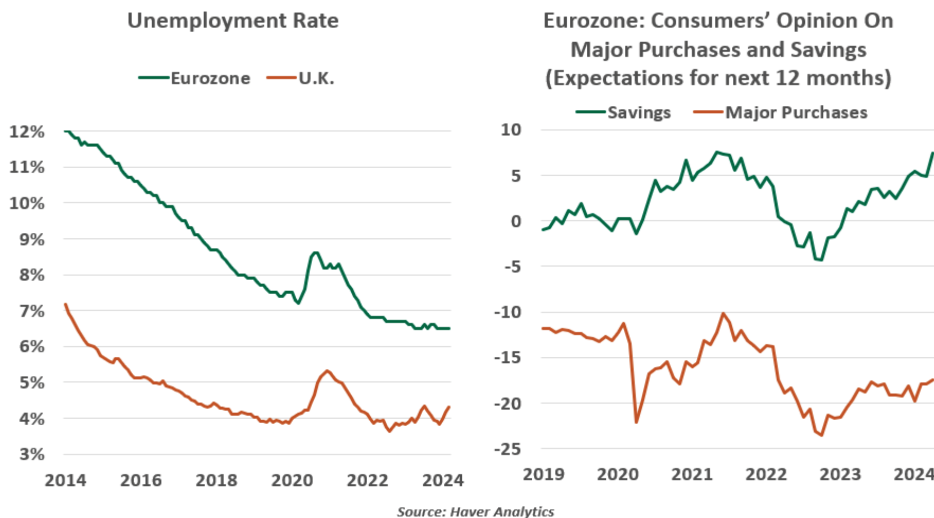
For the moment, China seems unlikely to retaliate in any great measure. Beijing has little appetite for a broad escalation in trade tensions, as it would make the challenge of avoiding deflation more difficult. While tariffs generally increase inflation in the countries that apply them, the impact to American inflation is likely to be very small in the quarters ahead.

But as the world moves further away from free trade and the embrace of comparative advantage, inflation will almost certainly increase. As well, the growing protection surrounding products and components which are important to global energy transition will make it even more difficult to contain climate change. The tariff increases announced earlier this month are in direct conflict with the Biden administration's efforts on this front.

Finally, each increment in trade friction between the United States and China raises the geopolitical friction between the two. The social and economic costs of this troubled relationship are becoming more noticeable.

Retail Therapy

People often raise their spirits by going shopping, also known as retail therapy. Economists are hoping that Europeans seek out this remedy more often as this year unfolds.



Source: Haver Analytics

European consumers grew cautious about discretionary spending in 2022, unsettled by the Ukraine war, the loss of purchasing power from inflation and the bite of high interest rates. Sharp disinflation over the past year fueled expectations that consumption would rebound, but those hopes have yet to be realized.

Labor market resilience has been one of the defining features of European economies in the post-pandemic recovery. Wages are growing at a solid pace, exceeding the rate of inflation. Yet households have remained prudent.

Consumer spending across euro area nations grew just 0.6% last year in real terms (in contrast with 2.2% in the U.S.). Retail sales were flat in the first quarter, while new car registrations declined from the fourth quarter of 2023. Retail sales in the U.K. paint a similar picture of stagnation in March, despite the Easter holiday. Consumer confidence is off its lows, but remains depressed across Europe.

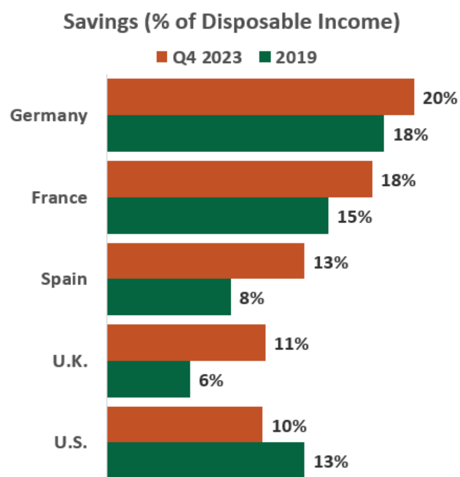
While European economies returned to growth in the first quarter, the consumption picture was quite mixed at the national level. Both Germany and Italy are still suffering from weak domestic demand. Though consumer spending rose in the U.K., the rebound was underwhelming, contributing only 0.1 percentage points to growth.

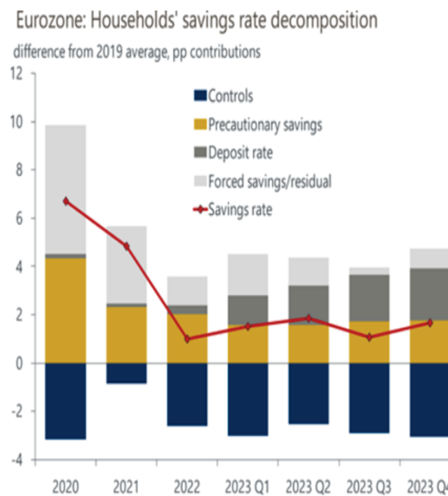
There are several factors that explain the contrasting behavior of European consumers compared to their American counterparts. Firstly, the drag produced by tight monetary policy is stronger in Europe than in the U.S. European mortgages reprice more frequently, raising monthly payments.

Secondly, European countries are engaged in fiscal austerity to a much greater degree than seen in the United States. As part of these efforts, subsidies to soften the costs of staples are being reduced, challenging household budgets.

Third, higher interest rates and decelerating inflation have made savings more attractive to Europeans. Eurozone consumers are now earning around 3.5% interest on their deposits. Savings rates have stabilized above pre-pandemic levels. Household deposits have more than tripled since mid-2022.

Lower policy rates in Europe will favor spending over saving.





