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WEEKLY ECONOMIC COMMENTARY

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Global Economic Research
50 South La Salle Street
Chicago, Illinois 60603
northerntrust.com

Carl R. Tannenbaum
Chief Economist
312-557-8820
ct92@ntrs.com

Ryan James Boyle
Chief U.S. Economist
312-444-3843
rjb13@ntrs.com

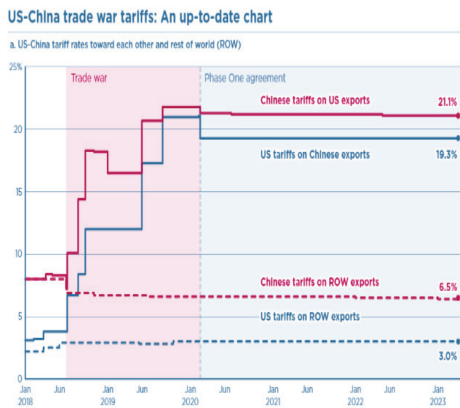
Vaibhav Tandon
Chief International Economist
630-276-2498
vt141@ntrs.com

Rewards and punishments are the alternatives for promoting cooperation. I applied both approaches to train my pet, and discovered that positive methods build a better bond and are more effective at reducing unwanted behavior.

This kind of "carrot or stick" dichotomy also applies to international trade negotiations. Over time, the U.S. has employed both tactics, alternatively leveraging incentives and threats to steer commerce with other nations. For almost a decade, however, sticks have dominated. And regardless of the election outcome, the U.S. is unlikely to be offering carrots to other countries anytime soon.

Trade policy is a focal point in the 2024 U.S. election. Tariffs currently in place affect an estimated $350 billion, or about 18% of the total, in imports from China. China's retaliatory duties cover about $100 billion, or about 11%, of goods arriving from the U.S. The result has been a significant reallocation of trade. China's share of total imports to the U.S. has fallen 8 percentage points since 2018 to about 14%. Countries like Mexico, Canada, Vietnam and Taiwan have filled the void left by Chinese goods.

Chinese exporters have managed to circumvent tariffs and trade barriers to an extent by



Sources: Peterson Institute, Oxford Economics, Haver Analytics

rerouting goods via countries like Vietnam and Mexico. The growing presence of Mainland companies in Mexico, and the widening U.S.-Mexico trade deficit, have become a fresh flashpoint. The Biden administration recently responded with tariffs on Chinese metals routed through Mexico.

The gap between Democrats and Republicans on issues ranging from immigration to fiscal policy are wider than ever. But their differences are much more narrow on matters related to global trade. Job losses in the manufacturing space, along with shifting

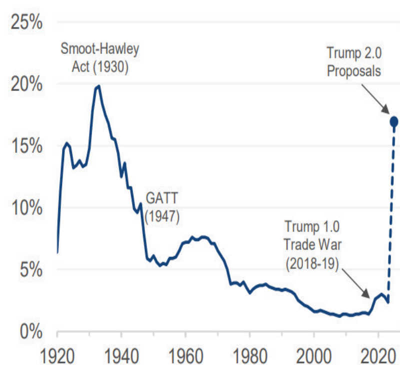
geopolitics, are informing both platforms. Both presidential candidates are focused on making U.S. manufacturing and supply chains more resilient, but they differ in their means of getting there.

Vice President Harris seeks to continue the strategy of offering carrots to domestic producers and sticks to foreign providers. She would carry on the current commitment to industrial policy by boosting investment in infrastructure and offering incentives to domestic firms to deepen their supply chains within the U.S. Sticks are also a factor, as Harris would likely maintain tariffs that are currently in force.

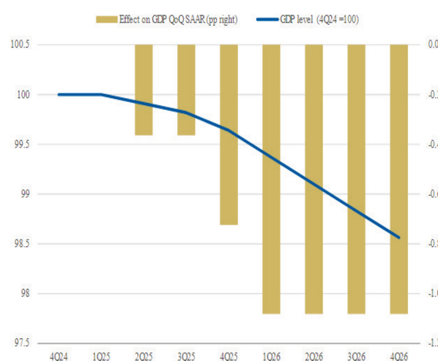
On the other side, former President Trump promises to use sticks more extensively by deploying new tariffs and additional protectionist measures to support domestic industries. If reelected, he has vowed to impose levies of 20% on all imports, 60% to 100% on all goods arriving from China and even more punitive rates on firms that offshore their production.

China is feeling the pain of tariffs, but the U.S. hasn't escaped unhurt.

U.S. Weighted-Average Tariff Rate, 1920-2023



Impact of Trump Tariff Proposals on U.S. Real GDP



Sources: Evercore ISI, Morgan Stanley

These moves would almost certainly lead to retaliation by other countries and would likely generate pushback domestically. As we discussed earlier this year, the truth about tariffs is that they are borne by households, and increasing them would act like a tax increase. However, the executive branch has broad discretion to implement these penalties.

