OUTLOOK

ECONOMIC DATA AND COMMENTARY

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Unfinished Business: Tariffs, Trade and the U.S. Economy

In recent months, the United States has resolved a number of disputes with key trading partners, which has provided a more positive environment for agriculture and other export-dependent industries. In late August, the Trump administration reached a preliminary agreement on a new trade deal with Mexico. Three weeks later came a similar announcement regarding an updated bilateral trade agreement between the United States and South Korea. Then, on September 30, the U.S. and Canada announced they too had settled a number of longstanding trade issues, paving the way for a new U.S.-Mexico-Canada trade pact to replace NAFTA. These developments were welcome news for U.S. exporters following months of growing uncertainty around the direction of American trade policy.

Still unresolved, however, is the situation between the U.S. and its largest single trading partner, China. Since January, the two nations have imposed billions of dollars in tariffs on each other's export products, with no resolution in sight. In addition, U.S. tariffs remain in place on all steel and aluminum imports, as do retaliatory tariffs imposed by Mexico on American agricultural and other products. Meanwhile, the U.S. is attempting to forge new trade agreements with Japan, the United Kingdom and the European Union.

For perspective on what remains a highly fluid trade situation, OUTLOOK turned to Scott Baier, chair of the economics department at the Clemson University and a senior economist on the Council of Economic Advisers in the administration of President George W. Bush. Baier says that the current administration's approach does appear to be bringing some trading partners to the negotiating table. Yet the larger, longer-term impact of today's trade conflicts is much more difficult to predict. OUTLOOK spoke with Baier about what has happened so far and what may be ahead.

OUTLOOK: A lot of media organizations have been using the term "trade war" in their recent coverage of U.S. trade policy. Is that an accurate characterization or hyperbole?

Baier: "Trade tensions" are when two countries or a group of countries cannot seem to agree over trade policies or outcomes. I think that has been bubbling under the surface with the NAFTA talks and U.S.-China relationships for some time. Trade tensions may also include one country levying tariffs or pursuing remedies through the World Trade Organization to relieve its domestic industries facing import competition. When countries retaliate, raising and counter-raising tariffs, that starts to look like a trade war.

This Month's Expert

Scott Baier is an associate professor and chairs the John E. Walker Department of Economics at the College of Business at Clemson University. He joined the Clemson faculty in 2001, after serving from 1996-2000 on the faculty in the Department of Finance and Business Economics at the University of Notre Dame. From 1999-2012, Professor Baier was a visiting scholar at the Federal Reserve Bank in Atlanta. From 2007-2008, Baier was a Senior Economist on the Council of Economic Advisers, where he provided economic analyses of current events and pending legislation and helped produce the Economic Report of the President.

Baier's award-winning research focuses on international trade and economic growth and development. His project, "The Causes and Consequences of Regionalization," was supported by a grant from the National Science Foundation. His paper, "How Important are Capital and Total Factor Productivity for Economic Growth?" – produced jointly with fellow Clemson Economics Professor Robert Tamura and Jerry Dwyer of the Atlanta Fed – won the 2007 Best Article Award in *Economic Inquiry*. Another paper, "The Growth of World Trade" (with Jeff Bergstrand), won the Bhagwati Award for the best paper in the *Journal of International Economics* in the years 2001 and 2002.

OUTLOOK: The U.S. has announced a series of tariffs this year, many of which have been aimed directly at China. How would you characterize the Chinese response?

Baier: So far, it has been tit for tat. When the U.S. imposed $34 billion of tariffs on Chinese imports in July, China responded with $34 billion on U.S. imports. Then came the additional $16 billion of tariffs in August on both sides. China has targeted U.S. industries including, prominently, soybeans, pork products and other agricultural goods, as well as autos and certain aircraft. These tariffs were designed to hit industries where the U.S. has a competitive advantage in producing and where China is a large enough importer to have an impact on key U.S. industries. China has been fairly careful so far not to impose tariffs at a level that might threaten to slow down its own economic growth.

The September announcement by the U.S. of immediate 10 percent tariffs on an additional $200 billion in Chinese goods that will rise to 25 percent in January takes things to a whole new level. The Trump administration's position is that because we import more from China than China imports from us, we have greater latitude when it comes to imposing tariffs. That's possibly true, but China has other ways it can retaliate.

