Global Macro Research

Top of Mind

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Issue 54

Trade Wars

From the editor: Given President Trump's long-held views that the US has been losing out on foreign trade, the likelihood and consequences of a trade war are Top of Mind. We share our views on how US-China trade tensions could play out: US action on China's currency policy and unilateral, targeted tariffs are likely, and China would respond proportionately. We then ask the same of two trade experts: Claire Reade, who formerly oversaw US trade negotiations with China (Trump is likely to hit Chinese manufacturing industries but will probably refrain from a blanket tariff) and Tu Xinquan, Dean of the China Institute for WTO Studies (China will hit back swiftly—and harder). The likely macro impact of a trade war? A drag on US growth, Fed rate cuts, and knock-on effects across Asia. More inside on targets of protectionism, dollar implications, and perspectives from CFR President Richard Haass on US leadership in trade and beyond.

Source: www.istockphoto.com.

Inside

Click here for a video summary

"Trump strongly believes that the US has substantial leverage… and therefore thinks that he can achieve whatever he wants with this confrontational strategy. But I disagree."
Tu Xinquan

"Trump's willingness to cross lines shakes up people's thinking, which has the potential to increase opportunities… But it also increases risks, especially if you miscalculate on red lines."
Claire Reade

"I do not see any logic in trying to improve relations with Russia on the grounds that it either gives us leverage over China or is a substitute for a good US-China relationship."
Richard Haass

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Macro news and views

We provide a brief snapshot on the most important economies for the global markets

US

Latest GS proprietary datapoints/major changes in views

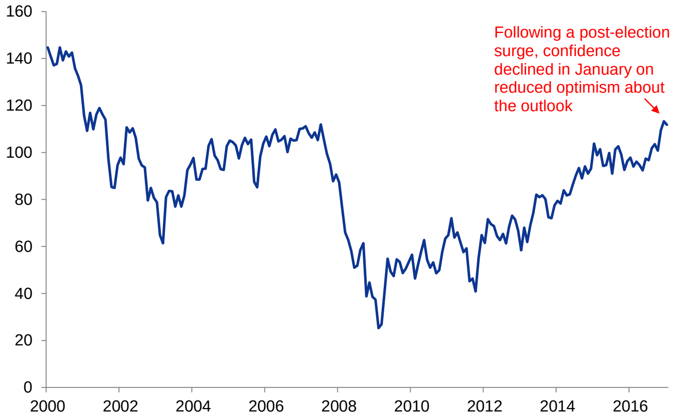
- We lowered our subjective odds of a Fed rate hike in March to 15% from 35% previously, reflecting the muted wage growth and higher unemployment rate in January's payrolls report. However, we raised our odds for June to 45% from 40% and continue to expect three hikes in 2017.

Datapoints/trends we're focused on

- Discussions by Fed officials on the central bank's balance sheet; we expect full reinvestment until mid-2018.
- Consumer confidence wavering near a 15-year high.

Past the "post-election surge"

US consumer confidence index, 1985=100



Source: The Conference Board, Haver Analytics.

Japan

Latest GS proprietary datapoints/major changes in views

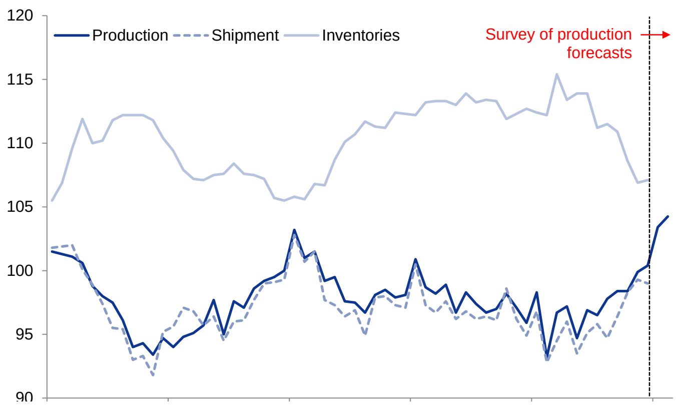
- No major changes in views.

Datapoints/trends we're focused on

- The dichotomy between stronger exports and production, driven by external demand, and still-sluggish domestic consumption. Export volumes rose 8.4% yoy in December, while retail sales momentum slowed to 1.7% yoy.
- A narrowing yoy decline in core CPI inflation, which we expect to turn positive in Q1 on higher energy prices.
- The highest number of non-farm jobholders on record.

Production pick-up

Japan industrial activity, indexed to 100 in 2010



Source: METI.

Europe

Latest GS proprietary datapoints/major changes in views

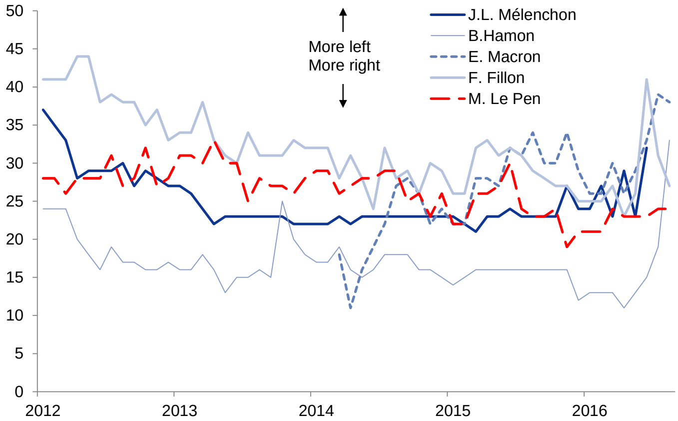
- No major changes in views.

Datapoints/trends we're focused on

- The UK Parliament's vote in favor of starting Brexit talks, putting PM May on track to invoke Article 50 in March.
- A string of political surprises in France, including Benoît Hamon's victory of the center-left primary, making the line-up for the 2nd round of presidential elections less certain.
- A soft upward trend in German core inflation, implying a very gradual pick-up in Euro area-wide core inflation this year.

A crowded playing field

French presidential candidates' "popularity barometer" ratings, %



Source: Kantar, TNS.

Emerging Markets (EM)

Latest GS proprietary datapoints/major changes in views

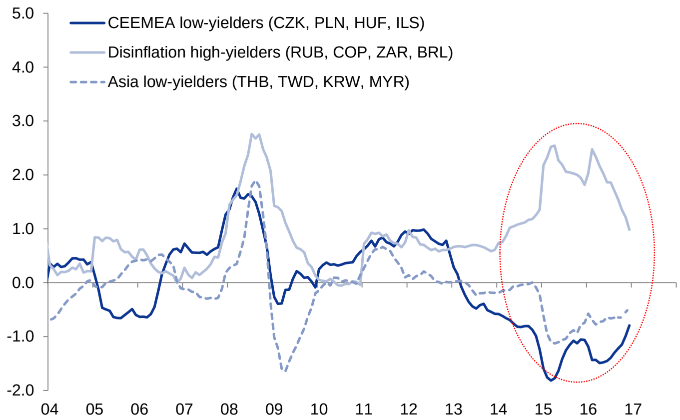
- No major changes in views.

Datapoints/trends we're focused on

- Risks from US trade policy, particularly in Mexico and EM Asia, even as hard data on EM exports continue to improve.
- An expected slowing of sequential growth in China in Q1, evidenced so far by declines in January manufacturing PMIs.
- A record low in Mexico consumer confidence, -26% yoy.
- Convergence of inflation trends across EM as inflation expectations approach targets from above and below.

Meet me in the middle

One-year ahead consensus inflation expectations vs. targets, %



Source: Consensus Economics, Goldman Sachs Global Investment Research.

Trade wars

As US President Trump's first 100 days get underway, investors are still trying to understand where his convictions and priorities lie. Although Trump has promised sweeping changes across the policy arena, he has arguably been most consistent on his views in one area: trade. In fact, his apparently deep-seated sense that America has gotten a raw deal on trade traces back to at least the 1980s, when he levelled virtually the same attacks against Japan that he does today against China (see pg. 9). It's therefore no surprise that his trade appointees and advisors mostly share his critical views, and that he spent some of his first few days in office beginning to walk away from trade agreements old and new. But whether Trump is truly willing to start a trade war, and what one would mean for growth, the dollar, and America's place in the world, is Top of Mind.

We begin by focusing on China, a focal point for Trump's trade advisors. GS Senior Political Economist Alec Phillips and Chief Asia-Pacific Economist Andrew Tilton walk us through how shifting US-China trade relations might play out. Their view: The Trump administration is likely to announce some measures on China's currency policy and impose unilateral tariffs targeting some Chinese imports that compete with US production, leading China to respond proportionately. Phillips and Tilton see some trade and investment issues where the two countries could instead strike alternative "deals" but, for now at least, US-China trade tensions look set to escalate.

We then ask two trade experts—one from the US, and one from China—for their take. Former Assistant US Trade Representative for China Affairs Claire Reade believes that Trump's desire for "quick wins" on trade will lead him to hit China's traditional manufacturing industries like steel, aluminum, and glass, be it with standard tools under the WTO or using executive authority afforded under some US laws. But she is fairly optimistic that the US administration will refrain from using across-the-board tariffs against China, which, in her view, would disrupt financial markets and ultimately end up as a "loss" for Trump. That said, Reade warns that China will respond quickly to *any* US action on trade, especially given that President Xi will not risk looking weak in the run-up to this year's leadership transition. And if China feels that a US action is extremely unfair or threatening, its response could be orders of magnitude greater.

Tu Xinquan, Dean and Professor at the China Institute for WTO Studies at the University of International Business and Economics in Beijing, agrees that China would retaliate swiftly against even a slight increase in tariffs. In his view, retaliation would likely take the form of tariffs on imports from the US in sectors such as agricultural products, cars, machines, or airplanes. Although targeting US companies in China could happen, Tu thinks the benefits from foreign direct investment are important enough for China to make this a last resort. But generally speaking, he believes the US has far less leverage over China—or other countries—than Trump might think, and argues that US influence will decline further as a result of Trump's withdrawal from the Trans-Pacific Partnership (TPP).

We then look more broadly at the likely targets of US protectionism. GS Emerging Markets (EM) Macro Strategist Ian Tomb assesses probable targets through the lens of voters in the politically important "swing states" that have likely felt most-harmed by labor competition from abroad. His answer: sectors such as machinery, motor vehicles, and apparel (in which these states experienced large job losses), and the countries that export these goods to the US—mainly China, other Asian EMs, and Mexico. (GS US Economist Daan Struvyen takes a different approach but reaches similar conclusions on pg. 8). On the flip side, Tomb asks who would suffer the most if the US takes protectionist measures; spoiler alert—US consumers and Mexico, which depends significantly on US buyers across broad swaths of its goods exports.

That said, GS Head of Latin American Economics Research Alberto Ramos argues that US tariffs would not necessarily succeed in pricing Mexican exporters out of the US market—ironically, in large part because of the substantial weakening of the MXN on the back of Trump's trade rhetoric. At the same time, he notes that US-Mexico trade relations are much more of a two-way street than, say, US-China trade ties, which should give Trump pause in targeting Mexico (although that hasn't seemed much of a deterrent so far…). The potential silver lining for Mexico: It should benefit from any improvement in US growth and could also lose a major competitor in the US market if US protectionism is directed elsewhere (i.e., China).

What would be the fallout from a trade-war scenario? The US would likely see higher inflation and a considerable drag on growth. Specifically, GS Global Economist Nicholas Fawcett estimates that Trump's proposed 45% tariff on China and 35% tariff on Mexico (with both countries retaliating in kind) would lower US GDP growth by 0.7pp by 2019, causing the Fed to cut rates even as consumer prices rise. And as Andrew Tilton points out, the impact of any US tariffs on China would reverberate across Asia through the region's cross-border supply chains, with small open economies like Taiwan and Korea particularly hard-hit.

And what would be the dollar implications? On the face of it, Trump's protectionist policies should prove dollar-supportive. But beyond this broad view, the dollar has been in focus in the context of the House Republicans' proposal for destination-based taxation with border adjustment (the not-so-catchy "DBTBA"—see pg. 19 for more). Proponents of the policy argue that taxing goods and services based on where they are sold—which would help exporters and hurt importers—would trigger an immediate, sharp appreciation of the dollar, c. 25%. GS FX Strategist Michael Cahill is skeptical on this front, but notes that markets would likely interpret DBTBA as an escalation of trade tensions. In that scenario, dollar strength against EM currencies—especially large exporters such as the KRW and RMB—seems more certain than against G10.

Finally, for a broader perspective on Trump's trade proposals and worldviews, we turn to Richard Haass, President of the Council on Foreign Relations. His key message: Stepping back from trade—and global leadership more broadly—will harm, not help US interests.

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Assessing the options on US-China trade

Andrew Tilton and Alec Phillips write that US-China trade tensions look set to escalate, but an alternative "deal" should not be ruled out

Investors in Asia, the US, and elsewhere are contemplating the prospects of US-China trade friction, if not an outright "trade war." President Trump's campaign threats to "use every lawful presidential power to remedy trade disputes" if China "does not stop its illegal activities," as well as his choice of key advisers who argue that the US has been hurt by the existing trade regime, have put the prospect of significant tariffs or other unilateral protectionist actions on the table.

Revisiting a "bad deal"

Trump and his advisors' comments focus heavily on the trade imbalance between the two countries – $319bn in 2016 (2.8% of China's GDP and 1.6% of US GDP). This imbalance in trade flows is mirrored by an employment shift, as US manufacturing facilities (and jobs) were "offshored" over the years, particularly in the wake of China's entry to the World Trade Organization (WTO) in 2001. Of course, not all US manufacturing jobs were lost to China; offshoring to other countries played a role, and automation a much bigger one. But credible estimates have suggested that Chinese import competition cost the US up to 2.4mn jobs—including nearly 1mn in manufacturing[1]—between 1999 and 2011. And some economists have found evidence that US job losses have corresponded with Chinese gains in the same sectors.[2] While some of these US workers found reemployment in other sectors, in the eyes of Trump's trade team, this imbalance in trade and manufacturing employment represents a "bad deal" that needs to be renegotiated.