A Harris administration will look to prioritize the US-Mexico-Canada Agreement's (USMCA) renewal and leverage the deal to fulfill its industrial policy and supply-chain security objectives. By contrast, the former President has already threatened to hit Mexican-made goods with 100% tariffs, and potentially insist on modifications to the USMCA when it comes up for review in 2026. At a time when trade within North America is poised to expand importantly, the uncertainty surrounding its terms is hindering investment.

China stands to be the biggest loser from an increase in trade barriers. According to Oxford Economics, U.S. levies on dutiable Chinese goods in combination with China's retaliation would bring China's share of American imports down to just 4%. Various studies have pegged losses of up to 2.5 percentage points to China's gross domestic product (GDP).

That doesn't mean the United States will come out unscathed. Tariffs are a tax on imports, a cost that either reduces margins or is passed on to final prices. With capital and intermediate goods accounting for more than half of U.S. imports, higher levies would lead to increased prices and disruptions across the value chain. Electronics and computer equipment, apparel, metals and furniture will be among the most impacted sectors.

Private and governmental studies have concluded that the U.S.' tariffs have been associated with increased prices, reduced output and lower levels of employment.

According to Morgan Stanley, a 60% tariff on China and a 10% blanket levy on imports from all other parts of the world would add almost a full percentage point to U.S. inflation, lower consumption and business investment by about 3% each and decelerate real GDP growth in the U.S. by 1.4 percentage points over the next two years. Higher inflation could also complicate the Federal Reserve's conduct of monetary policy.

The Tax Policy Center estimates that new Trump tariffs will generate considerable gross revenues. But the boost to net federal revenues will be far lower over the next decade, as those levies would reduce other activity and tax receipts. And the cost to households would be substantial.

Escalating trade battles have left no one better off.

There was a time when U.S. trade policy was quite simple: America, with a large consumer market and competitive private sector, favored trade liberalization as it provided more market access for the U.S and others. This helped keep prices low and improve ties around the globe.

Today, however, there is concern that trade practices in China and elsewhere have limited access for U.S. companies and placed America at a disadvantage. Negotiations have not produced tangible progress, and so penalties have been assessed.

Sticks alone will not bring countries to heel. Eventually, we need to get some carrots back onto the bargaining table if we want better cooperation.

Back To The Well

Increasing headwinds to China's economy (including trade restrictions) led officials to announce another round of stimulus recently. But while the measures were cheered in the financial markets, they got a cool reception from Western economists.

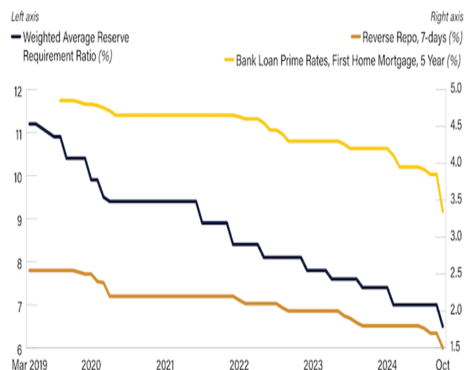
Since the year 2000, China's merchandise exports (in U.S. dollar terms) have grown at a compound rate of almost 12% per year. Trade has been a central driver of China's economic growth, which has averaged more than 8% annually over that time. But the pace of expansion was falling even prior to COVID-19, and the post-pandemic trend of re-shoring has taken a further toll. Chinese exports fell by 5% in 2023.

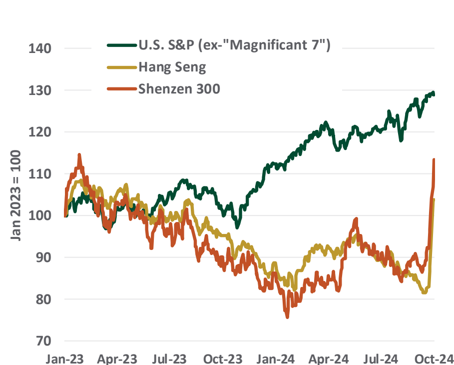
Already low relative to Western countries, household spending in China has fallen off in the last two years. The pandemic increased precautionary spending, and losses on property investments have required some balance sheet repair. While China's reported unemployment rate has been stable, there is concern that it is understated. Joblessness among young workers stands at 17%.

To keep activity from slipping further, Chinese policymakers have been increasingly active. In the spring, they announced a series of measures designed to stimulate production. Our coverage of that effort noted that it might be misdirected; pushing up output amid soft domestic and international demand can serve to increase the risk of deflation. China's producer prices have been declining for some time, and its consumer price index has increased very slowly.