OUTLOOK: What non-tariff measures might China consider?

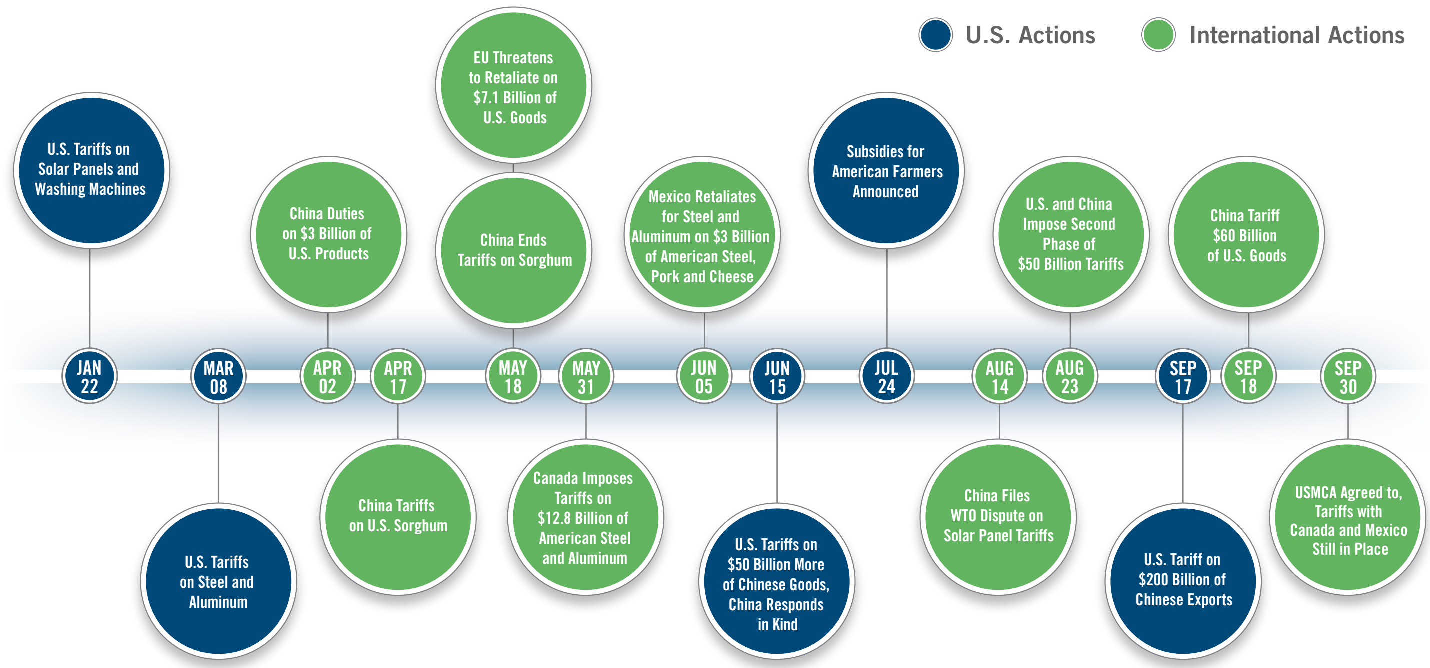
Baier: There's some anecdotal evidence that China is already using non-tariff barriers – for example, by holding U.S. products longer at the port for additional inspections, verifications and licensing checks. In other words, they're slowing down the whole delivery process for U.S. goods entering China. In a competitive global economy, speed is essential. International trade isn't just about getting people to buy your goods, it is also about how quickly you can get those goods from one place to another.

OUTLOOK: What impact are Chinese counter-tariffs having on U.S. agriculture and other industries?

Baier: They're putting downward pressure on the price of goods. Over the past year we've seen a roughly 25 percent drop in soybean prices. Now, part of that is due to a bumper crop in the United States and an increase in global supply of soybean products. Still, there's no doubt that the tariffs have reduced foreign demand for our soybeans and that has caused the price of soybeans in the domestic market to fall.

As a remedy, President Trump has offered $12 billion in financial support for farmers. A recent study from the U.S. Chamber of Commerce showed that if we were going to compensate all of the industries that have been negatively impacted by the tariffs, that figure would have to be more like $39 billion.

