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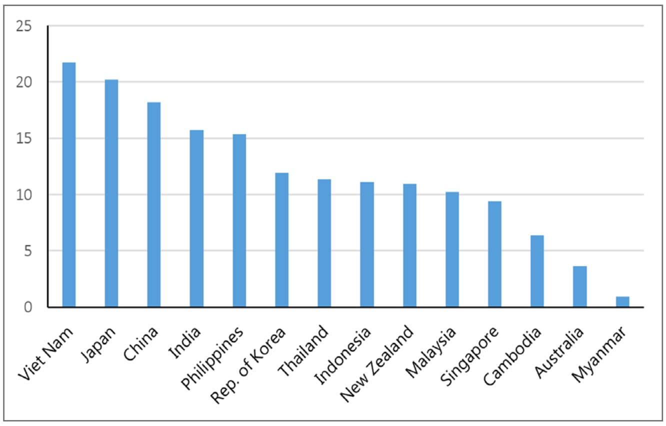
US' Trade Policy: Impacts on East Asia and Possible Retaliation

The 'America-First' trade policy, as stated in the '2017 Trade Policy Agenda', has four key elements. First, the Trump administration reiterates the conviction of Congress that Americans are not directly subject to World Trade Organization (WTO) rulings. Second, it is committed to using a 'safeguard' that allows the President to impose import relief if increasing imports are deemed to cause harm to domestic industries. Third, the United States (US) administration is committed to using all powers available to it to encourage countries to give US producers' fair and reciprocal access to their markets. Last, the Trump administration favours bilateral negotiations and will insist on fair trading practices by its trade partners.

The President's 2017 Trade Policy Agenda suggests US trade policy takes a more aggressive approach to fix the trade imbalance between the US and its trading partners. The US has already pulled out of the Trans-Pacific Partnership. In addition, one of the proposals of the Republicans regarding trade policy is the introduction of a US border adjustment tax. In brief, this measure implies that for the purpose of corporate tax payment, the costs of imported inputs can no longer be deducted from a company's total revenue while revenues from exports will not be included in a company's total revenue, making goods exports tax free. This measure will in effect be a tax on imports and a subsidy on exports.