On September 23, Chinese authorities announced another round of policy measures. Interest rates were cut, and the reserve ratios that banks must maintain were reduced. Down payment requirements for loans to purchase second homes were lowered. Additional capital for banks may be made available to boost their ability to resolve losses and sustain lending. Measures to encourage institutional investors to purchase equities were also introduced. China's stock markets welcomed the news, rallying by more than 25% in the two weeks following the announcement.

Economists were more guarded in their assessment. Chinese households and businesses are seeking to control their leverage, so lowering interest rates may not prompt additional borrowing. Promoting equity purchases may push prices further from their fundamental value; historically, experiences with financial stress do not improve until markets are allowed to fully correct.





Sources: Eurasia Group, Macrobond, Bloomberg

Beijing's stimulus has lifted stock markets, but may not lift economic growth.

Chinese authorities did allocate additional funding for state-owned enterprises to purchase vacant apartments and convert them into affordable housing. The total size of the program remains well short of the depreciation in residential property markets, though, and participation in the program has been low so far.

Arresting declines in asset prices can have a favorable impact on public sentiment, which has been flagging in China. For much of the year, Chinese investors have been flocking to the safety of government bonds. The size and timing of the policy changes seemed to suggest that officials are very much aware of the challenges they are facing. Some analysts are expecting further stimulus following the annual "Two Sessions" gathering next March, if not before.

China's growth picture will not brighten without substantial assistance for domestic demand. A prominent Chinese economist has proposed a program equal to 10% of China's gross domestic product, which would be more than the spending done by the United States in the wake of the 2008 financial crisis. A key difference, however, is that Americans were only too glad to spend the money given to them; incentives may have to be offered to Chinese households to overcome their preference for saving.

The acknowledgement of the depths of economic challenge by Chinese officials is a positive step. But the journey to recovery will be long, and Western countries will continue to put roadblocks in the way.

On The Waterfront

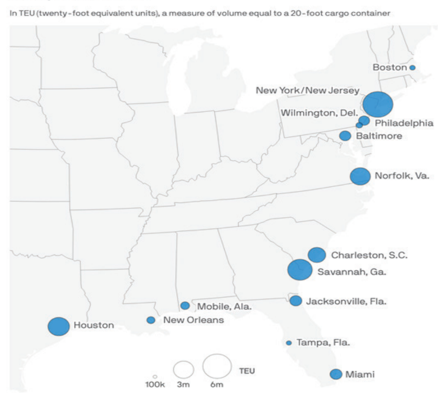
Sports fans know that a lot can change in the fourth quarter of a game. So too for the U.S. economy, as a substantial labor action commenced the minute that calendars turned to the fourth quarter of 2024.

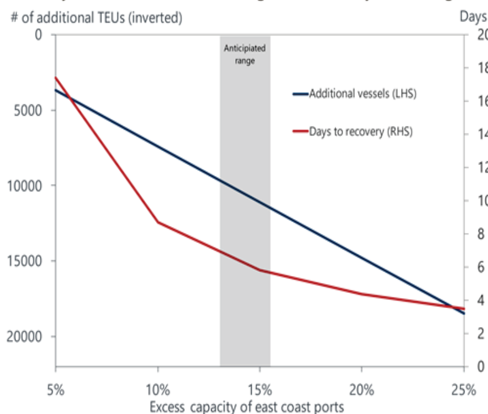
Roughly 45,000 members of the International Longshoremen's Association union conducted a brief strike this week. These are the workers who move cargo between ships and ground transportation. The 14 affected ports, spanning from Texas to New England, account for 19% of the nation's imports and 10% of exports, by value. The workers' primary demand was protecting their jobs against automation, along with higher wages.

One demand proved easier than the other. An offer by the U.S. Maritime Alliance of a graduated 62% wage increase over five years was enough to end the strike after three days. But the deal only runs through January 15 of next year. Negotiations will continue on the more thorny issue of protecting workers' jobs against automation. This trend is inexorable and not unique to the ports; strident demands may be in vain.

The strong leverage of workers was a theme of the COVID reopening cycle. A shortage of labor amid high demand enabled workers to make more aggressive demands. Despite a normalizing labor market, the stevedores demonstrated that labor still has some power. Consultancy RSM estimated a loss of $4.3 billion in trade, or about 0.1% of gross domestic product, for each week the strike carried on. The knock-on shortages of fresh food and raw materials for production of vehicles and pharmaceuticals had the potential to cause broad upset.

While short, the port strike showed that supply chain friction can still arise.





Sources: U.S. Army Corps of Engineers / Axios, Oxford Economics, Sea-Intelligence

The strike was one among many reasons to be braced for an unusual interval ahead. A prolonged walkout could have weighed down readings of employment and gross domestic product. The damage from Hurricane Helene is still being tallied but has certainly brought some regions to a standstill. Oil prices are on the rise again amid escalations in the Middle East. Election uncertainty is forestalling decisions about investments. The fourth quarter, only days old, is already bringing much more suspense than we would like.

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@NT_CTannenbaum

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