Sources: OECD, Oxford Economics

Increasing pessimism around the economic outlook has also prompted caution. Research shows that rebuilding net worth following the pandemic also contributed to the higher savings rate.

The two major European central banks are on track to start making policy less restrictive this summer, which will make saving less attractive and may spur more spending. Lower rates will reduce debt repayment burdens and boost new lending. According to Oxford Economics, 100 basis points of policy rate cuts in the eurozone will likely reduce household savings by €12 billion and boost real consumption by 0.5%.

Household spending in Europe is the largest element of expenditure, accounting for a little over half of nominal gross domestic product in the eurozone and about two-thirds in the U.K. Hence, for a more durable and robust rebound, consumers will have to loosen their purse strings. That would be just the therapy that European economies need.

Levering On Up

Home ownership is a widely-shared financial goal. Among other benefits, homeowners can expect a much greater degree of wealth accumulation. With rare exceptions, residential real estate gains value steadily. In recent years, the pandemic-driven demand surge pushed U.S. home values up at an outsized rate of over 15% per year in 2021 and 2022; they have since held those gains.

But for all their benefits, our homes are not liquid assets. They sometimes feel quite the opposite, requiring homeowners to continually shell out for maintenance and taxes. We may feel wealthy for owning an appreciating asset, but with no cash flow to show for it. Gains in value are only realized after a sale—perhaps to move to a retirement destination, perhaps a windfall bequeathed to our next of kin.

If home equity were more freely realized, the potential benefit to consumption could be tremendous. The ICE Mortgage Monitor Report estimates that Americans have over $11 trillion of *tappable* home equity, the value that homeowners could borrow without exceeding an 80% loan-to-value ratio. Approximately 48 million mortgage holders have tappable equity, averaging $206,000.

Recent increases in home values have produced a surge in household wealth.

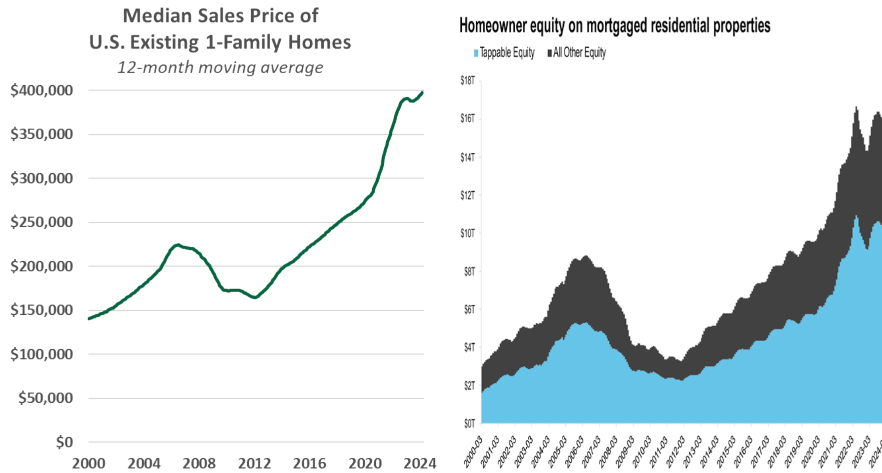
Products are available to extract value from our real estate holdings. Mortgages can be refinanced, with additional cash borrowed in excess of the old loan's principal. Refinancing, with or without cash taken out, is common in a falling-rate environment. Today, these deals are moribund. Borrowers are not eager to let go of their low fixed-rate mortgages.

Borrowers can instead leave their first mortgage intact and take on a second obligation against their available equity, structured either as a closed-end installment loan or a home equity line of credit (HELOC). By pledging the home as collateral, borrowing limits and interest rates are more favorable on these products than could be obtained from a credit card or unsecured personal loan. However, they carry the costs and difficulty of underwriting a mortgage and perfecting a second lien on a property. For that reason, products that access home equity are typically taken out by borrowers intending to finance major expenses like home improvement.

Hoping to enhance consumers' ability to tap their equity, mortgage guarantor Freddie Mac has proposed a new offering to purchase second mortgages. Traditionally, Freddie Mac and Fannie Mae have been the two government-sponsored entities (GSEs) that purchase and repackage residential mortgages into mortgage-backed securities. They have always dealt in first-lien mortgages, but they have not touched second mortgages since reforms were made in the wake of the 2008 global financial crisis (GFC).

Borrowers would benefit from the new initiative by keeping the favorable rate on their existing primary mortgage, while taking out additional cash. The proposed structure of a 20-year installment loan would keep payments low, and the security of GSE sponsorship would keep

interest rates in check. Originators and servicers could earn fee revenue selling and managing these loans. The GSEs would gain a broader view of market risk, as current second mortgage products are typically held on lenders' balance sheets, not in secondary markets.



Sources: National Association of Realtors, Haver Analytics, ICE, McDash +Property

Stimulating home equity borrowing has its down sides.

But the risks of property sector leverage are a not-so-distant memory. Easy lending terms and financial products derived from mortgage debt were the fuel for the GFC. As favorable as the housing outlook is at the moment, that experience taught us that homes can indeed lose value. Newly-minted home equity loans would take the first losses in the event of default, and GSE sponsorship puts U.S. taxpayer funds at risk.

Moreover, allowing homeowners to reach into their equity would jeopardize the much stronger financial position that their homes help them attain. Savings that they might need later in their lives would be drained away prematurely. Financial planners often note that houses are not intended to be automated teller machines; families might be advised to use these assets to sustain their standards of living in retirement. And if the program were to see rapid uptake, the sugar rush of additional cash will complicate the effort to contain inflation.

Adding leverage to household finances is a known recipe for stress. We wish that policymakers would devote more effort to improving the availability and affordability of homes; easier borrowing for current homeowners should not be a priority.

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