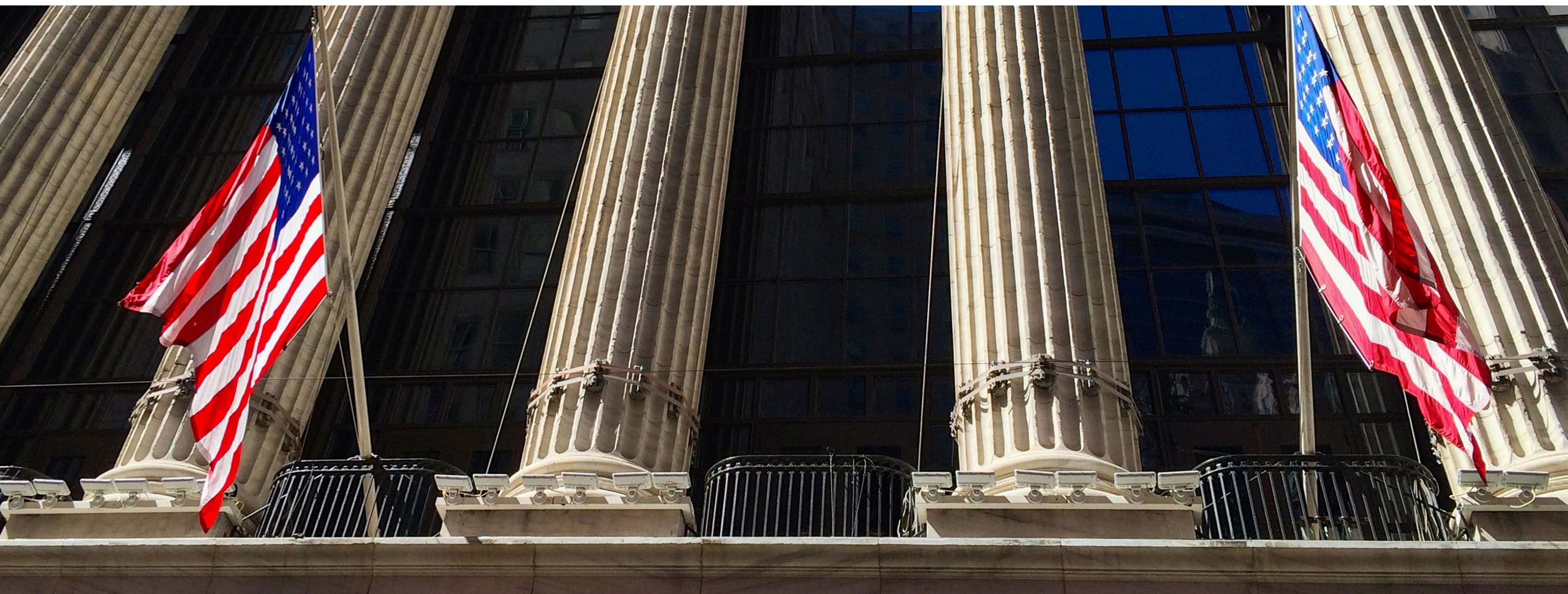
Should the US implement the border adjustment tax, it is very likely that East Asian countries, with their high reliance on the US as their export destination, will be adversely impacted as exports to the US market made up 22% of Viet Nam's total goods exports, 20% of Japan total goods exports, and 18% of China's total goods exports in 2016 (Figure 1). Furthermore, 17% of Southeast Asia's total exports went to China and 9% of Southeast Asia's total exports went to Japan, which makes them vulnerable to indirect effects of the Trump administration's policies targeting China and Japan.

Figure 1. Export to the US as a share of total export (%)



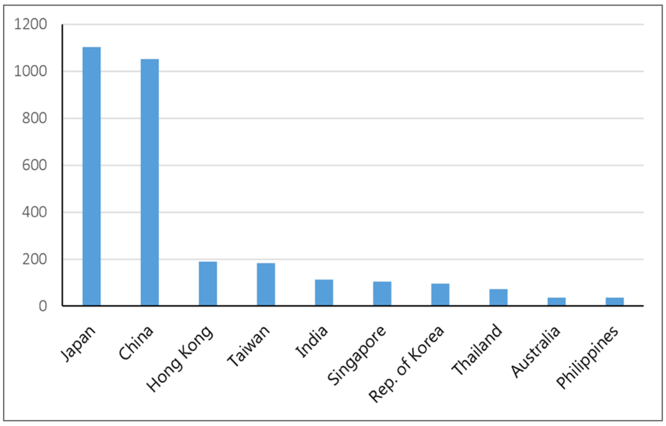
Source: CEIC, 2017.

Although it has not been implemented yet, the Trump administration's aggressive trade policy is likely to face retaliation from East Asian countries as it seems bound to be disrespectful of WTO rules. Retaliation might be carried out on two fronts: source of financing and trade.



On the source of finance, East Asian countries, especially Japan and China, have some leverage as they are the largest and second-largest holders of US debt, respectively, based on January 2017 data (Figure 2), with Japan holding 18.5% of US debt held by foreign countries and China 17.6%. Their decisions on whether to sell US Treasury Securities affect the level of bond yields of US Treasury Securities. If they decided to dump US Treasury Securities, the cost of debt for the US to fulfil its obligations would increase.

Figure 2. East Asian Countries Possession of US Debt (in Billion USD)



Source: US Department of Treasury, 2017.