The US trade toolkit

Market concern has focused on possible US measures to restrict imports from China. Broadly speaking, such measures include "small" and "large" actions. "Small" actions might entail taking antidumping measures or countervailing duties (tariffs applying to specific industries) or filing cases against China in the WTO, both of which prior US administrations have utilized frequently. Declaring China a "currency manipulator"—as Trump promised during the campaign to do on his first day in office, but later stepped back from—would also fall into this category, as it obligates the US Treasury only to implement "enhanced monitoring" in the first instance and imposes few meaningful penalties even in the worst case.[3]

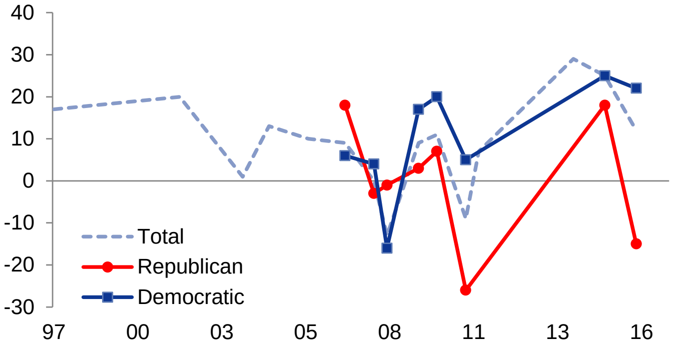
More substantial US actions would include across-the-board tariffs on Chinese imports (Trump advisor Peter Navarro proposed 45%) or a "border-adjusted tax," which would effectively be a tariff on imports from all countries.

US escalation in the cards?

We believe the Trump administration is likely to make an announcement on China's currency policy and impose unilateral tariffs on a number of products. In general, we expect this administration to be much more active in using existing "trade enforcement" tools than recent administrations, for three reasons. First, the domestic political atmosphere regarding trade has changed, with increased skepticism of trade agreements and greater opposition to "free trade" among Republican voters. Second, President Trump has emphasized the importance of negotiations in a variety of areas, and taking unilateral action might be viewed as an opening step in negotiations with trading partners over broader policy changes. Third, and most importantly, Trump has been publicly critical of US trade policy for decades and made it a key aspect of his campaign; we see little reason to believe that he will not follow through on these commitments in general terms, particularly given that the President has authority to impose tariffs and other trade restrictions.

Republicans less keen on free trade

Share of survey respondents that views trade agreements as a "good thing" minus the share that sees them as a "bad thing"



Source: Pew Research Center (last survey conducted March 17-27 2016).

It is not yet clear what President Trump will do on trade enforcement, but the most likely options in the near term involve the announcement of a formal process to determine whether China is "manipulating" its currency, and the initiation of trade remedy cases on products that have significant domestic production but where imports constitute an important share of the domestic market, like steel, large appliances, machinery or possibly parts of the auto sector. While we are reasonably confident that there will be new restrictions put on some product categories, we are less certain regarding the likelihood of broader tariffs applied to all imports from a given country, or in general. The president has the authority under several US laws to impose such tariffs if he chooses, and the Trump transition team was reportedly considering a tariff on imports as high as 10% in December, according to a transition team member. Our expectation is that near-term activity is likely to be limited to targeted actions, with blanket tariffs held out as an additional tool that might be used later.

China's options to return fire

Should the US act unilaterally, Chinese policymakers are likely to react proportionately, in our view. Smaller actions (e.g.,

[1] Acemoglu, Daron, David Autor, David Dorn, Gordon H. Hanson, and Brendan Price. "Import Competition and the Great US Employment Sag of the 2000s." *Journal of Labor Economics*, 2016.

[2] Ebenstein, Avraham, Margaret McMillan, Yaohui Zhao, and Chanchuan Zhang. "Understanding the Role of China in the "Decline" of US Manufacturing." 2012.

[3] Technically, China does not meet all three of the criteria for currency manipulation used by the US Treasury in its latest report on trading partners' foreign exchange policies. However, these criteria could be modified by the administration, and would also not prevent unofficial "tweets" to the same effect.

"currency manipulation" accusations) might be met with public statements or targeted reprisals against limited categories of US exports. Retaliation would not necessarily take the form of tariffs; "health inspections" of food commodities or other such measures could be employed, or US firms could find it more difficult to obtain licenses or otherwise do business in China.

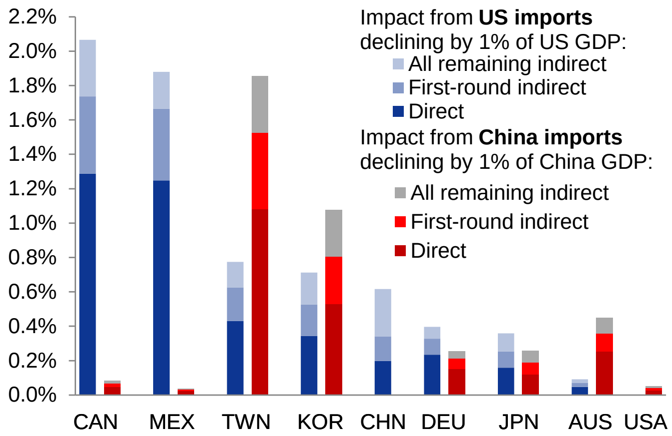
Larger US actions could elicit multiple smaller responses, or a shift in approach. For instance, China could reallocate reserves out of US Treasuries, and/or take actions to ameliorate the impact of US tariffs on its economy, albeit with some constraints. Fixing the CNY weaker against the USD is one possibility, though this could exacerbate capital outflow pressures. Another strategy would be to accelerate efforts on regional trade deals such as the Regional Comprehensive Economic Partnership; these are underway in any case, but it will take time before they have a material impact on the countries involved. Regardless, the attention on China's policy positions ahead of this year's political transition makes it unlikely that any US action on trade would go unanswered.

The fallout

The impact of US-China trade frictions will naturally depend on the scope of the measures taken. While "small" US actions—particularly antidumping measures similar to the recent levies on tire imports from China—could have significant industry-level effects, they would be unlikely to change the macroeconomic outlook for either country. In contrast, more broad-based US tariffs or taxes would have substantial impacts on trade flows and growth. For context, our global economics team has estimated that an 11% increase in the US' effective tariff rate would slow US growth by 0.7pp by 2019 (see pg. 14).

A hit to more than just the parties involved

Impact on output (% of GDP) from declines in US/China imports[4]



Source: World Input-Output Database, GS Global Investment Research.

More broadly, a trade war would very likely cause collateral damage in Asia, particularly to smaller open economies. We have noted, for example, a greater share of value added in US computer imports comes from Asia ex-China than from China itself (see also pg. 8). And the integration of cross-border supply chains means that small open economies like Korea and Taiwan would be highly sensitive to US and/or China trade barriers, even if they themselves are not targeted specifically. For example, we find that a reduction in US imports by 1% of US GDP (or about 7% of US imports) could cause Taiwan and Korea to lose output worth about 0.7-0.8% of GDP—potentially larger than the impact on China.[4]

Another way forward

Of course, a US-China trade escalation may yet be avoided. In fact, there are some areas where Washington and Beijing may be more likely to reach a mutual understanding. With the new US administration only a couple of weeks old, it's hard to be confident, but we would make a few observations.

First, the US could seek to reduce its trade deficit with China via measures other than tariffs. For example, steps to protect US intellectual property and other measures to enhance US services exports could help boost Chinese imports from the US. Quantity restrictions on Chinese exports (similar to the "voluntary export restraints" on Japanese autos in the 1980s) could be another route, although reaching an agreement on such measures would be considerably more difficult.

Progress on the US-China Bilateral Investment Treaty (BIT) is another possibility. Though Trump has spoken out against multilateral trade agreements, he has been more supportive of bilateral deals and has not focused on the BIT, which would set rules for foreign direct investment (FDI) and has been in negotiations since 2008. Admittedly, a large-scale US opening to FDI from China seems unlikely given the Trump administration's concerns about how prior agreements have worked out—in fact, the risks lean in the other direction. That said, the US administration also appears focused on ensuring reciprocity in trade relations. In the case of FDI, China has been more restrictive than the US—though both impose significant constraints on investment from the other—and if the administration sees Chinese investment in the US as a source of jobs, some limited steps in this area might be allowed.

Finally, it is worth noting that Chinese and US interests are currently aligned on what is often a contentious aspect of any trade negotiation—their exchange rate. Both China's policymakers and Trump would prefer a weaker US dollar—the former because it would reduce capital outflow pressures, and the latter for trade competitiveness reasons. Of course, willing it to be so is not enough. Trump's upcoming appointments to the Fed (including the Chair and Vice-Chair in 2018) could have a substantial impact on the path of policy.

In short, while US-China trade tensions look set to escalate, an alternative "deal" that serves the interests of both countries should not be ruled out.

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[4] Note that these estimates refer to the impact on gross output, i.e., production activity, and not on GDP growth. GDP is a measure of value added—the value of gross output, less the value of material inputs purchased. If converted to value-added terms, the losses in Taiwan and Korea would be 0.4-0.5% of GDP.

Interview with Claire Reade

Claire Reade is the former Assistant US Trade Representative for China Affairs (2010-2014). In this capacity, she was responsible for managing US trade negotiations with China. From 2006-2010, she served as Chief Counsel for China Trade Enforcement (2006-2010) at the Office of the USTR, coordinating efforts to ensure that China met its international trade obligations and playing a leading role in nine WTO disputes. Prior to joining USTR, she was a senior international trade partner at Arnold & Porter. Reade returned to Arnold & Porter as Senior Counsel in 2015.

The views stated herein are those of the interviewee and do not necessarily reflect those of Goldman Sachs.

Allison Nathan: Are Trump's anti-China trade proposals just a strategy to extract concessions, or does he have enough conviction to follow through with them?

Claire Reade: Trump and an increasing number of other observers have a strong sense that the trade and investment relationship between China and the US these days is unfairly asymmetric. Some observers even believe that China is really a dyed-in-the-wool cheater. I'm not sure where Trump stands on that, but his comments reveal a gut-level belief that we're in a tough zero-sum game and that we've been losing that game with China. It also seems that Trump has had a long history of concern that major foreign trading partners are getting the better of the US in deals. This suspicion about whether the US is "winning" is something that seems to be in his DNA. It is also pretty clear that he has a strong interest in being on offense in trade and sees foreign access to the US market as a source of significant leverage that others in the US government have wasted. So my guess would be that he is likely to act quickly and sharply.

Allison Nathan: Trump has proposed a 45% tariff on all US imports from China. Can he legally do this?

Claire Reade: Only Congress can authorize tariffs. But the fact is that Congress has delegated the President the power to impose tariffs in a number of circumstances under existing legislation. For example, the President could declare a national emergency and impose tariffs temporarily at whatever level he wants. That said, I am not aware of any past instance of the US imposing an across-the-board tariff against a country for commercial or trade reasons. Complete bans on imports historically have only occurred as part of sanctions on countries that have been deemed very dangerous, such as North Korea.

Allison Nathan: Do you think Trump will actually implement an across-the-board tariff on China?

Claire Reade: I don't think so. It seems that Trump's ultimate goal would be to see changes in Chinese policy that benefit US products and services or jobs. But I think an across-the-board tariff, which would certainly lead China to retaliate, would generate a systemic disruption that could threaten pensions, 401Ks, and global markets. Ultimately, I don't think that gets him a "win" or leads to the benefits that he says he's seeking. It would actually be a loss for him. At the same time, Trump is a businessman who has surrounded himself with international business experts who would almost certainly advise against deeply rattling the US or global economy. So I would be surprised if he took an action that would have such far-reaching ramifications. He could instead take targeted action against particular industries where China is engaged in non-market behavior that is harming US interests. That would seem to make the similar political point without those systemic risks.

Allison Nathan: So you are not concerned that Trump's trade appointments, who have spoken out aggressively against China, will influence trade decisions?

Claire Reade: I don't know how his team will operate. Traditionally, the Treasury functions as the last word on important issues of macroeconomics and global finance. And there are very sophisticated people operating at the Treasury, as well as the Commerce Department and inside the White House, who understand both Trump's goals and the downside risks. If you're trying to boost the economy and increase jobs, there are certain actions that you just don't want to take. Perhaps I'm an optimist, but I think that understanding will keep him from taking policy steps that are too risky.

Allison Nathan: So what trade measures do you think Trump *is* likely to implement against China?

Claire Reade: If Trump is looking for "quick wins" with China, my guess is that his USTR will be very focused on traditional manufacturing industries like steel, aluminum, glass and solar—areas where government support in China has led to massive overproduction and trade distortions. I think Trump and his team are going to hit those industries in China with whatever tools they have. Of course, the US can use anti-dumping and countervailing duties and bring cases against China in the WTO. But there are also some laws on the books that are broader and vaguer and would allow Trump a lot of flexibility to take action. Some of those may not necessarily be consistent with WTO rules, but I'm not sure how Trump and his team will deal with this fact.

Allison Nathan: Do you think Trump's confrontational negotiating strategy will be effective in the trade arena?

Claire Reade: We'll soon find out. The recent flare-up with Mexico is a small example of this confrontational style in action, although Mexico is a much smaller player for the US economically; I think China falls in a different class in terms of the implications of taking sharp, aggressive action.

Handling relations with another country is like playing three-dimensional chess—maybe even 10-dimensional chess—and the game never ends. Compared to making a business deal, you have to look longer-term and consider many more factors, all while having less control. The question is whether he can adapt his business instincts to operate effectively in that more complex context.

Allison Nathan: Do you think Trump appreciates the complexity of these situations at this point?

Claire Reade: He seems to like to distill things down to a point where he can make a decision. So the challenge for him will be to develop enough background to make intelligent, informed decisions. I think he still has a learning curve on that. But I find his relative silence on China since the inauguration interesting because it may mean that he recognizes that the stakes are too high and everybody could lose if he acts on his initial impulses.

Allison Nathan: Some argue that Trump is using foreign policy issues like Taiwan and the South China Sea as bargaining chips for trade. What do you make of this?