2018 TRADE DISPUTES TIMELINE



Source: CoBank

OUTLOOK: The first major tariffs enacted by the U.S. this year were imposed on steel and aluminum imports. Why did the Trump administration target those products in particular?

Baier: It goes back to the view that the steel and aluminum industries are important for manufacturing, and the president, during his campaign, stressed that he was going to build back the U.S. manufacturing base. So I think steel and aluminum were low-hanging fruit to prop up employment and production.

What's interesting is that Trump took this action citing section 232 of the Trade Expansion Act of 1962, which authorizes the president to use trade policy to protect industries vital to national security. Section 232 is intended for times of war or during national emergencies; the administration is stretching the definition of "national security" to include economic welfare. Section 232 also lets the president act on his own, without consulting Congress.

> "It's interesting to note that some manufacturers that were protected by earlier tariffs are now feeling the brunt of the new ones."

OUTLOOK: Are the tariffs working as they were intended?

Baier: There's some initial evidence that they are, at least for those industries that are being protected. We're seeing rising U.S. employment in steel and aluminum. Another measure to assess the impact is to look at price. And, certainly, we have seen the price of imported aluminum and steel rise, which means that domestic aluminum and steel producers are becoming more cost competitive. They can charge higher prices, too, because the price of imports is rising.

OUTLOOK: What effect are the tariffs having on other U.S. manufacturers?

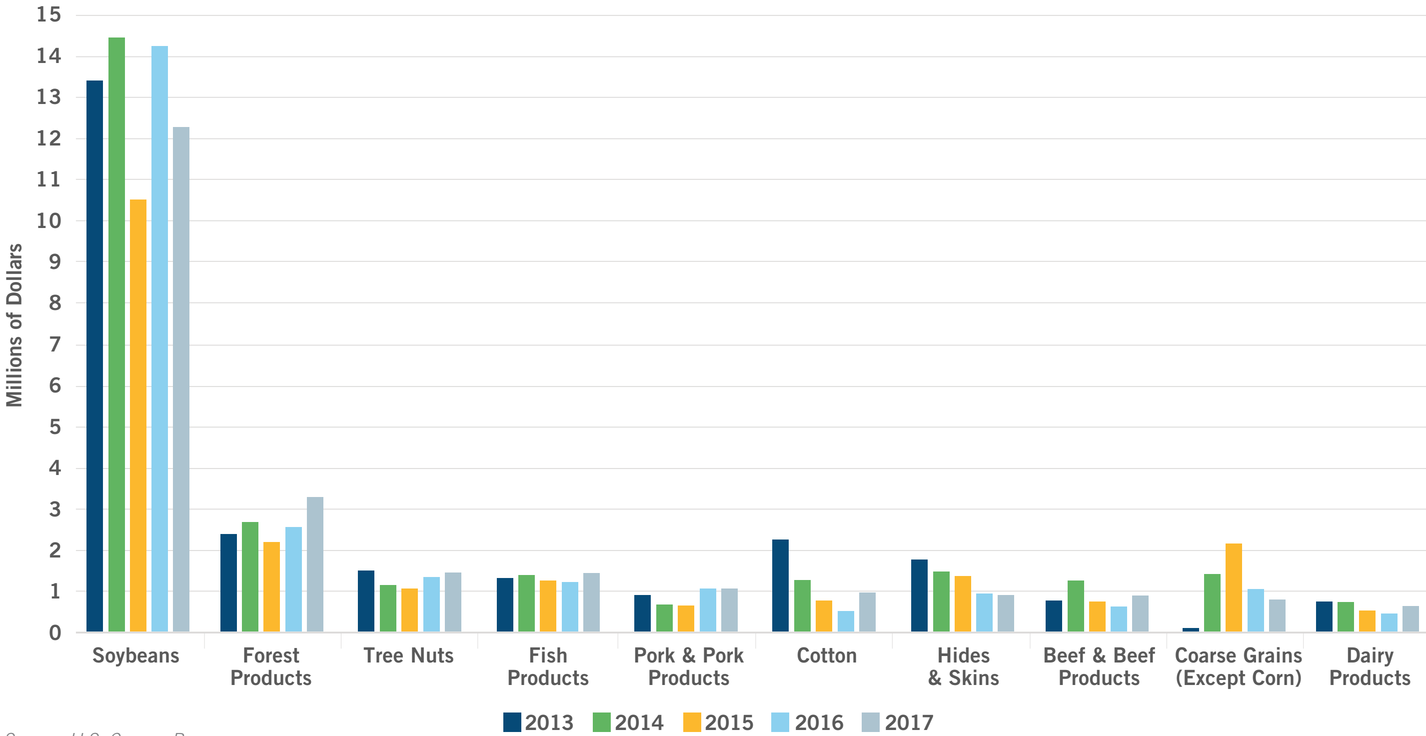
Baier: Higher steel and aluminum prices translate directly into higher costs for any firm that uses steel. The American Institute for International Steel, a consortium of steel-using companies, has been rallying to try to open markets back up because those companies' costs are increasing. One recent study estimated that for every steel or aluminum job saved, 16 other jobs will be lost because of downstream costs and reduced demand. Affected manufacturers include construction, automotive, farm equipment, food processing, beverages and electronics. Smaller start-up manufacturers are likely to be even more acutely affected, because they have less leverage when it comes to negotiating prices or acquiring commodities or goods that are in short supply.