However, it is unlikely Japan and China would dump their US Treasury Securities, for two reasons. First, although in absolute value terms their holdings of US Treasury Securities amount to an astonishing US$2.15 trillion, their total value comprises only 10.8% of total US Treasury Securities in circulation in the global market, while 66% of US Treasury Securities are held by domestic financial actors and institutions. Second, as the purpose of countries holding US Treasury Securities is partly to maintain the value of their exchange rate, it is unlikely Japan and China would take such action as it would have implications for their exports – should they decide to reduce their holdings of US Treasury Securities, given that the US Treasury Securities market is very liquid, the effect on the yield will be quite limited while the effects of the fluctuations of their currencies would probably have a negative impact on their exports.

On the trade retaliation front, it is still unclear how East Asian countries would respond to any aggressive trade policy aiming to curb US imports. What is for sure is that a trade conflict would harm all parties involved. If pressed, China might retaliate in two ways: by increasing tariffs on products on which it runs a trade deficit with the US (for example soybean and maize imports from the US); and by imposing tighter regulations on US firms that produce and operate in the country. The latter would be more likely than the former as China would not allow customers to pay higher prices, and soybean and maize in particular are basic daily consumer products as well as inputs for many derivative products. Further, to ease the tensions that have arisen as a result of the US complaint that China enjoys a US$347 billion trade surplus with the US, China will consider allowing increased foreign equity caps in the financial sector (i.e. on securities and insurance), which is expected to be further discussed in the context of negotiations on a China–US bilateral investment treaty, and end the ban on beef imports from the US and buy more agricultural products.

To conclude, after three months in power, President Trump has proved that he is intent on keeping his campaign promises to curb imports from overseas and take a step back from multilateral agreements the US had traditionally championed. Although actual policy measures taken so far are still limited and require the approval of the US Congress, it is clear that the current administration is unfavourably disposed towards free trade. At the same time, it is still unclear how the East Asian countries would react as there are potential costs and benefits arising from retaliatory measures both through the financial system and through trade policies. It is widely assumed that China and Germany are likely to lead on trade liberalisation through multilateral forums and agreements.

Fed Rate Increase: Limited Impact on East Asia

The US central bank, the Federal Reserve (Fed), raised its target range for the federal funds rate (FFR) from 0.75% to 1% in March 2017, the third time the Fed raised interest rates in the last decade. The increased interest rate reflects the strengthened US economy, as evident from four main indicators.

First, the US economy continued to expand at a moderate pace of 2% in Q4 2016, supported by 3.1% private consumption growth. Second, job gains averaging about 200,000 per month from December 2016 to February 2017 maintain the solid pace seen over the past year with the result that the rate of unemployment reached a recent low at 4.7%. Third, the seasonally-adjusted consumer price index rose by 2.8% in January compared to 0.85% last July. Further, core inflation – which excludes volatile energy and food prices and tends to be a better indicator of future inflation – was 2.2% in January, which is in line with the Fed's longer-term objective of 2% inflation. Last, the upward trend in the US Institute for Supply Management's Purchasing Managers Index, which rose from 50.7 in April 2016 to 57.2 in March 2017, indicates that there is higher business confidence in the US economy, especially in the manufacturing sector.

In light of these facts, the Fed argued that it took its decision to maintain macroeconomic stability now to prevent the economy from overheating. It also took into account that a rapid rise of the FFR in future could risk disrupting financial markets and pushing the economy into recession.

Although traditionally Fed rate increases have adversely impacted foreign economies through currency depreciation and stock index drops as the capital flows back to the US, the two rate increases in December 2016 and March 2017 have not adversely affected East Asian countries. This is evident from the upward trend of East Asian stock indexes and the relatively stable US exchange rate in the past 3 months (Table 1).