Claire Reade: I don't have any insider knowledge on his negotiating strategy, but Trump's mental file on China does not seem to be segregated by issue area. His challenge will be to understand how China views these issues. For example, Taiwan is a core sovereignty issue that will evoke strong nationalist responses in China; it's not something that China would be willing to put on the table as a trade bargaining chip. That incompatibility between what Trump thinks can be on the table and what China doesn't will have to be dealt with. Having said that, Trump's willingness to cross lines does shake up people's thinking, which has the potential to increase opportunities for the US. But it also increases risks, especially if you miscalculate on red lines. I probably worry more about the risks, particularly where we may not have good options on the downside or do not fully understand what we're getting into.

Allison Nathan: How might China respond to US trade restrictions? From your experience negotiating with the Chinese, do you think an equal "tit-for-tat" response or a disproportionately larger retaliation is more likely?

Claire Reade: I think China will respond quickly to any US action. If China feels it just needs to balance the situation created by a US action then the response is likely to be proportional. But if China believes that the US action is extremely unfair or threatening, or if the US hits a red line without realizing it—frankly, the scariest scenario—then you could get a response that is orders of magnitude greater. I predict that China will be very strategic. But China has a critical political transition this fall and major economic challenges that tie to the success of that transition and to the ongoing strengthening of President Xi's position. So there is no chance that President Xi will allow himself to be seen as weak in any way. We've seen in the past what happens when China feels seriously insulted: we can see severe negative spillovers for an entire country's products, services, and people. For example, island disputes with Japan in 2012 had very significant impacts, with Japanese companies boycotted and unable to access materials. Japanese cars were smashed in the streets and there was outright hostility against Japanese people.

Allison Nathan: Trump also previously threatened China with the "currency manipulator" designation. What would he hope to achieve with that, and what do you make of him backing away from this since the inauguration?

Claire Reade: Those statements seemed to be coming from his gut-level sense that China has been cheating, an argument that was often made when China seemed to be artificially depressing its currency to boost its exports. But the Chinese have more recently been propping up their currency, which helps—not hurts—the US. There seems to be an increasing awareness of that and therefore a higher likelihood that labeling China a currency manipulator today could look like the US shooting itself in the foot, particularly if it leads China to let its currency weaken, which could harm US exports.

The other consideration is that the official Treasury designation would only trigger negotiations and no other immediate action. So the question is whether an announcement that meets a political campaign promise but has no dramatic consequence would satisfy a president who seems very action-oriented. Alternatively, Trump could pursue these concerns via other channels like the legislation to impose trade penalties for currency manipulation that has floated around Congress in the past.

Allison Nathan: Could Trump's more protectionist/ isolationist approach backfire by actually leaving China with more leverage and influence?

Claire Reade: I think that stepping back from the Trans-Pacific Partnership (TPP) does create reputational problems for the US. It sends the message that the US is not reliable. China is probably very happy with this outcome. I do think China will have more leverage over Asia-Pacific trade as a result, be it through the "One Belt, One Road" initiative, the Asian Infrastructure Investment Bank, or the Regional Comprehensive Economic Partnership. The region will support efforts to promote regional integration, because Asian economies do not have large internal markets and therefore benefit significantly from reduced trade frictions. That said, China is not ready to take on the market and regulatory disciplines that TPP requires, so we will be unlikely to see deals as strong as TPP.

Allison Nathan: On the other hand, will a tougher US approach on China embolden other governments to get tougher on China as well?

Claire Reade: There is certainly an opportunity for the US to take the lead in tackling problems that China's non-market economy has imposed on global trade and the economic system, which I think other countries would welcome. The question is how this could be done constructively, how far one can push, and how patient and incremental someone like Trump, who likes to see quick results, would be willing to be.

Allison Nathan: Which country has more at stake here?

Claire Reade: The amount of exports involved for both the US and China is not large enough to devastate either economy, even if all trade were blocked. The question is: in a trade war, what harm would occur and how long could you stand it? In the US, the effects of severe trade action on growth and the many constituencies that either export or depend on imports would create a challenging political situation. And because China has a totalitarian regime, it may be able to stand the pain longer.

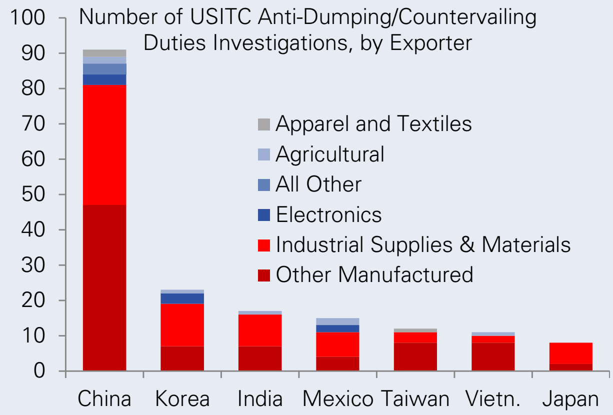
US trade relationships: It's complicated

Where might the Trump administration apply trade restrictions? We see risks from trade barriers in three main areas: (1) the "usual suspects" already under scrutiny by US firms and trade officials; (2) countries/products where the US has large trade imbalances; and (3) multinationals' intermediate inputs, which could get caught in the crosshairs of policy.

The Usual Suspects

China, Metals, Chemicals, and Manufactured Goods

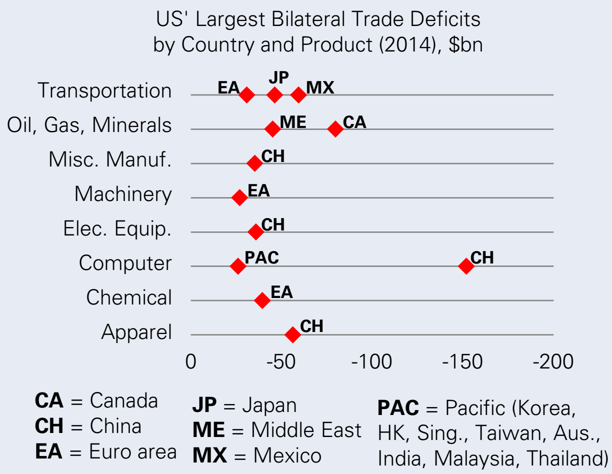
Trade restrictions are more likely in the "usual suspect" sectors, where US firms already bring frequent complaints to US trade officials. For example, about one-third of investigations by the United States International Trade Commission (USITC) in response to complaints about "dumping" or "foreign subsidies" focus on China—significantly more than Korea, India, and Mexico combined. The most investigated industries include primary metals (such as steel), chemical products, and various manufactured goods. Such investigations can lead to concrete policy action, such as the 522% tariff on certain Chinese steel products levied since May 2016.



Bilateral Imbalances

Asia, Mexico; Computers, Apparel, Autos (Among Others)

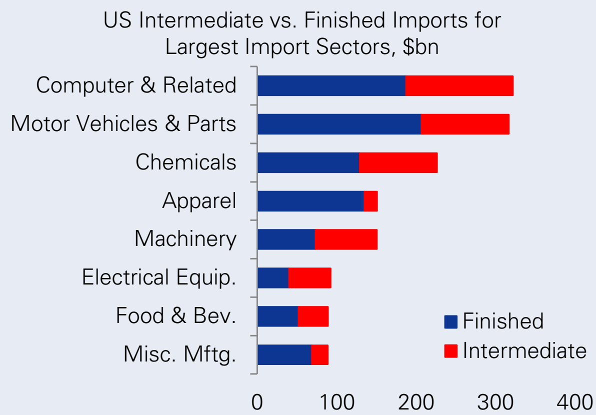
Currently, 80% of major US goods industries are in deficit (the primary exception is "other transport equipment"—mostly aircraft). Trade restrictions could target the areas with the largest imbalances. By sector, the largest deficits are in computers and related products, motor vehicles, and apparel; by country, they are with China and the rest of Asia, Mexico, and Western Europe. US policymakers could also choose to target specific product-country combinations; for example, the goods trade deficit with China is largely driven by computers, and to a lesser extent electrical equipment and apparel. Other pockets of significant US non-commodity goods deficits include trade in cars with Mexico, Japan, and Europe, as well as in chemical products and machinery with Europe.



Multinationals Caught in the Crosshairs

Intermediate Inputs Along the Supply Chain

A third area at risk from trade restrictions is intermediate inputs in multinational firms' supply chains. Traditional trade statistics can sometimes obscure the fact that multinationals often source inputs in many countries and assemble them in one location. For example, around one-third of auto-related US imports are used to produce vehicles in US factories. The Trump administration might shy away from trade restrictions in industries with such large exposure to imported inputs. That said, any restrictions that do get implemented may affect countries that are not large exporters directly to the US. For example, a more detailed breakdown of US goods imports shows that China actually makes up a smaller share (16%) of value added for computers and related products than the rest of Asia (21%).



Source: Department of Commerce, USITC, Goldman Sachs Global Investment Research. For more, see "Trade Relationships: It's Complicated," US Economics Daily, 23 November, 2016.

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Thirty years of Trump on trade

"... [W]e've fallen into the habit of mistaking the easy availability of cheap, sweatshop-produced product for solid and sustainable economic stability .... What I would do if elected president would be to appoint myself U.S. trade representative .... Our trading partners would have to sit across the table from Donald Trump and I guarantee you the rip-off of the United States would end."

- 2000 book, The America We Deserve by Donald J. Trump

"Over the years, the Japanese, unimpeded by the huge costs of defending themselves … have built a strong and vibrant economy with unprecedented surpluses … Now that the tides are turning and the yen is becoming strong against the dollar, the Japanese are openly complaining and, in typical fashion, our politicians are reacting to these unjustified complaints … 'Tax' these wealthy nations, not America. End our huge deficits..."

- 1987 ad placed by Donald J. Trump in US newspapers

"What's unfortunate [about the Japanese] is that for decades now they have become wealthier in large measures by screwing the United States with a self-serving trade policy that our political leaders have never been able to fully understand or counteract."

- 1987 book, The Art of the Deal by Donald J. Trump

"The reason NAFTA looks okay now is because the economy is strong, but when the economy is not strong … NAFTA is going to look like a disaster."

- 1999 interview with Larry King (CNN)

"I mean, [the Japanese have] totally taken advantage of the country .... They dump the cars and the VCRs and everything else. We defend Japan for virtually nothing, which is hard to believe."

- 1988 interview with David Letterman (CBS)

"I'm not an isolationist … I think that you have to be treated fairly by other countries. If other countries aren't going to treat you fairly … they should suffer the consequences."

- 1999 interview with Larry King (CNN)

"Many things. A toughness of attitude would prevail. I'd throw a tax on every Mercedes-Benz rolling into this country and on all Japanese products, and we'd have wonderful allies again."

- 1990 interview with Playboy Magazine, asked the first thing he would do if he became president

"It's *much* more improvisational than people might think."

- 1990 interview with Playboy Magazine, asked whether he has a master plan for deal-making

Source: www.istockphoto.com (image); books and media outlets indicated above (quotes).

Interview with Tu Xinquan

Tu Xinquan is Dean and Professor at the China Institute for WTO studies at the University of International Business and Economics in Beijing. His research and teaching focuses on Chinese trade policy, the WTO, government procurement, and US-China trade relations. He is the author of *China's Position, Role, and Strategy in the WTO*. Below, he argues that China will not tolerate even a 1% increase in tariffs by the US administration above what applies to other countries.

The views stated herein are those of the interviewee and do not necessarily reflect those of Goldman Sachs.

Allison Nathan: What is the mood in China's policy circles around US President Trump's trade proposals?

Tu Xinquan: Of course, we are concerned. At first, there was a sense that his protectionist proposals would never happen, but now we are taking them more seriously.

Allison Nathan: Do you think Trump's aggressive stance on trade is a negotiating strategy or part of a more deeply held ideology?

Tu Xinquan: Trump is less ideological than President Obama, in my opinion. He is operating as a businessman trying to make a deal, so I think he is fairly pragmatic in that sense. He clearly thinks that China has had an unfair advantage in international trade. But he cares more about China's trade surplus and the harm he believes it has caused to US workers than, say, the nature of China's political system.

Allison Nathan: Will Trump's confrontational negotiating style be effective in extracting trade concessions?

Tu Xinquan: I don't think so. Trump strongly believes that the US has substantial leverage over other countries including China and therefore thinks that he can achieve whatever he wants with this confrontational strategy. But I disagree. An aggressive approach was perhaps effective in the 1980s when the US coerced Japan into making concessions. But we aren't in the 1980s anymore. China is different; the US is different; the world is different. There is a narrower gap in power between the US and China than there was between the US and Japan. China is not a political or military ally of the US and does not depend on the US for protection, as did Japan. And China is more open than Japan was in the 1980s. Japan had very few multinationals in the '80s, whereas China has attracted substantial foreign investment. Chinese exports are not only Chinese; many foreign companies based in countries including Japan, Korea, Europe, and the US now make things in China and export them to the world. So today restrictions on Chinese exports will affect many multinationals and economies given China's place at the center of the global value chain.

Allison Nathan: Trump has proposed imposing tariffs of up to 45% on Chinese goods. How would China respond?

Tu Xinquan: First of all, I don't think this is possible because China is a WTO member. The US has given most favored nation (MFN) status to China, which means that US tariffs on China should be the same as for other trading partners. So imposing any additional tariff on China would amount to the US cancelling MFN status—a very drastic move. Of course, if a 45% tariff were imposed, it would trigger a trade war. China would definitely retaliate and would likely go above and beyond the US measures, potentially imposing tariffs as high as 80-90% on imports from the US. That said, an across-the-board tariff of any size on US imports from China would be significant—certainly much more so than anti-dumping or countervailing duties on only specific products—and would require that China respond. China would not tolerate even 1% more in tariffs than what is imposed on other countries.

Allison Nathan: In what other ways could China retaliate against protectionist measures by the US? Could it take action against US companies operating in China?

Tu Xinquan: The first step would likely be tariffs on imports from the US in sectors such as agricultural products, cars, machines, or airplanes. Beyond that, it would depend on the scale of US measures against China. If the US measures are very severe, some action against US companies in China could perhaps be taken. But given how much US companies and investments have helped the Chinese economy, targeting them would be a last resort. Another option would be to sell US Treasury bonds, but I also rate that as far less likely than tariffs on imports from the US.

Allison Nathan: How concerned is China about potentially being designated by the US as a currency manipulator? How would China likely respond?