It's interesting to note that some manufacturers that were protected by earlier tariffs are now feeling the brunt of the new ones. For example, appliance manufacturers benefited from a tariff imposed last January on imported washing machines. But now, higher steel and aluminum prices have cut into their profit margins and they have not performed as well.

OUTLOOK: What's the impact on service industries?

Baier: It's easy to assume that services industries wouldn't be affected. But the impact on them, while indirect, is likely to be real. If production in steel-using industries declines due to higher costs, they're going to consume fewer financial, legal and business services. There will be less need for payroll services and transportation. The service sector is a major portion of the economy – and has a significant overall surplus with other countries – and a lot of those jobs support manufacturing.

TOP 10 U.S. AGRICULTURAL EXPORTS TO CHINA



Source: U.S. Census Bureau

OUTLOOK: How optimistic are you that the United States will ultimately resolve its trade disputes with China?

Baier: It won't be easy. In addition to the tariffs and heated rhetoric already standing between the United States and China, the USMCA added a potential new hurdle: A clause stating that if Mexico, Canada, or the U.S. independently form a trade agreement with a 'non-market economies' such as China, then the other countries can renegotiate or leave USMCA. Yet while that would seem to discourage a bilateral U.S.-China trade deal, Mexico has already announced that they are considering opening negotiations with China. In other words, that clause may not be as much of an obstacle as it seems, in which case, a U.S.-China deal might be possible. Like everything else over the past couple of years, the situation seems to change from day to day if not minute by minute. For all of the challenges, I still believe that there is too much at stake between the U.S. and China, its largest trading partner, for them not to reach some type of agreement.

> "In terms of potential losses, the deal on autos could end up being very costly for U.S. consumers."

OUTLOOK: How would you characterize the new United States-Mexico-Canada Agreement (USMCA), and what enabled the various sides to reach an agreement after all of the public acrimony?

Baier: Once the United States had reached an agreement on autos, everything else in the U.S.-Mexico agreement fell into place. Structurally, the United States and Canada are similar, and so there were just a few additional issues that needed to be ironed out in their negotiations. Once there was an agreement in principle in dairy, it was easier to reach a deal. Perhaps some of the public acrimony was just positioning so that it looked like neither government caved in and each got the concessions it wanted.

OUTLOOK: What are the main advantages of USMCA for U.S. interests? Did we lose anything?

Baier: Some have argued that the USMCA is not really at all different from NAFTA while others have said that USMCA incorporates the best parts of the Trans-Pacific Partnership [negotiated and signed by the Obama administration and then rejected by the Trump administration] and adds some specific provisions that are more relevant for the U.S., Canada and Mexico. It will be difficult to know until the agreement is ratified by Congress – and there's no guarantee that will happen, especially if Democrats gain control of the House of Representatives. That said, I think new and novel provisions on cybersecurity and the digital economy in USMCA would protect U.S. interests. In addition, the agreement was able to obtain better market access for industries in which the U.S. may be the low-cost producer. For example, many U.S. dairy products would face lower barriers as a result of USMCA.