Table 1. East Asian Countries – Selected Monetary Indicators Movement

Monetary Indicators	Value on			Change since	
Foreign Exchange Rates (Monthly Average)					
USD Exchange Rates	**Mar-16**	**Dec-16**	**Mar-17**	**Dec-16**	**Mar-16**
IDR	13,193	13,417	13,346	0.5	(1.2)
MYR	4.06	4.46	4.44	0.5	(9.1)
PHP	46.7	49.8	50.3	(0.9)	(7.6)
SGD	1.37	1.44	1.40	2.2	(2.4)
THB	35	36	35	2.5	1.0
VND	21,876	22,138	22,254	(0.5)	(1.7)
AUD	1.33	1.36	1.31	3.6	1.5
CNY	6.50	6.92	6.89	0.4	(6.0)
INR	66.9	67.8	65.8	3.0	1.6
JPY	113	116	113	2.7	0.0
KRW	1,182	1,183	1,134	4.2	4.0
NZD	1.48	1.42	1.43	(0.5)	3.7
Stock Market Index (End of Month)					
JCI Indonesia	4,845	5,297	5,568	5.1	14.9
FTSE Malaysia	1,718	1,642	1,742	6.1	1.4
PSEi Philippines	7,262	6,841	7,311	6.9	0.7
Straits Times Singapore	2,841	2,881	3,175	10.2	11.8
SET Thailand	1,408	1,543	1,579	2.3	12.2
ASX Australia	5,152	5,665	5,864	3.5	13.8
SHCOMP China	2,979	3,103	3,222	3.8	8.2
SENSEX India	25,342	26,627	29,620	11.2	16.9
Nikkei 225 Japan	16,759	19,114	18,909	(1.1)	12.8
KOSPI Rep. of Korea	1,996	2,026	2,160	6.6	8.2
NZSX New Zealand	6,752	6,881	7,196	4.6	6.6
S&P 500 Index	2,035	2,238	2,368	5.8	16.4

Source: CEIC and Bloomberg, 2017.

There are two main reasons why East Asian countries are not experiencing any significant turbulence in their financial systems. First, investors have priced in tighter Fed monetary policy since the first FFR increase in December 2015, thereby limiting the impact of asset reallocation after the recent two FFR hikes. Second, they have managed their economies fairly well, as shown by stabile growth rates, healthy current account balance to GDP ratios, appropriate foreign exchange reserve levels, and more flexible exchange rates (Table 2).

Although so far the FFR increase has not had any adverse impact on East Asian economies, as can be seen from the stable movement of currency exchange to the US dollar and rebounding stock markets, those East Asian countries with current account deficits and high external debt to GDP ratios are still vulnerable to currency depreciation vis-à-vis the US dollar. In addition, higher US benchmark rates also limit the room for Emerging East Asian countries to lower their policy rates to stimulate their economies.

Table 2. East Asian Countries – Selected Macroeconomic Indicators

	GDP Growth (%)		Current Account/GDP (%)		External Debt/GDP (%)		FX import cover (months)	
Country	**2016**	**2017**	**2016**	**2017**	**2016**	**2017**	**2016**	**2017**
Indonesia	5.0	5.2	-1.8	-1.9	33.9	30.5	8.8	8.3
Malaysia	4.2	4.4	2.0	3.1	65.5	67.4	6.3	5.9
Philippines	6.9	6.4	1.1	0.8	25.6	25.9	9.8	9.3
Singapore	2.0	2.1	19.0	19.3	157.4	152.7	6.8	6.8
Thailand	3.2	3.4	11.4	11.6	32.1	31.1	9.4	9.2
Viet Nam	6.2	6.6	1.7	-0.4	41.6	39.2	2.5	2.3
Australia	2.5	2.8	-2.6	-2.1	122.8	118.9	2.6	2.5
China	6.7	6.2	2.3	1.8	12.2	12.1	18.7	16.5
India	7.1	7.2	-0.5	-0.8	22.4	22.3	9.1	9.0
Rep. of Korea	2.7	2.8	7.0	7.6	26.5	25.5	8.9	8.3
New Zealand	4.1	3.3	-3.0	-3.1	46.7	45.5	4.5	4.1

Source: Economist Intelligence Unit, 2017.

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