Tu Xinquan: The US made this designation in the 1990s before China was a WTO member, so there is a precedent. Of course, today, the Chinese government is focused on maintaining a stable exchange rate and has been defending its currency rather than weakening it. That said, Mr. Trump may just want to take some action against China, and the currency manipulator label is a relatively easy thing to do. So he may pursue that no matter what the facts are.

I don't think China would respond dramatically to the designation, which in and of itself is just a label. Any response would depend on actions taken after the designation; for example. if the US passes a new trade law to punish currency manipulators, that would be another story.

Allison Nathan: Which country would have more at stake in a trade war, the US or China?

Tu Xinquan: Both sides have a lot at stake. Of course, US exports to China are much smaller than Chinese exports to the US, but they are still worth more than $100 billion. They are large enough for tariffs to make an impact. On the other hand, as I said, Chinese exports are not only made by Chinese companies. So a trade war would hurt all sides significantly.

Allison Nathan: Could a trade war with the US create opportunities in China, e.g., for Chinese brands?

Tu Xinquan: It's hard for me to see it that way. US imports don't really compete with Chinese products, especially consumer products, which China imports mostly from Europe, Japan, or Korea. The famous US consumer brands like Apple that are consumed in China are also produced there.

Allison Nathan: Some argue that Trump could take a hard line on certain foreign policy issues like Taiwan or the South China Sea to gain concessions on trade. Would such a strategy work?

Tu Xinquan: I doubt it. Taiwan and the South China Sea are exceptionally sensitive issues that hit at the core of China's sovereignty; I can't envision them as bargaining chips because nothing is as important. If Trump was truly serious, for example, about recognizing Taiwan, China would still refuse to make any deal over Taiwan publicly. Perhaps some trade concessions could be granted secretly, but even that would be very, very difficult. I also believe that any deal around these issues would be just as difficult on the US side. For instance, I doubt Congress would allow the administration to commit to a ban on US arms sales to Taiwan in exchange for voluntary export restrictions from China.

Allison Nathan: Will Trump's trade proposals and his decision to withdraw from the Trans-Pacific Partnership (TPP) give China more leverage? Or might they inspire other countries to get tougher on trade with China?

Tu Xinquan: Trump's trade policies are hurting the United States' reputation in terms of globalization. That is beneficial to China because, after years of accusing China of protectionism, the US now appears to be more protectionist itself. So although China is still less open than the US in reality, its image is comparatively better, which has given it more leverage. For example, Australia has said there could be an opportunity for China to join the TPP, and the negotiation of the Regional Comprehensive Economic Partnership (RCEP), a regional trade deal led by China, has gained more attention. With the pressures that TPP had imposed on China now gone, China has more space to negotiate a new deal in the region.

To your second question, I don't think other countries would follow Trump's approach and impose more trade restrictions on China because many other economies, including Europe for example, are even more dependent on China than the US is.

Allison Nathan: Can China step up as a global trade leader?

Tu Xinquan: I think so. This is a unique moment in history: There is a backlash against globalization led primarily by the US—once the biggest advocate of globalization. That certainly presents an opportunity for China to take leadership. And I believe China should seize this opportunity given how much it has benefitted from trade and globalization.

But China's leadership would be different from US leadership. China is less open and market-oriented than the US and therefore prefers a more moderate model of globalization. China's model takes a more voluntary or self-binding approach to trade practices rather than imposing international rules on other countries. The so-called "One Belt, One Road" model for economic cooperation across parts of Asia represents this; for example, it focuses more on reducing physical transaction costs through interconnected infrastructure rather than on reducing institutional transaction costs through rules.

Allison Nathan: How focused is China on being acknowledged as having "market economy status" within the WTO? If it gains this status, how much would change?

Tu Xinquan: This has been a hot topic over the last year. China has filed cases with the WTO against the US and the EU to achieve this acknowledgment, and we are now awaiting the results. This status matters, but not to a large degree; it really only affects anti-dumping cases against China. If China gains this status, then Chinese companies targeted in such cases will benefit from lower penalties.

Allison Nathan: Is there validity to claims that Chinese government support has given Chinese companies and industries an unfair trade advantage?

Tu Xinquan: Government support for state-owned enterprises (SOEs) is an issue, but I am not sure it has been an advantage. The fact is that SOEs are not good for China's efficiency. Others might argue with this, but in my view, China would be more competitive if it had less SOEs.

As far as other types of support are concerned, governments do give subsidies to some industries. However, unlike export subsidies, these are not prohibited by the WTO. They probably do improve the international competitiveness of some Chinese companies, but similar subsidies exist in many countries, including the US. For example, state governments in the US often offer subsidies to foreign companies, including Chinese firms, in order to attract investment. It is possible to initiate a WTO case against such practices or try to impose some countervailing duty, but the point is that not all government subsidies are illegal under WTO rules. And in some areas, like green energy, regional development, and innovation, it probably makes sense to have subsidies.

Allison Nathan: How effective has the WTO been in addressing trade concerns?

Tu Xinquan: I think the WTO dispute settlement mechanism has worked well over the last twenty years. Of course, the processes are slow and cumbersome, and not always enforced, but most of the time members adhere to the rulings. The few cases of non-compliance with rulings have actually been on the part of the US and the EU. The Chinese care a lot about their reputation and have been quite good about complying.

Overall, I think it would be better for the US to address its concerns with Chinese policies via the WTO. The process may not be quick, but winning the case there gives a country more leverage and legitimacy than if it took action unilaterally. Bypassing the WTO is less persuasive and more likely to be viewed by other countries as an abuse of power.

US protectionism: tough on more than EM

Ian Tomb argues that EM Asia may be the likeliest target for US trade restrictions, and that Mexico has the most to lose — but that the costs of US protectionism would also fall on US firms, workers, and consumers

US President Trump has made a quick pivot from the campaign trail to the oval office, beginning to deliver on his promise to change "failed" trade policies and thereby "bring back" US jobs. In recent weeks he has withdrawn from the Trans-Pacific Partnership, reached out to Canada and Mexico on the renegotiation of the North American Free Trade Agreement, and raised the prospect of a 20% tax on imports from Mexico and elsewhere. Though Trump's aggressive trade stance could ultimately avoid a protectionist outcome, it still bears asking where he might aim to deliver the biggest protectionist punch and, in turn, who would suffer most from such a hit.

The likely targets

Where would the Trump administration naturally begin in picking its targets for protectionist measures? One answer might be to appeal to voters in politically important "swing states" that have felt most harmed by labor competition from abroad, particularly from emerging market (EM) countries. In 16 swing states that helped send President Trump to the White House and will be crucial to his potential bid for re-election in 2020, US workers have seen substantial job losses in several trade-sensitive industries. The declines in employment have been largest in the manufacturing of machinery, but also in motor vehicles, metal industries, furniture and wood products, rubber and plastics, and apparel and textiles.[5] These sectors are therefore likely targets of import restrictions, as are the EM countries that export goods in these categories to the US—mainly China, other EMs in Asia, and, to a somewhat lesser extent, Mexico. All told, these exposures suggest a relatively more favorable environment for EMs that export less-sensitive goods to the US (supporting currencies like: RUB, BRL, ZAR, and INR), while pointing to a need to hedge China and CNY risk.

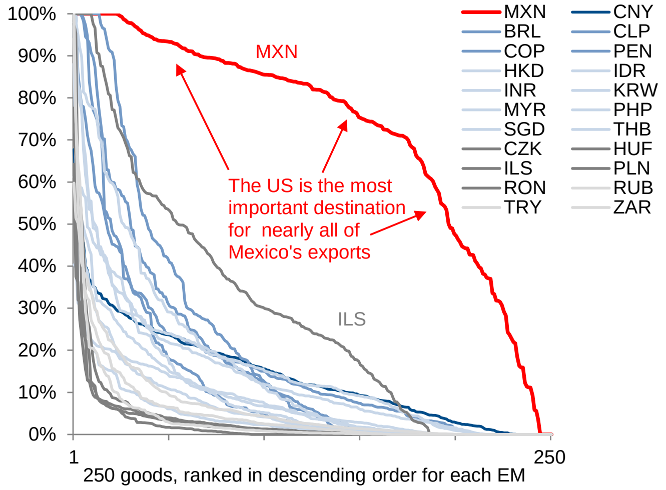
The most vulnerable: Mexico

The follow-on question is: Which of these countries has the most to lose from any protectionist measures the US ultimately chooses to enact? The short answer is Mexico. For nearly all of the roughly 250 categories of goods Mexico exports abroad, the US is the most important importer.

On the face of it, this level of exposure to US demand does not bode well for Mexican assets and the MXN in particular. That said, Mexico's close ties to the US also imply upside risk from improving US growth, which could create a friendlier backdrop for the ongoing improvement in Mexican exports and, potentially, for the MXN should Trump's rhetoric towards Mexico turns out to be more talk than action. At the same time, much of the downside risk has likely already been priced into the MXN, which remains very cheap after months of underperformance.

Mexico's exceptional US exposure

Share of the exports of each country imported by the US, for a comprehensive set of 250 different goods, %



Source: Goldman Sachs Global Investment Research, UNCTAD.

The domestic casualties

While the Trump administration has emphasized the plight of US workers in industries that directly compete with imported goods, it has paid far less attention to the overall domestic impacts of US protectionism. If restrictions on foreign goods were implemented, US firms could face rising input costs, and if trading partners responded with tariffs on US goods in a "trade war" scenario,[6] US firms could face shrinking external demand. Either of these effects could prompt globally-connected firms to reduce wages and cut workers.

US consumers, who currently enjoy large benefits from a wide range of cheap EM imports, would be another likely casualty. As a share of imports, the US receives 84% of its toys and games, 74% of its footwear, 73% of its computers, and 71% of its telecom equipment from China and other countries within EM Asia. When it comes to industries that feature low levels of domestic production and large labor cost disadvantages vs. EM (think apparel), it would likely be especially difficult to raise import tariffs without generating higher prices and significant pain for US consumers. Whether or not US voters consciously connect their livelihoods and bank balances to US trade policy, they are unlikely to be happy with the administration if their jobs at globally-connected US firms are endangered, and the prices they pay for key consumer goods have risen in four years' time.

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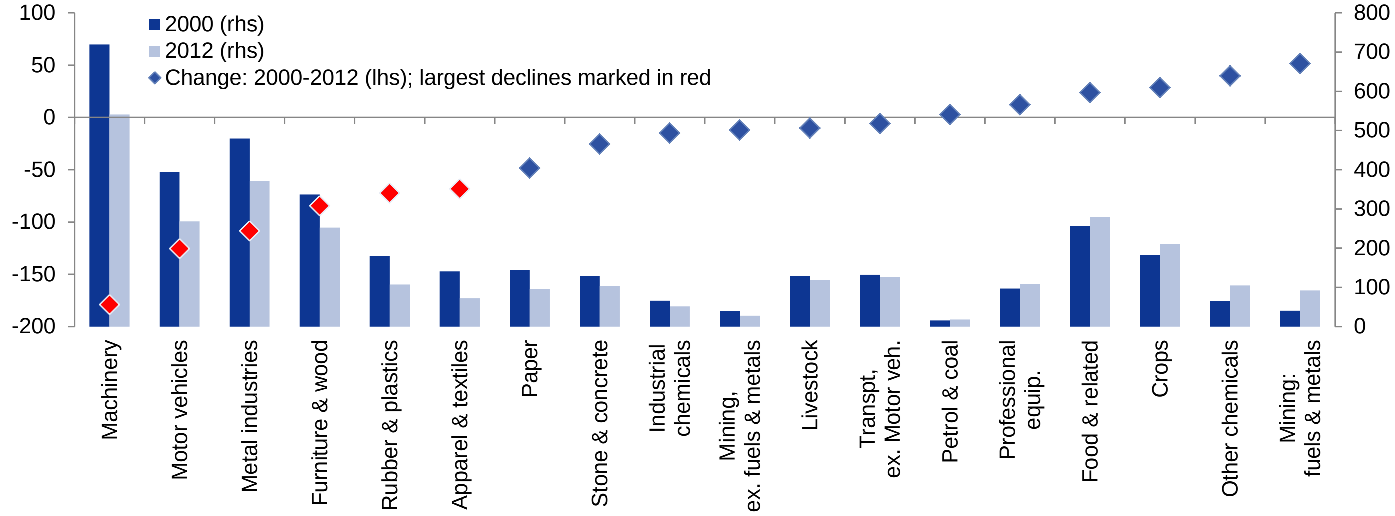
For more, see "Mapping US 'swing state' job losses into EM export risks," Emerging Markets Analyst, 6 December 2016.

[5] Using a complementary approach, US Economist Daan Struyven provides further evidence that these industries are at risk of US protectionism (see pg. 8 in this issue).

[6] Chief Asia-Pacific Economist Andrew Tilton (pgs. 4-5) and interviewees Claire Reade (pgs. 6-7) and Tu Xinquan (pgs. 10-11) discuss the possibility that Chinese policymakers could respond actively to US protectionism.