In terms of potential losses, the deal on autos could end up being very costly for U.S. consumers. To qualify for duty-free trade, 75 percent of cars will now need to be manufactured in North America, with 40 to 45 percent of each car made by workers that earn at least $16 per hour. Producers in Canada and Mexico could decide that it is less costly to just incur the duty and not worry about these restrictions. The current duty on cars imported into the U.S. is only 2.5 percent. If the administration believes this will happen, it will likely move forward with the 25 percent tariffs on all autos under Section 232 of the Trade Expansion Act.

OUTLOOK: With USMCA, will anything change regarding the steel and aluminum tariffs and the retaliatory tariffs from Mexico and Canada?

Baier: Most observers believed that this would be part of the USMCA agreement, but United States Trade Representative Robert Lighthizer recently stated that he sees those tariffs as separate issues. President Trump has suggested using a quota system for Mexico and Canada. So this issue hasn't been resolved and is still evolving.

> "… at least initially, consumers have been spared. But they ultimately will be affected."

OUTLOOK: What's the importance of the recent trade agreement with South Korea?

Baier: The revised U.S.-Korea agreement provides better access to the Korean market for U.S.-produced automobiles. In addition, tariffs on light trucks imported into the U.S. will remain at 25 percent until 2041. The cap on exports by U.S. auto producers to Korea has been increased from 25,000 to 50,000 per manufacturer – even though no U.S. producer was close to the 25,000 last year. Korea will also be excluded from U.S. steel tariffs as long as its exports do not exceed 70 percent of its average exports from 2015 to 2017. Korea exporters will still be subject to aluminum tariffs.

OUTLOOK: How is all of this likely to affect the U.S. economy?

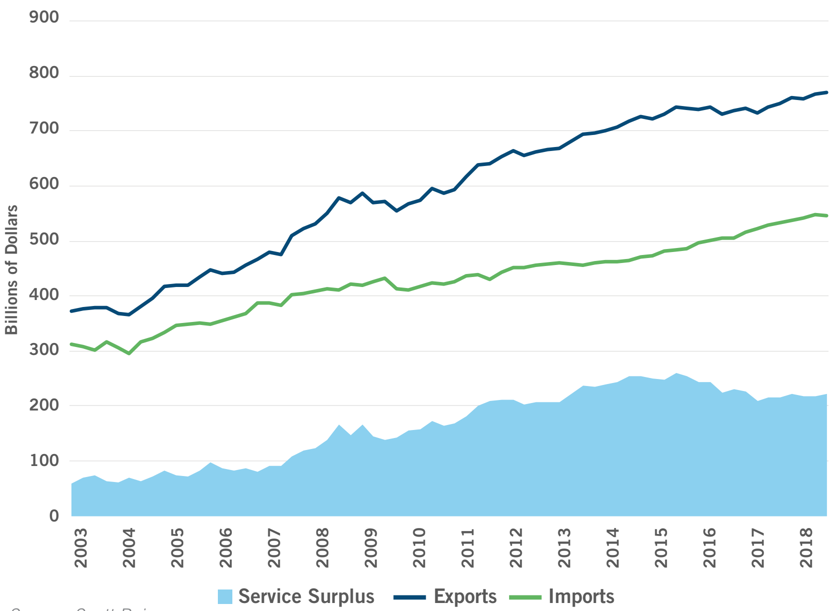
Baier: In its August report, the Congressional Budget Office forecast gross domestic product growth at 3.1 percent for 2018, which is still relatively high. But they anticipated GDP to slow to 2.4 percent in 2019. One factor the report cited is increased trade uncertainty, which could lead to fewer capital investments by businesses, disrupted supply chains and other direct and indirect effects. Of course, many factors beyond trade tensions contribute to the CBO's forecasts. But if the portion attributable to trade tensions reduces GDP even by only 0.2 percentage points – the figure I've heard most often – that's not a trivial amount.

OUTLOOK: How are American consumers faring?

