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By John Vail,
Chief Global Strategist

nikko am
Nikko Asset Management

GLOBAL RAMIFICATIONS OF THE EUROZONE'S HUGE TRADE SURPLUS

It seems that US Administration officials may be upset that the Eurozone CPI has not risen fast enough to make the ECB reduce its super-accommodative policies, and have, thus, turned to verbal rhetoric and other methods to prevent the Euro from weakening while the Fed raises rates. It may be no coincidence that many economists and currency analysts, after years of ignoring such "old fashioned" indicators, are now talking about the massive trade surplus that the region enjoys with the world, but in particular with the US. This surplus has long been huge, but surged to new heights in December, forming a major reason why the overall US trade deficit expanded sharply at the end of the year. Clearly, the US Administration desires a reduced trade deficit and, thus, the ECB and its currency will be clear targets, along with China. Is it coincidence that Trump threatened to tax European auto imports, perhaps up to the 10% level that it imposes on its imports of US autos, if Europe retaliates against the steel and aluminum tariffs?

Pure free-traders dislike protectionist trends and such can indeed be dangerous, but it will very likely be a continuing reality as even if Democrats win in the future, as they will need to be populist to win the Rust Belt and American labor in general. Thus, in my view, **Voluntary Export Restraints in autos, steel and other items are about to make a major comeback from the Reagan years**. The US Administration would have preferred to use market forces and moderate dollar depreciation (as long as it does not cause higher US interest rates) to achieve a lower trade deficit, but such seem too slow to work in isolation. Thus, it will need to use currency and protectionist jawboning with the goal of import substitution. As I have long counselled Japanese observers, it is better to get ahead of this trend and replace exports of low-end goods with US production. As a lesson for this, Korean washing machine companies recently hit by high US anti-dumping duties clearly now wish they had built US plants earlier. Fortunately for Japan, its trade surplus with the US is rather small, at one sixth of China's and a third of the Eurozone's in December, but it should prepare for more robot-light FDI into the US (especially the diversion of auto production in Mexico) or fewer low-end exports despite the excellent geopolitical relationship between the two countries.

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As for the Eurozone, the currency and trade surplus must both be analyzed as a regional whole. It does not matter if some Eurozone countries are not as competitive as Germany, in the same way that California's trade balance cannot be separated from the US. The Eurozone trade surplus in December was at nearly half of China's level. This is too large and European officials cannot continue to claim that the Euro is too high. More likely it is 10% undervalued even after its recent appreciation, which would return it to its 2014 level of nearly 1.40: USD.

The positive aspect of a moderately weaker USD is that it will delay hikes by the BOJ and ECB and suppress bond yields there, which will then continue to help suppress US bond yields. This is important as continuing Fed hikes are already causing US government interest expenses to surge for shorter term instruments and if bond yields were to rise commensurately, it would cause inordinate trouble. Hopefully, this scenario, coupled with import substitution will reduce the US trade deficit and rebalance the world economy.

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