US "swing states" have seen substantial job losses in industries that produce the same goods…

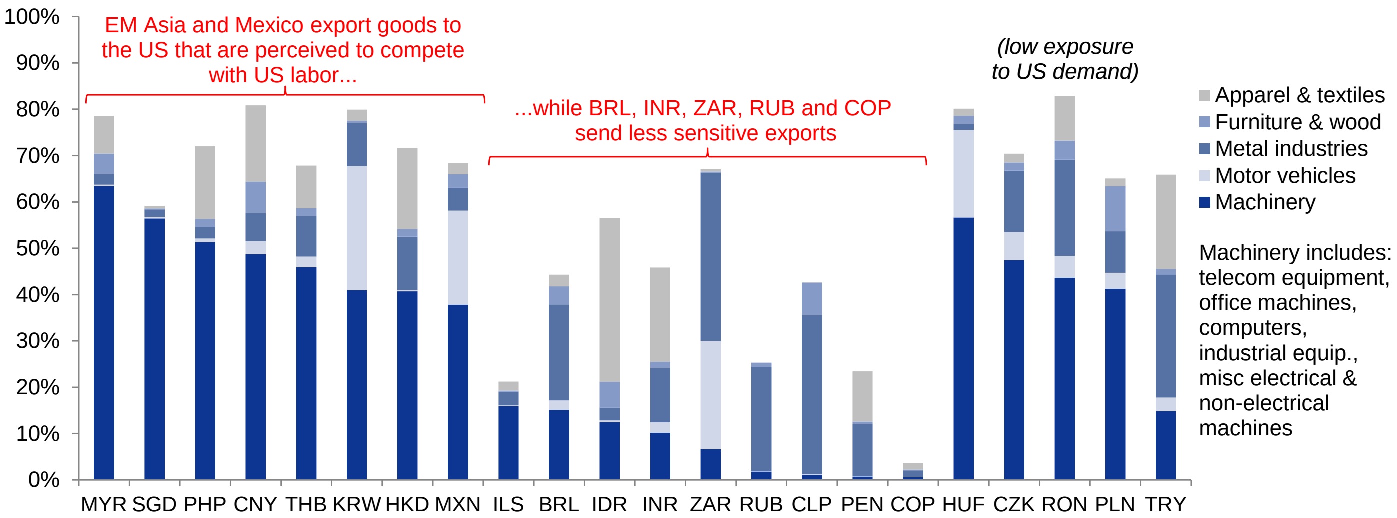
Employment by industry (in thousands) of white, working-age males without a 4-year college degree living in 16 US "swing states"



Source: Goldman Sachs Global Investment Research, IPUMS-USA.

…that the US imports from China and EM Asia

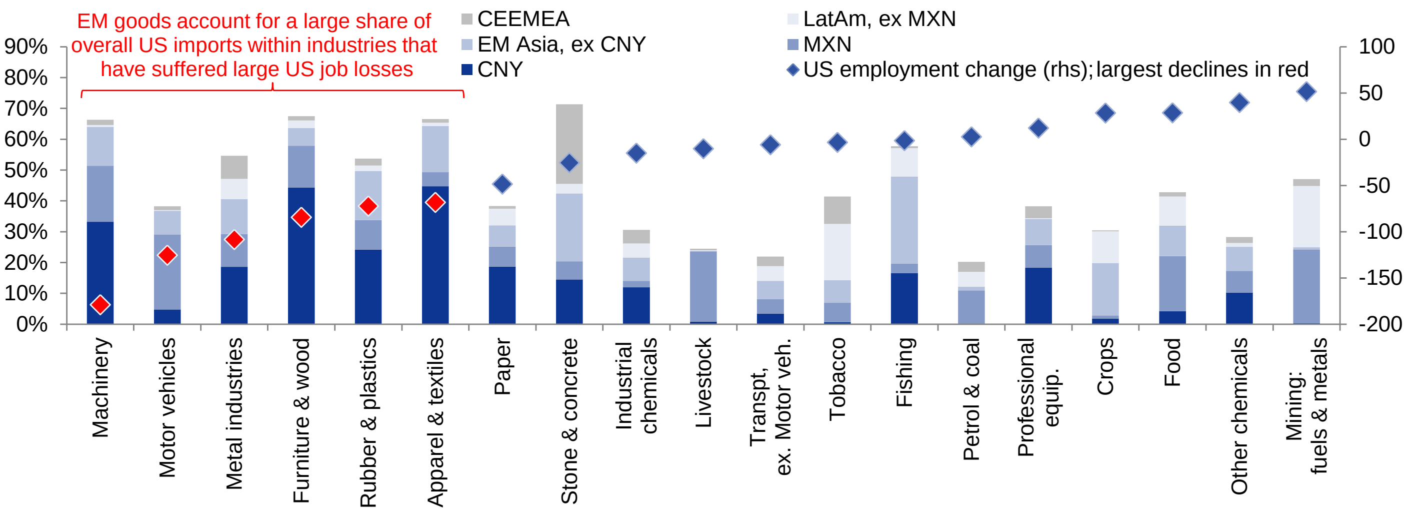
Each category's share of all goods exported to the US from the displayed country, %



Source: Goldman Sachs Global Investment Research, UNCTAD, IPUMS-USA.

But broad restrictions on EM imports would be painful for US consumers

Diamonds: 2000-2012 change in employment (in thousands) of white, working-age males without a 4-year college degree living in 16 US "swing states"; bars: share of US imports of the displayed good that are imported from the displayed country/countries, %



Source: Goldman Sachs Global Investment Research, UNCTAD, IPUMS-USA.

Tariffs: Who has most to lose?

Nicholas Fawcett models the impact of US tariffs, finding that they would be a bigger drag on growth in the US than in China

As part of his controversial agenda on trade, President Trump has suggested imposing a 35% tariff on imports from Mexico and a 45% tariff on imports from China. The intellectual argument made for imposing tariffs rests largely on the premise that US trade deficits with China and Mexico—currently 1.6% and 0.3% of US GDP, respectively—somehow indicate US economic failure. By raising the import price, the reasoning goes, the US will be better off, as demand for imports would fall and demand for domestically-produced substitutes would rise.

But it is wrong to think that when the US imports something from Mexico or someplace else, it somehow loses out. The opposite is true, as it gains something it needs—namely, things that consumers would like to buy, and firms would like to use in order to make finished products.[7] The US may not produce these things as efficiently or at all, so it is not a simple, cost-less matter of domestic substitution of imports. And, of course, what goes around comes around: Both Mexico and China would likely retaliate with at least equivalent tariffs on imports from the US, triggering a trade war that would lead to a fall in the demand for US exports. Trade is not a zero-sum game; by curbing imports, the US could lose out in the long run.

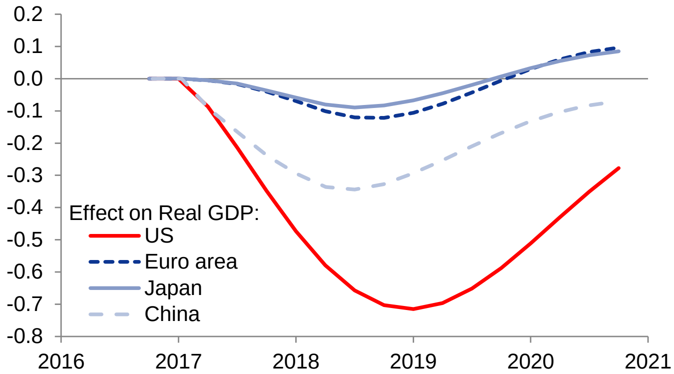
The hit to US growth

How would such tariffs affect the US economy? The 35% and 45% tariff rates mentioned above translate into an increase in the average effective tariff rate of around 11%, reflecting the fact that the US trades with other countries unaffected by the proposed tariffs. Our analysis—which considers the forces influencing domestic consumers and firms at home, international trade, inflation, exchange rates and domestic financial conditions—suggests that the most immediate impact would be rising inflation. Given that around one tenth of the US CPI basket is imported, inflation would accelerate as a direct result of an increase in import prices. So the burden of tariffs on Mexican and Chinese imports would fall not only on firms there, but also on US firms and consumers.[8]

At the same time, tariffs would weigh on US growth. If we assume that Mexico and China retaliate with equivalent tariffs, this would substantially reduce demand for US exports, depressing US GDP by around 0.7pp by 2019. In fact, tariffs would likely hit US GDP so sharply that the Federal Reserve would be prompted to reduce interest rates to cushion the blow—despite an increase in inflation.

Tariffs: bad for the world, worse for the US

Effect of US tariffs on real GDP, percent deviation from baseline



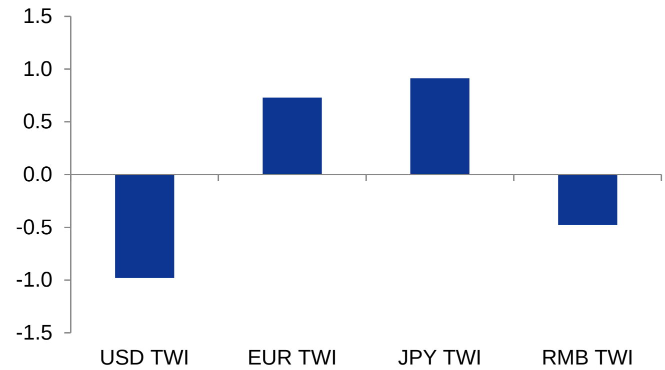
Source: Goldman Sachs Global Investment Research.

The hit to global growth

In this nascent trade war scenario, tariffs would also have negative global spillovers. The estimated drag on growth in China—of around 0.3% of GDP—would be smaller than on the US, but nonetheless sizeable. And the fallout would spread to other advanced economies, even if they aren't affected by the tariffs directly. Both Japan and the Euro area would suffer from a fall in broader US import demand, largely as a consequence of more subdued growth there. And the flip side of US monetary policy loosening and accompanying depreciation in the dollar is that the yen and euro would likely both appreciate, compounding the slowdown.

Unwelcome FX effects

Effect of US tariffs on currencies, percent deviation from baseline



Source: Goldman Sachs Global Investment Research.

Of course, there are caveats to these estimates. For example, our results do not capture specific effects on imported intermediate goods, or on the possible knock-on effects on supply chains. Nonetheless, the overarching conclusions confirm fears that tariffs would not achieve the aim of boosting the US economy; they would quite likely do the opposite, and reduce the variety of goods and services bought by US consumers and firms. The spillovers to the rest of the world would be negative. Finally, there is also the irony that the US could suffer more than China.

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[7] Paul Krugman observed in a 1993 paper that "exports are not an objective in and of themselves: the need to export is a burden that a country must bear because its import suppliers are crass enough to demand payment."

[8] Work by our US Economics team suggests that these tariffs would raise US PCE inflation by a cumulative 0.6pp.

Mexico: Trade friend, not foe

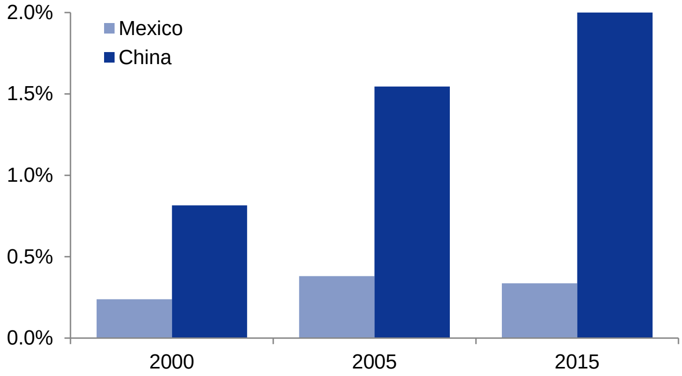
Alberto Ramos argues that Mexico is not the right target for more restrictive trade policies

One of the key themes of the recent US presidential election was the bilateral trade deficit with Mexico (roughly US$60bn in 2015, according to US official data) and the move of quality manufacturing jobs from the United States to Mexico. Similar issues arose with regards to trade with China.

Notwithstanding the trade deficit, Mexico has been a valuable trading partner for the United States. More than the quantity and direction of trade, the quality and characteristics of the US-Mexico trade relationship are likely far superior and efficiency-enhancing than those with most other US trading partners. That is, the deep and dense trade and financial linkages between the US and Mexico, which arose naturally from the development of complex cross-border integrated manufacturing supply chains, have been mutually empowering. Reversing them would therefore likely impart an economic and welfare cost for both countries.

Diverging deficits

US trade deficit by trading partner, % of GDP



Source: US Census Bureau.

Friendlier than China (and many others)

The composition of the bilateral trade flows with Mexico is a lot friendlier to the United States in absolute and comparative terms, than what could perhaps be inferred from the $60bn trade deficit statistic alone.

First, US-Mexico trade is a two-way street.

- While the bilateral trade deficit with China has been widening for more than a decade (from $84bn in 2000 to a record $367bn in 2015), the deficit with Mexico has been broadly contained (and has actually moderated from $66bn in 2010).
- Mexico bought 16% of all US exports in 2015 (equivalent to $236bn, or more than double the $116bn bought by China, a much larger economy). A large share of US manufacturing exports goes to Mexico—about 18%, close to the 19% that goes to the EU, not far from the 21% shipped to Canada, and three times larger than the amount shipped to China.
- The US has a US$10bn services surplus with Mexico, which in part reflects goods trade (insurance, freight, storage, etc.).

Second, US companies benefit from Mexico.

- Many Mexican exporters are US-owned/-controlled companies (which is not the case, for instance, in China). Transfers (or accrual) of profits and dividends to US firms operating in Mexico have reached ~US$6bn annually.
- There is vibrant intra-industry (reciprocal) trade between the United States and Mexico (not the case with China). The United States imported US$244bn of manufactured goods from Mexico in 2015, but also exported a hefty US$179bn of manufactured goods to Mexico;
- An estimated 40% of the value added in US imports from Mexico originated in the United States, vs. 25% on imports from Canada and just 4% on imports from China.[9]
- Studies have shown that the development of cross-border supply chains allowed US manufacturing—particularly in the auto industry—to become more globally competitive.[10]
- US FDI in Mexico has complemented investment and job creation in the United States. A 2014 PIEE paper argued that a 10% increase in employment at the Mexican subsidiaries of US firms led to a 1.3% increase in employment and 4.1% increase in R&D spending in their US-based operations.[11]

Third, Mexico's trade stance and policies have been closer to the spirit of "free and fair trade" than is perhaps the case with some other trading partners of the United States. Mexico has not been singled out for manipulating its currency, limiting or restricting the access of US goods or companies to its market, large-scale industrial dumping practices, or of improperly acquiring industrial commercial secrets and/or inadequately enforcing intellectual property.

Tariffs may not do the trick

Perhaps more importantly, a tariff on US imports from Mexico would likely fall short of its intended effect. Having depreciated since 2013, the MXN is currently undervalued by more than 25%, and may become even more so in case of a US tariff. Crucially, the weak MXN has significantly reduced local unit labor costs in USD. Therefore, in our assessment, Mexican exporters are unlikely to be priced out of the US market if the US administration imposes a moderate tariff on all imports from Mexico (e.g., a 15% ad-valorem tariff). In most cases, the cost of a tariff would be split between the US consumer (who would pay higher prices for the imports) and the Mexican producer/exporter (whose proceeds in USD would decline).

