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Trump's Protectionist Threat to Latin America

Laura Alfaro, Guillermo Calvo, Roque Fernandez, Pablo Guidotti, Guillermo Perry, Liliana Rojas-Suarez, and Ernesto Talvi

The economic impacts of Donald Trump's trade dispute with China have so far been limited, but the countries of Latin America are nonetheless paying an early price. For a region where many economies are already constrained by weakened fiscal positions, the additional uncertainty caused by rising protectionism is especially unwelcome.

Despite many dire predictions, the ongoing trade dispute between the United States and China has not resulted in a global economic downturn. With South Korea, Brazil, Australia, and Argentina permanently exempted from US tariffs on steel and aluminum, and with certain measures applied only to final goods and primary products, the impact of rising Sino-American trade tensions has so far been limited.

But that does not mean the tilt toward protectionism has been harmless. On the contrary, US President Donald Trump's posturing has increased economic uncertainty, contributed to stock market corrections, and added volatility to capital markets. For countries in Latin America, in particular, these and other perils are fueling concern that more severe economic pain is in store.

From Argentina to Mexico, the threat of a trade war between the world's two largest economies has raised risk premia and led to measurable declines in investment. Projected interest-rate hikes in the US are also boosting uncertainty in Latin America, where countries with large borrowing requirements are particularly vulnerable to disruptions in capital markets.

Although the Sino-American trade dispute has not significantly affected economic growth in either country, if either economy did slow, Latin American countries would certainly suffer. The collateral damage would include a fall in commodity prices, reduced aggregate demand, lower capital inflows, and fiscal retrenchment.

For economies already constrained by weakened fiscal positions, trade-induced upheavals would be costly. In Brazil, for example, the debt-to-GDP ratio is more than 80%, and debt burdens are growing in Colombia, Mexico, and Uruguay as well. Argentina is running a large fiscal deficit, while the main source of financial vulnerability in Chile is the private sector's rising external debt.

Mexico's unease is further amplified by the uncertain future of the North American Free Trade Agreement (NAFTA). The Mexican case, in particular, demonstrates how prolonged trade-related threats, even when unrealized, affect capital flows, exchange rates, inflation, interest rates, and, ultimately, economic activity.

To be sure, the impact of America's trade protectionism will be felt far beyond Latin America. In a world that is highly integrated financially and prone to episodes of volatility, weakened multilateralism will reduce the ability of global bodies – like the World Trade Organization and the International Monetary Fund – to mediate disputes.

Moreover, the financial risks associated with the US serving as the main provider of global money cannot be overlooked. If America's trade disputes reduce confidence in the dollar, many economies will pay a heavy price.

Still, Latin American economies – which have benefited greatly from expanded trade with China and the US – may have more to lose than most. For example, one of the biggest regional unknowns is how America's retreat from multilateral engagement will affect the IMF's ability to respond to future capital-market disruptions. In the past, the US has led IMF efforts to deal with financial crises in emerging markets. With the US signaling that it will abandon this role, the Fund's ability to respond effectively is now in doubt.

For Latin American countries, this concern is not hypothetical. Financial and technical assistance to the region in the 1990s and 2000s was critical to its recovery from the lost decade of the 1980s. Today, with many Latin American economies increasingly vulnerable to external shocks, it is not unreasonable to think that IMF assistance could once again be necessary. Argentina is a case in point.

In other words, with trade conflicts escalating, international interest rates climbing, and US-led safety nets weakening, a perfect storm is gathering on Latin America's economic horizon. If the region is to steer clear of it, two course corrections are urgently needed. First, governments must consolidate their fiscal positions to reduce current-account deficits and lower external debt. And, second, the IMF – with or without US leadership – must strengthen its instruments and policies to address future financial crises in emerging markets.

The threat of an all-out Sino-American trade war showed signs of abating in May, when the two sides held talks and agreed to a deal that would reduce their multibillion-dollar trade imbalance. However, details of that agreement were scarce, and less than two months later, US tariffs on Chinese goods valued at $34 billion came into effect, with China immediately announcing retaliatory tariffs. For countries caught in the crossfire, and with uncertainty obscuring the future of global trade, the best hope for stability is to prepare for every eventuality.

LAURA ALFARO, Warren Alpert Professor of Business Administration, Harvard Business School; former Minister of Planning and Economic Policy, Costa Rica

GUILLERMO CALVO, Professor, University of Columbia; former Chief Economist, Inter-American Development Bank

ROQUE FERNANDEZ, Economics Professor, UCEMA University; former Minister of Finance, Argentina

PABLO GUIDOTTI, Professor of the Government School, University of Torcuato di Tella; former Vice minister of Economy, Argentina

GUILLERMO PERRY, Non-resident Fellow, Center for Global Development; professor, University of the Andes; former Minister of Finance, Colombia

LILIANA ROJAS-SUAREZ, is a senior fellow at the Center for Global Development, and President of the Latin American Committee on Macroeconomic and Financial Issues (CLAAF)

ERNESTO TALVI, Director, Brookings Global-CERES Economic & Social Policy in Latin America Initiative, Brookings; Academic Director CERES; former Chief Economist, Central Bank of Uruguay

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