Policy priorities should lie elsewhere

In short, while we cannot rule out trade frictions ahead, we believe that the Mexico-US trade relationship is solid, dense and arises from the natural economic and production complementarities between the two neighboring economies that have developed and deepened over the last 20 years.

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For more, see "Mexico: Navigating Domestic Headwinds and External Risks/Uncertainty," Latin America Economics Analyst, 16 December 2016.

[9] Robert Koopman, William Powers, Zhi Wang, Shang-Jin Wei, NBER Working Paper No. 1642, September 2010.

[10] M. Angeles Villarreal and Ian F. Fergusson, The North American Free Trade Agreement, Congressional Research Service, April 2015.

[11] Theodore Moran and Lindsay Oldenski, How US Investments in Mexico Have increased Investment and Jobs at Home, Peterson Institute for International Economics, July 2014.

Interview with Richard N. Haass

Dr. Richard Haass is the president of the Council on Foreign Relations. He served as director of policy planning for the US Department of State, where he was a principal advisor to Secretary of State Colin Powell, from January 2001 to June 2003. From 1989 to 1993, he was special assistant to President George H.W. Bush and senior director for Near East and South Asian affairs on the staff of the National Security Council. He is the author or editor of fourteen books, including *A World in Disarray: American Foreign Policy and the Crisis of the Old Order* (2017). Below, he argues that US stepping back from global leadership on trade would harm, not help, US interests.

The views stated herein are those of the interviewee and do not necessarily reflect those of Goldman Sachs.

Allison Nathan: President Trump's views on trade seem tied to a deep-seated sense that US leadership in the world has served the interests of other countries much more so than the interests of the United States. Do you agree?

Richard Haass: No. The US has earned an enormous return on the investment it has made in the rest of the world, starting with Europe after WWII, and has been well-served by its leadership role over the past 70 years. We have experienced significant stability, no great-power conflicts, and unprecedented, tremendous prosperity, as has much of the rest of the world. And it is important to understand that our investment in the rest of the world is not an act of charity; it's an act of self-interest. We benefit from a more stable world that is not defined by war, and where the US can trade and invest freely.

I worry that Mr. Trump doesn't see these benefits of American involvement in the world and focuses too much on the costs. The domestic problems he is focused on are real, but he attributes them all too often to our dealings in the world rather than to our failings at home.

Allison Nathan: So you don't have sympathy for President Trump's argument that we have been spending too much on foreign policy/defense while losing out on trade?

Richard Haass: US spending on the rest of the world, including on defense, intelligence, aid, and diplomacy, is currently roughly half of what it was as a percentage of GDP during the Cold War. We can easily afford doing what we need to abroad and still do what we need to at home; there is no necessary tension between spending on guns and spending on butter.

Our domestic problems have not resulted from spending overseas. They have resulted from a combination of taxes that have been too high, particularly corporate taxes; insufficient infrastructure investment; substantial spending on education with little to show for it; an immigration system that does not let in enough of the most talented people in the world; and—more than anything—refusal to reform entitlement spending.

As for trade, the fact is that no trade deal could shield the effects of every worker in every firm or every industry from the effects of foreign competition or technological innovation. The right policy would include but go beyond writing better trade agreements and would prepare American workers for a world in which they have to get trained and retrained several times over the course of their careers.

Allison Nathan: Protectionism nevertheless seems to have a role to play in President Trump's "America First" strategy. Will this strategy serve US interests?

Richard Haass: I don't think so. Trade has an important geopolitical dividend. It's a way of supporting allies and promoting human development around the world, as well as integrating adversaries in a way that makes them think twice before they disrupt the status quo. So trade contributes to stability in the world. I am concerned about the new administration's negative view on trade and the economic and geopolitical consequences of any policies that could trigger trade-related conflicts with either China or Mexico.

Rather than benefitting the US, I believe Mr. Trump's "America First" message may prompt those countries that have been dependent on us to tilt towards other regional powers like Russia in Europe, China in Asia, or Iran in the Middle East. Alternatively, they may choose to take matters into their own hands and perhaps increase their spending on armaments or consider a nuclear option. That adds up to a world of greater potential for conflict and of reduced American influence. It's just not obvious to me how talking about 'America First' serves America's interests.

> "Trade has an important geopolitical dividend. It's a way of supporting allies and promoting human development around the world, as well as integrating adversaries in a way that makes them think twice before they disrupt the status quo…It's just not obvious to me how talking about 'America First' serves America's interests."

Allison Nathan: President Trump's statements on foreign affairs have often singled out China. Trump seems to view the One China policy and other foreign policy issues as areas where the US has leverage. Do you agree?

Richard Haass: I don't see any leverage accruing to the US from questioning the One China policy. One can only derive leverage from situations where your willingness to see things through is greater than the other side's. This just isn't the case here. The One China policy is mainland China's single most important national-security concern; no Chinese leader has any room for maneuver on it. If we seem to question it, rather than giving us leverage over the rest of the relationship, it will effectively shut down the relationship.

More importantly, why put in doubt a situation in which the status quo is perfectly acceptable? Even though the issue of Taiwan's relationship with the mainland remains unresolved, the status quo has endured for 45 years. I simply don't understand why we would try to disrupt a situation that is working well and risk bringing about one that could be politically, economically, and diplomatically costly—and could even bring the US and China into direct conflict.

Allison Nathan: Could Trump's statements on Russia and China reflect a desire to ally himself with the former in an effort to isolate the latter? Would such a strategy make sense in today's world order?

Richard Haass: I don't see any argument for pursuing "triangular diplomacy" like what the US deployed in the late 1960s and early '70s. And I certainly do not see any logic in trying to improve relations with Russia on the grounds that it either gives us leverage over China or is a substitute for a good US-China relationship. China's population is nine times the size of Russia's. China is integrated into the global economy in ways that Russia is not. To put it bluntly, the US-China relationship will be the single most important relationship of the 21st century, so it makes absolutely no strategic sense to sacrifice the prospects of that relationship in order to promote a much more limited relationship with Russia.

Allison Nathan: It is striking to see Chinese President Xi speaking out in defense of globalization at the same time that Trump seems to be embracing isolationism and/or nationalism. Do you think a world where China is leading globalization is possible, and what might it look like?

Richard Haass: I find it hard to imagine such a world simply because there are important aspects of openness that are inherently inconsistent with the primacy of the Communist party and the concentration of power that characterize China. China is not prepared to embrace the kind of openness we associate with globalization today. You're more likely to see a highly selective embrace of globalization on terms that would suit China economically without challenging its political order. That selective approach to globalization may make sense for China but it doesn't serve American interests.

It is both ironic and frustrating to see the leader of China seize the mantle of globalization days before the US president gave a speech that embraced protectionism and isolationism. China isn't in a position to be a serious champion of globalization, but my biggest concern is that the US stops being a champion—that it steps back from responding to globalization in a way that serves the interest of the US and others.

Allison Nathan: How would you characterize the international system that Trump is inheriting?

Richard Haass: I would describe the current system as being in a state of disarray—the word I use in the title of my new book. The world order that emerged after WWII has stood out for its lack of military conflict between great powers, but it is increasingly being challenged. In part, that's simply due to globalization; it has been difficult for governments to keep pace with the fast and large flows across borders. Adding to that is the dissemination of power across state and non-state actors, which has decentralized decision-making.

There is evidence of disarray all around us. The Middle East has a number of failed states and several ongoing military conflicts; Europe has seen a resurgence of populism and nationalism, leaving the European project more uncertain than ever; and Asia is grappling with the challenging questions of how to accommodate a rising China and a hostile North Korea with nuclear and ballistic missile capabilities. Given the number, breadth, and difficulty of the issues at hand, Mr. Trump is arguably inheriting a more daunting foreign-policy inbox than any US president in modern times.

> "I don't see any argument for pursuing "triangular diplomacy" like what the US deployed in the late 1960s and early '70s. And I certainly do not see any logic in trying to improve relations with Russia on the grounds that it either gives us leverage over China or is a substitute for a good US-China relationship."

Allison Nathan: What is your advice to President Trump as he faces this disarray?

Richard Haass: Rather than adding to the already full inbox of tricky foreign-policy issues, deal with what is already there. That means: Don't revisit the One China policy; don't tear up the Iranian nuclear agreement—as imperfect as it may be; don't pursue a narrow immigration policy that will cause national security and economic problems at home and alienate many abroad; and don't threaten the progress we have made in breaking down global trade barriers.

Allison Nathan: How could the international order be strengthened or improved from here?

Richard Haass: In my view, the current order, which is based on respect for nations' sovereignty, is inadequate to manage the disarray of today's interconnected and often borderless world. A new order based on mutual, voluntarily recognized, sovereign obligations is needed. Countries must not only respect each other's sovereignty but also take responsibility for what may be going on within their borders that could affect other nations, be it intellectual property infringement, abundant burning of polluting fossil fuels, or the harboring of international terrorists. President Trump's America First doctrine appears to be largely inconsistent with this idea.

Destination-based taxation and the USD

Michael Cahill questions whether DBTBA's effects on the US dollar will be as swift or as seamless as proponents expect, arguing that the greatest consequences for FX may come from the policy's impact on trade relations

Between higher tariffs and fiscal expansion, President Trump's proposed policies look set to support another leg of US dollar strength. But another policy proposal, although much less likely, has potentially far-reaching implications for FX: the House Republican plan to switch to destination-based taxation with border adjustment, or DBTBA. Under the proposed framework, taxes would be based on where goods and services are sold, rather than on their origin, with a so-called "border adjustment" that would allow firms to deduct domestic wages. This would result in a lower tax rate for firms that are net exporters and a higher tax rate for net importers (see pg. 19 for more details), making US exports more competitive than US imports.

Since free-floating currencies in principle reflect economies' competitiveness, the shifts caused by DBTBA would warrant an adjustment in the FX market. Indeed, proponents of DBTBA argue that the dollar would appreciate immediately and substantially in response to the proposed tax changes, so there would be no effect at all on trade flows or competitiveness; specifically, to fully offset DBTBA's effects, the dollar would need to appreciate 25% across the board. In reality, however, an immediate and complete offset to the policy is unlikely. That said, the policy change would still likely result in a stronger dollar, at least against emerging markets (EM)—in no small part because it would send a message of rising trade frictions.

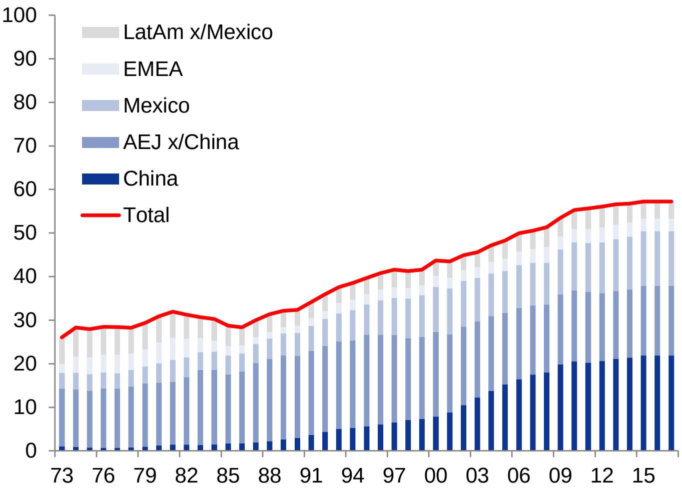
Operating on shaky assumptions

The theory behind DBTBA rests on shaky assumptions about the FX market. First, it assumes that exchange rates are free-floating (or, in the case of pegs, that they will be reset to keep the same level of competitiveness). However, many EMs intervene in some way to limit volatility against the dollar. Keep in mind that about 60% of the trade-weighted US dollar is against EM currencies, and China alone has a weight of more than 20%. Since EMs intervene both under appreciation and depreciation pressure, it would seem more than competitiveness considerations are at work; one obvious incentive for this intervention is to limit the volatility of EM financial liabilities denominated in US dollars.

A second—and perhaps more troublesome—assumption is that all foreign transactions are denominated in foreign currency and that companies do not hedge their currency risk. If that were true, firms with foreign costs would see them decline immediately in US dollar terms, and exporting firms would receive less in dollar terms. But if a firm has foreign costs denominated in dollars it would not matter whether the dollar fully adjusts or not; it would still be forced to raise prices and/or take a hit to margins, at least in the short term. In short, the adjustment to DBTBA would come through the real exchange rate—via inflation pressure—rather than the nominal exchange rate.

Not as free-floating as you'd think

Weight of EMs in the Fed's broad US dollar index, %



Source: Federal Reserve.

Think trade tension rather than tax shift

Finally, a third, more implicit assumption underlies DBTBA: that there would be no international retaliation to this tax change. But the new regime would likely be viewed as a violation of WTO rules, potentially provoking retaliation. Moreover, a policy that is widely expected to penalize importing firms (at least in the short run) would signal an aggressive turn in US trade policy. As a result, markets could very well treat DBTBA as an escalation of trade tensions between the US and the rest of the world.

FX implications of rising trade tensions

Less trade, and by extension lower potential growth in the US, could translate into a slower, shorter Fed hiking cycle. And concerns about supply chain disruptions could weigh on investor sentiment, as could renewed worries about China given the potential harm to Chinese exports. That sets up for a repeat of the market dynamics from early 2016, when China worries led to significant bouts of risk-off, and provided an additional boost to safe-haven currencies like JPY as markets rolled back Fed hike expectations.

We expect the dollar to strengthen against EM in this environment, and substantially so against the largest net exporters, like KRW and RMB. However, the performance of the dollar against the G10 is less obvious, given the potential support for G10 currencies, like JPY and EUR, from safe-haven flows and the unwind of the "policy divergence" trade.

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Q&A on destination-based taxation

The upshot: DBTBA would tax only goods and services consumed in the US, with domestic costs deducted from the tax bill. Think stronger dollar, higher inflation, a boost to net exporters, and a challenge for net importers. **Odds of it passing: 20%.**

What is DBTBA? Destination-based taxation with border adjustment (DBTBA) is effectively equivalent to an import tariff plus an export subsidy. Instead of taxing companies' total income net of total costs, DBTBA would tax companies only on income earned domestically and allow them to deduct only domestically sourced costs. DBTBA is part of the House Republican tax plan.

Why is it under consideration? DBTBA would be a significant revenue generator, enabling a cut to the corporate tax rate at a time when many US lawmakers are concerned about the budget deficit. GS economists estimate that DBTBA would raise enough revenue to offset lowering the statutory federal corporate tax rate from 35% to around 25% (vs. the 20% rate in the Republican plan). Moreover, if the Republican plan is deemed long-term revenue-neutral, it could pass with a simple majority in the Senate (rather than 60 votes) via the budget reconciliation process.[12] DBTBA could also help address key concerns with the current tax system by encouraging domestic production and reducing companies' ability/incentive to shift profits abroad.

Show me the money (back in the US, that is)

	Domestic Sales	Foreign Sales
Domestic Production	**Current Law:** Taxed by US when earned **Proposal:** Taxed by US when earned	**Current Law:** Taxed by US when earned **Proposal:** No US tax; free repatriation
Foreign Production	**Current Law:** Taxed by US when profits are repatriated **Proposal:** Taxed by US when earned; cost of imported goods no longer deductible	**Current Law:** Taxed by US when profits are repatriated **Proposal:** No US Tax; free repatriation

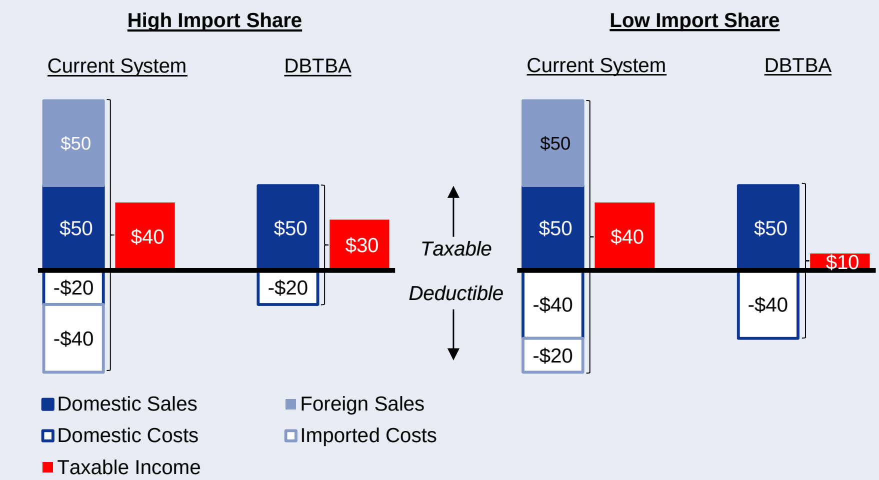
Source: Office of the Speaker of the House, Auerbach (2010), Tax Policy Center, Goldman Sachs Global Investment Research.

How would it work? In theory, the dollar would strengthen enough to completely offset DBTBA's effects on prices and trade flows. (Otherwise, domestic goods would be cheaper than imports, and US companies would earn more from exporting than from selling domestically.) For example, a US importer would no longer deduct the cost of parts bought overseas, but the cost of those parts would be lower in dollar terms. That said, GS economists are skeptical about the speed and the extent of this FX adjustment in practice, as well as how much it would actually be passed through to companies right away (see also pg. 18).

Who stands to win or lose? Net exporters (like aircraft manufacturers) would benefit, while companies with a high net import share (like apparel or computers) would suffer. Importers with smaller margins would be the most vulnerable under DBTBA, having less of a buffer against the loss of import cost deductibility. Another area that would see significant change is energy, where US oil and product prices would rise sharply relative to global prices. For more on asset implications, see pg. 20.

How likely is it? GS economists put the odds of DBTBA at 20%. Aside from creating clear winners and losers, DBTBA could have some unwelcome implications. At least initially, consumers would likely see higher inflation. And the dollar appreciation caused by DBTBA would lower the dollar value of non-dollar-denominated US assets held abroad while raising the value of foreign countries' dollar-denominated debt. Lastly, DBTBA is likely to run afoul of WTO rules.

A mixed bag for corporates



Illustrative only. Source: Goldman Sachs Global Investment Research.

For more on DBTBA, see US Daily: Q&A on the Economics of the Border Adjusted Tax, 2 February 2017 and:
US Daily: Tax Reform: Is the Destination-Basis Tax Coming to America?, 22 November 2016.
US Daily: What Would the Transition to Destination-Based Taxation Look Like?, 8 December 2016.
US Economics Analyst: Q&A on Tax Reform, 16 December 2017.
US Economics Analyst: The Economics of Corporate Tax Reform, 14 January 2017.
US Daily: Some Alternatives to the Border Tax, 18 January 2017.
US Daily: Can Border Adjustment Really Pay for Permanent Statutory Corporate Tax Rate Cuts?, 31 January 2017.

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[12] GS economists have written that the revenue offset generated by DBTBA is likely to fade over time, but note that the Republican tax plan could still potentially pass through budget reconciliation with the help of dynamic scoring, a process that accounts for a tax policy's future macroeconomic effects when estimating its impact on revenue.

A snapshot of our views

How would increased trade restrictions—taxes, tariffs, or otherwise—affect your asset class?
For more detail, click on the name of the asset class or analyst in the left-hand column.

DM FX

Robin Brooks
Silvia Ardagna

- US import restrictions would likely be supportive of the US dollar, particularly against EM currencies.
- In terms of DBTBA, we think markets would interpret the policy as an escalation of trade tensions, leading to substantial USD appreciation vs. EM, particularly large net exporters such as KRW and RMB.
- Should this interpretation of DBTBA weigh on risk sentiment, it could reduce market expectations for Fed rate hikes, thereby holding back USD appreciation against the G10. EUR and JPY would likely outperform EM currencies in such a scenario, as in most risk-off periods.

EM FX

Kamakshya Trivedi

- Protectionist US trade measures would be negative for EM growth and, in turn, for EM currencies. The risks are arguably highest in China and EM Asia, which export goods that may be perceived as competing with US labor. This reinforces our existing view that KRW, MYR, SGD, THB, and TWD have further room to weaken. In contrast, we like BRL, RUB, INR, ZAR, and COP, which tend to send the US commodities and other goods that are less politically sensitive than exports to the US from EM Asia.
- The dominance of the US in importing Mexican goods means Mexico has the most to lose from a realized impulse of US protectionism. However, this risk is priced to a significant extent, the MXN scans as undervalued on our suite of valuation metrics, and may benefit from stronger US growth.
- Overall, trade-related risks reinforce our 2017 Top Trade recommendation to be long "good carry" in EM (BRL, RUB, INR and ZAR), and to "hedge the China (and CNY) risk" using KRW and SGD.

Equity

David Kostin
Ben Snider

Caesar Maasry

Kathy Matsui
Hiromi Suzuki
Kazunori Tatebe

Tim Moe
Richard Tang

Peter Oppenheimer
Sharon Bell

- Trump's proposed tariffs and the Republicans' DBTBA proposal would both have negative implications for Asian equity markets. A 5% decline in US import growth could lead to an 8% drop in MXAPJ over 3 months, with the greatest impact in Korea, China, and Taiwan. However, the market does not appear to be discounting much trade risk or differentiating among stocks with varying degrees of vulnerability. Among Asian names with US revenue exposure, the most vulnerable are companies with non-US production that may face a negative impact from US policies and potential loss of market share.
- Given the fairly concentrated impact of past US tariffs on Asia, we favor a targeted approach to hedging against the risk of unfavorable US trade policies; click the Asia equity analysts' names at left for a link to our list of Neutral and Sell-rated names that could be vulnerable to concerns over rising trade barriers.
- Across the broader EM equity space, the markets with the largest trade exposure to the US—such as Mexico, China, Taiwan, and Korea—have underperformed the most relative to their expected returns. Below the index level, however—and in contrast to parts of EM FX—trade risks so far appear to be taking a back seat. As in Asian equities, the companies across EM with largest US exposure do not appear to be pricing in a meaningful shift in US trade policy. We would shy away from these stocks, as trade risks may escalate. Our preference remains for "domestic cyclical" oriented EM equities.
- European equities appear less vulnerable to US trade restrictions or the DBTBA. A company with 50/50 US/Europe exposure that imports just 10% of COGS into the US would see group profits fall 8%. That said, large listed European companies do not generally manufacture in Europe and sell into the US. Indeed, the 45 stocks in our US-exposure basket (GSSTAMER) have an average US sales exposure of 50%, but also have c. 40% of their employees and 50% of their assets in the US.
- The EU also represents just 8% of US imports of labor-intensive goods, which could be targeted with the aim of repatriating jobs to the US. EU exports to the US are larger in high-tech and skill-intensive industries, implying higher margins and better pricing power to absorb a tax or tariff adjustment.
- Japan's macro vulnerability to US trade protectionism and/or DBTBA appears relatively limited. However, the market is already distinguishing between Japanese stocks with low (<20% revenues) vs. high (>20%) US exposures. The market also appears to be distinguishing firms with relatively small gaps between their US sales and their US production ratios (which should outperform) from those with relatively large gaps (which are more vulnerable). Click the Japan equity analysts' names at left for a link to our list of Neutral/Sell-rated stocks with significant US exposure and downside to their target prices.
- In the US, we expect that any protectionist trade policies would benefit domestic-facing firms (GSTHAINT) relative to companies with high foreign revenues (GSTHINTL). As far as DBTBA is concerned, US companies with high net imports and low margins (e.g., apparel firms) stand the most to lose, while companies with the largest export share (e.g., aircraft manufacturers) stand the most to gain.

Commodity

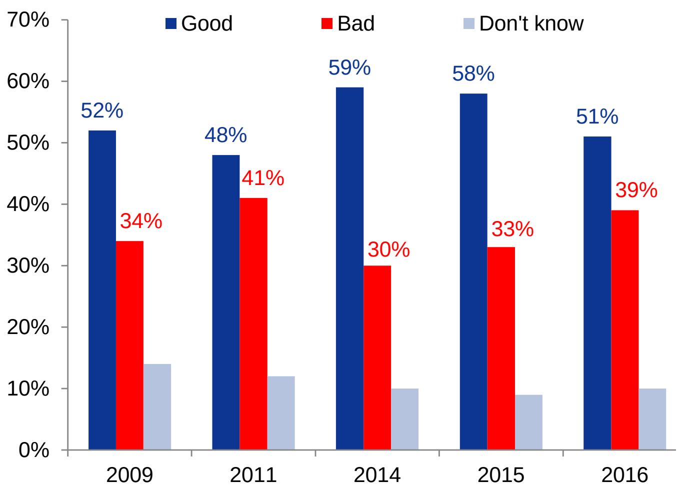
Jeff Currie
Damien Courvalin

- DBTBA at a 20% corporate tax rate would immediately lead to a 25% appreciation of US crude and product prices vs. global prices, providing US producers excess returns and incentivizing them to sharply increase activity. This would raise the prospect of a renewed large oil surplus in 2018, likely prompting an immediate sharp decline in global oil prices. Beyond the impact on 2018 spot prices, the extent of the decline in deferred global oil prices will depend largely on the DBTBA's inflationary impact on US service costs and its deflationary impact, via USD appreciation, on foreign production costs. Given the contracted nature of oil services, these shifts would pass through only gradually. Longer-term, the decline in the US tax rate could force a deflationary tax policy response abroad, sustainably reducing oil's marginal cost of production and long-term oil prices (potentially to $40/bbl Brent, by our estimates).
- These shifts would hold for other commodity markets, including markets where the US is a larger producer than consumer, like agriculture. It would also hold for global gas, depressing global LNG prices, although other factors may initially lead to mostly regional shifts in US gas prices.

Trade perspectives in pics

US sentiment on trade: Worsening at home…

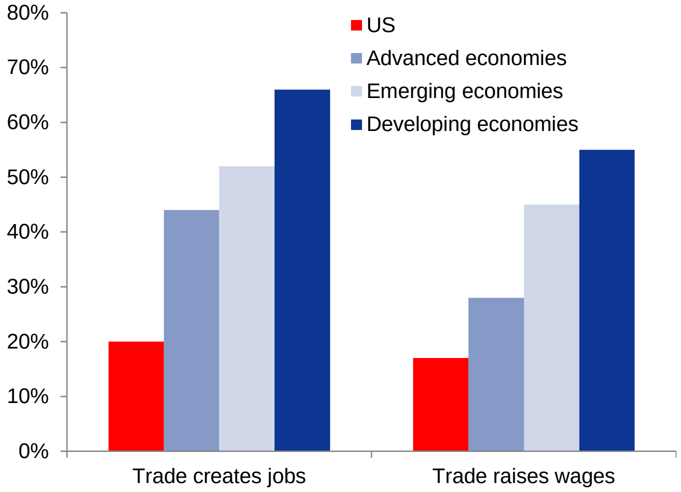
Survey respondents saying FTAs have been good/bad for the US, %



Source: Pew Research Center (last survey conducted March 17-27 2016).

…and more negative than abroad

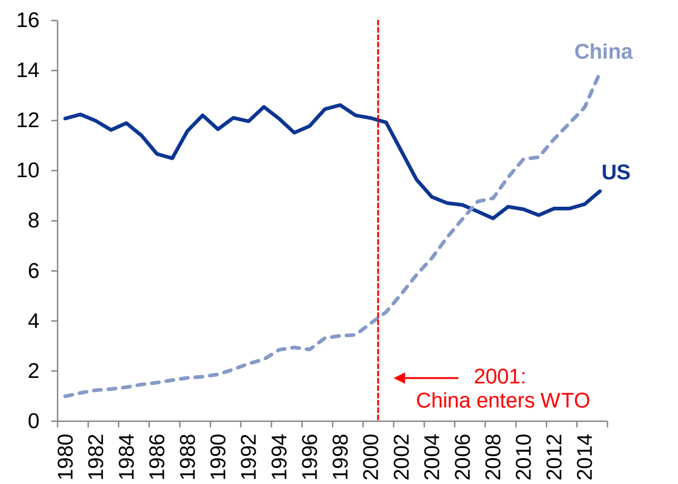
Survey respondents agreeing that trade creates jobs/raises wages, %



Note: Country groups show medians. Advanced median excludes the US.
Source: Pew Research Center Spring 2014 Global Attitudes Survey.

China has been a focal point for US trade policy…

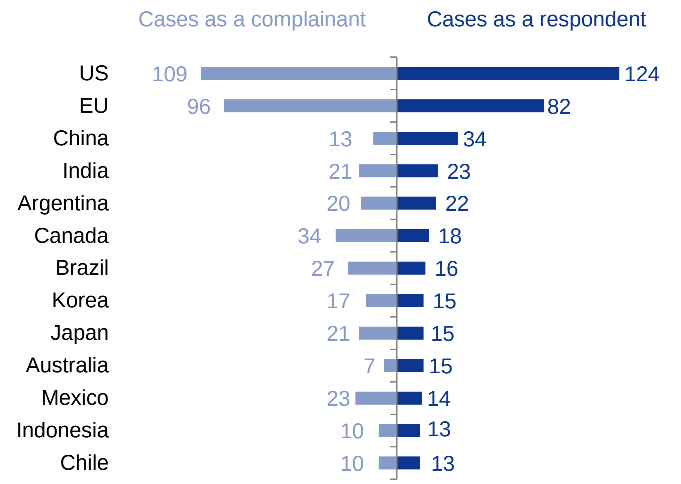
US and Chinese share of world exports, %



Source: IMF, Haver Analytics.

…but is not the biggest target of WTO complaints

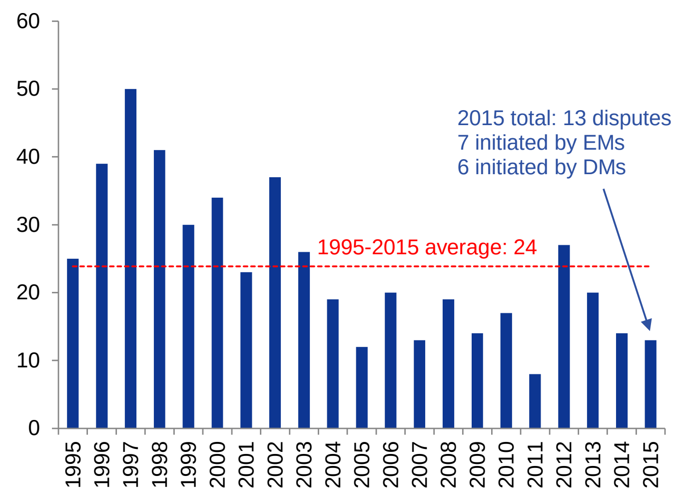
Countries most frequently involved in WTO cases shown by no. of cases in which the country was a complainant/respondent, 1995-2015



Source: WTO.

WTO disputes have been below-average…

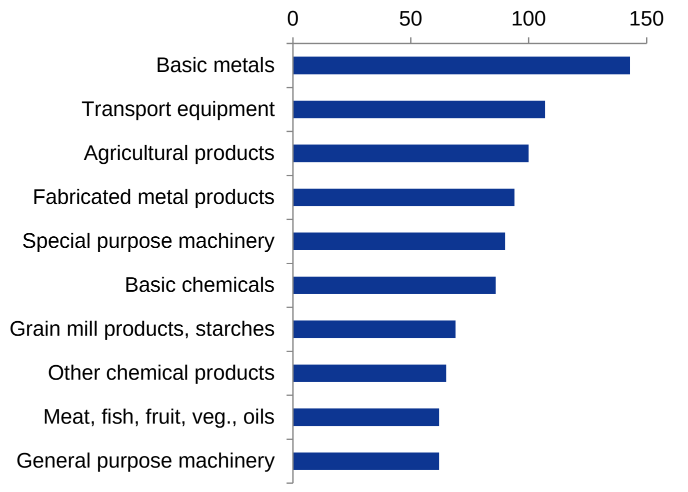
No. of WTO disputes initiated each year



Source: WTO.

…while trade barriers focus on the "usual suspects"

No. of discriminatory measures* imposed in each sector, globally (2015)



**Includes tariffs and other duties, as well as state aid. Source: Global Trade Alert.*

Trade terms

Import/export quota: A limit on the quantity of a particular import/export.

Import tariff: A tax on imports that can be applied as a fixed amount per unit/quantity of imports (a specific tariff) or as a percentage charged on the value of imports (an ad valorem tariff).*

Export subsidy: A policy incentivizing exports via subsidies or other forms of government support contingent on export targets, or requirements for using domestic goods. The WTO prohibits export subsidies but allows "actionable" subsidies (e.g., production subsidies) that are not specifically intended to influence trade flows, provided that they do not harm the interests of another WTO member. WTO members can respond to export subsidies by filing a dispute with the WTO or by conducting an investigation to authorize **countervailing duties**.

Countervailing duty: A tariff levied in response to **export subsidies**. To impose countervailing duties, WTO members must prove that another member's actions constitute a prohibited subsidy and are harming domestic industry. Countervailing measures under the WTO are usually limited to five years.

Dumping: Selling exports at a price below the usual price in the exporter's domestic market. The WTO does not regulate dumping (which—unlike an export subsidy—is done by companies, not by governments). However, the WTO does allow members to respond, either by filing a dispute with the WTO or conducting an investigation to authorize **anti-dumping duties**.

Anti-dumping duty: A tariff levied in response to **dumping**. To impose anti-dumping duties, WTO members must prove that another member's actions constitute dumping and are harming domestic industry. Anti-dumping measures under the WTO are usually limited to five years.

Tariff-rate quota or tariff quota: A tiered system whereby a country imposes a lower **tariff** on imports below a particular quota and a higher tariff on imports above that quota.

Safeguard action: A temporary restriction on imports permitted by the WTO in response to an import "surge" demonstrated, via investigation, to be causing serious harm to domestic industry. Safeguards are usually limited to four years but can be extended in some circumstances. Exporters targeted by safeguards are entitled to compensation from the importer or may otherwise retaliate in kind, though not always immediately.

Currency manipulator: A designation the US Treasury can make under the 1988 Omnibus Trade Act, which requires Treasury to report biannually on trading partners' exchange rate policies. Applying the designation requires the US to initiate negotiations with the trading partner to adjust the exchange rate and "eliminate the unfair advantage." It does not currently trigger specific penalties, though US lawmakers have previously proposed legislation that would enact punitive measures.

Non-tariff barrier: Trade restrictions other than tariffs, including **import quotas**, **export subsidies**, import licensing requirements, certain customs procedures, and various other bureaucratic/legal processes that encumber trade.

Sanitary and phytosanitary (SPS) measures: Import restrictions related to health and food safety standards. The WTO permits such measures, provided that they are based on scientific evidence and recognized standards, but it acknowledges that governments may use SPS issues as a pretext for protectionism.

**Note: The "big border tax" that has been mentioned in President Trump's tweets is most likely comparable to an import tariff, in contrast to the border-adjusted tax included in the House Republicans' tax proposal (see pg. 19 for more).*

Source: WTO, Goldman Sachs Global Investment Research.

Summary of our key forecasts

	GDP Growth (% yoy)				FX				Equity				Rates (% eop)				Revision Notes
	2017		2018		3-mth		12-mth		3-mth		12-mth		Policy*		10-yr		
	GS	Cons	GS	Cons	GS	Cons	GS	Cons	GS	Cons	GS	Cons	2017	2018	2017	2018	
Global	3.6	3.2	3.7	3.4	-	-	-	-	-	-	-	-	-	-	-	-	
					EUR/$		EUR/$		SP500		SP500						
US	2.2	2.3	2.2	2.3	1.08	1.03	1.00	1.05	2400	-	2300	-	1.25 to 1.50	2.25 to 2.50	3.00	3.50	On January 4, we raised our 2017/2018 10-year US Treasury yield forecasts to 3.00%/3.50%, respectively, from 2.75%/3.30% previously, reflecting our expectations for higher inflation and expansionary fiscal policy.
					EUR/$		EUR/$		Eurostoxx 50		Eurostoxx 50						
EURO AREA	1.4	1.4	1.4	1.5	1.08	1.03	1.00	1.05	3400	-	3450	-	0.00	0.00	-	-	On January 6, we raised our 3/6/12-month Eurostoxx 50 targets to 3400/3400/3450, respectively, from 3150/3200/3250 previously, reflecting support from improved macro data, fading deflationary fears, higher oil prices, and modest support from the EUR/USD exchange rate.
					EUR/$		EUR/$		DAX 30		DAX 30						
GERMANY	1.4	1.5	1.4	1.6	1.08	1.03	1.00	1.05	-	-	-	-	-	-	0.80	1.35	
					$/JPY		$/JPY		TOPIX		TOPIX						
JAPAN	1.3	1.0	1.1	0.9	118	117	125	120	1600	-	1660	-	-0.10	-0.10	0.20	0.50	On December 22, we raised our 3/6/12-month TOPIX targets to 1600/1500/1660, respectively, from 1550/1500/1600 previously, reflecting greater-than-expected yen weakness and increased net buying by foreign investors. On January 4, we raised our 2017/2018 10-year JGB yield forecasts to 0.20%/0.50%, respectively, from 0.15%/0.30% previously, reflecting our view that BOJ easing and JPY depreciation will lift inflation expectations, increasing the BOJ's tolerance for higher bond yields.
					$/CNY+		$/CNY+		MXCN		MXCN						
CHINA	6.5	6.5	6.3	6.2	7.00	7.00	7.30	7.20	-	-	66	-	2.10	1.75	-	-	
					$/BRL		$/BRL		BOVESPA		BOVESPA						
BRAZIL	1.1	0.7	2.6	2.2	3.20	3.40	3.40	3.49	-	-	-	-	10.00	9.00	-	-	

Commodities	Brent crude oil ($/bbl)				Copper ($/mt)				Gold ($/toz)				Corn (cent/bu)			
	3-mth		12-mth		3-mth		12-mth		3-mth		12-mth		3-mth		12-mth	
	GS	Cons	GS	Cons	GS	Cons	GS	Cons	GS	Cons	GS	Cons	GS	Cons	GS	Cons
	59	55.16	57	58.00	5800	-	5600	5365	1200	1200	1250	1240	350	-	335	-

Note: Recent revisions marked in red; GDP consensus is Bloomberg; all other consensus is Reuters; commodity 12-mo consensus is Reuters for 2017 average.

+ CNY daily fix * Euro area rate is MRO rate. China rate is 7-day repo rate.

Source: Bloomberg, Thomson Reuters, Goldman Sachs Global Investment Research.

Glossary of GS proprietary indices

Current Activity Indicator (CAI)

Measures the growth signal in the major high-frequency activity indicators for the economy. Gross Domestic Product (GDP) is a useful but imperfect guide to current activity. In most countries, GDP is only available quarterly, is released with a substantial delay, and initial estimates are often heavily revised. GDP also ignores important measures of real activity, such as employment and the purchasing managers' indexes (PMIs). All of these problems reduce the effectiveness of GDP for investment and policy decisions. Our CAIs are alternative summary measures of economic activity that attempt to overcome some of these drawbacks. We currently calculate CAIs for the following countries: USA, Euro area, UK, Norway, Sweden, China, Japan, Hong Kong, India, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand, Australia and New Zealand.

Financial Conditions Index (FCI)

Financial conditions are important because shifts in monetary policy do not tell the whole story. Our FCIs attempt to measure the direct and indirect effects of monetary policy on economic activity. We feel they provide a better gauge of the overall financial climate because they include variables that directly affect spending on domestically produced goods and services. Each FCI is calculated as a weighted average of a policy rate, a long-term riskless bond yield, a corporate credit spread, an equity price variable, and a trade-weighted exchange rate; in the Euro area we also include a sovereign credit spread. The weights mirror the effects of the financial variables on real GDP growth in our models over a one-year horizon.

Global Leading Indicator (GLI)

Our GLIs provide a more timely reading on the state of the global industrial cycle than the existing alternatives, and in a way that is largely independent of market variables. Global cyclical swings are important to a huge range of asset classes; as a result, we have come to rely on this consistent leading measure of the global cycle. Over the past few years, our GLI has provided early signals on turning points in the global cycle on a number of occasions and has helped confirm or deny the direction in which markets were heading. Our GLI currently includes the following components: Consumer Confidence aggregate, Japan IP inventory/sales ratio, Korea exports, S&P GS Industrial Metals Index, US Initial jobless claims, Belgian and Netherlands manufacturing surveys, Global PMI, GS Australian and Canadian dollar trade weighted index aggregate, Global new orders less inventories, Baltic Dry Index.

Goldman Sachs Analyst Index (GSAI)

Our US GSAI is based on a monthly survey of Goldman Sachs equity analysts to obtain their assessments of business conditions in the industries they follow. The results provide timely "bottom-up" information about US economic activity to supplement and cross-check our analysis of "top-down" data. Based on their responses, we create a diffusion index for economic activity comparable to the ISM's indexes for activity in the manufacturing and nonmanufacturing sectors.

Macro-data Assessment Platform (MAP)

Our MAP scores facilitate rapid interpretation of new data releases. In essence, MAP combines into one simple measure the importance of a specific data release (i.e., its historical correlation with GDP) and the degree of surprise relative to the consensus forecast. We put a sign on the degree of surprise, so that an underperformance will be characterized with a negative number and an outperformance with a positive number. We rank each of these two components on a scale from 0 to 5, and the MAP score will be the product of the two, i.e., from -25 to +25. The idea is that when data are released, the assessment we make will include a MAP score of, for example, +20 (5;+4)—which would indicate that the data has a very high correlation to GDP (the '5') and that it came out well above consensus expectations (the '+4')—for a total MAP value of '+20.' We currently employ MAP for US, EMEA and Asia data releases.

Real-Time Inflation and Activity Framework (RETINA)

RETINA provides a comprehensive econometric methodology able to filter incoming information from the most up-to-date high frequency variables in order to track real GDP growth in the Euro area. Along with a GDP tracker, RETINA also captures the interrelated mechanisms of the area-wide pricing chain, providing a short-term view on inflation dynamics.

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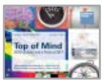

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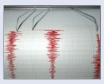

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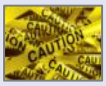

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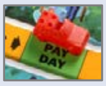

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Reg AC

We, Allison Nathan, Marina Grushin, Michael Cahill, Nicholas Fawcett, Alec Phillips, Alberto Ramos, Daan Struyven, Andrew Tilton, and Ian Tomb, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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