Baier: Until September, the U.S. tariffs were aimed mostly at intermediate inputs and capital goods – in other words, products that companies use to build their own products rather than items consumers might buy directly. So at least initially, consumers have been spared. But they ultimately will be affected. If the tariffs raise the production costs of domestic firms, those higher costs get passed on to consumers. And now the tariffs on $200 billion worth of Chinese goods include a significant amount of consumer products.

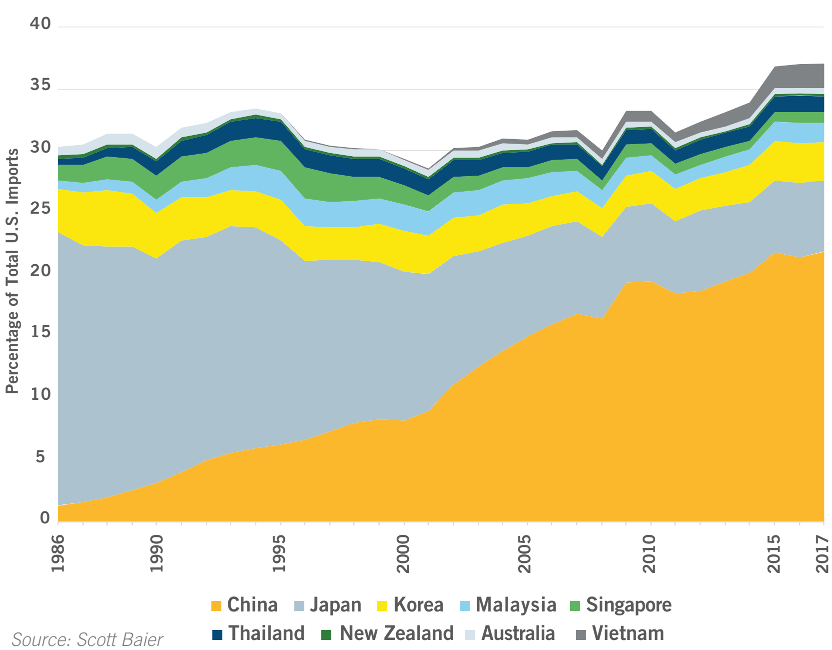
Another important area where consumers might be affected is variety. Imports don't just help keep prices low, they give American consumers an incredible range of choices. That's something we've all grown accustomed to. The natural result of tariffs is to disrupt trade, which, in addition to raising prices, inevitably chokes off some varieties of goods.

U.S. SERVICES TRADE SURPLUS



Source: Scott Baier
Note: As of March 31 for each year listed.

U.S. IMPORTS FROM ASIA-PACIFIC COUNTRIES



Source: Scott Baier

OUTLOOK: How is the current situation affecting the way other countries view the United States as a trading partner?

Baier: Over the past 50 or 60 years, countries worldwide have invested a lot of time, energy and money in creating multilateral trading standards such as the General Agreement on Tariffs and Trade, signed shortly after World War II, and its successor, the World Trade Organization, created as the result of GATT negotiations in 1995. These are rules-based organizations in which countries agree to do things in a certain way. And when disagreements arise, there is a place to go to seek remedies and work things out.

Now, the WTO is not perfect and there's plenty of room for improvement. But it has had a positive impact on global development, increasing world trade and world income levels. And there are very tough issues yet to be resolved – such as setting global environmental and labor standards – in which the WTO can play a key role. The big concern among many countries right now is that by pursuing a go-it-alone policy, the U.S. has turned its back on the idea of international cooperation. And if one large country moves away, will other countries do the same and will that weaken the WTO?

OUTLOOK: How likely is it that these measures will help achieve President Trump's stated goal of reducing U.S. trade deficits?

Baier: The administration's focus on bilateral deficits (with individual countries such as China or Mexico) seems misplaced. As an analogy, I run a persistent bilateral trade deficit with my local grocery store – I buy lots of things from them and they buy nothing from me. What matters is my overall financial position – my current income and expenses as well as my

> "The United States is and will remain a major force in international trade. Still, losing partners is always a risk when you get involved in trade wars."

future income and expenses. The same holds true for countries. How much you buy from one specific country matters less than the overall picture of what you're buying and selling around the world.

Overall trade deficits are typically driven by macroeconomic factors rather than trade policy. When our national savings rate is lower than our rate of investment, we run a trade deficit – what accountants call the current account deficit. Instead of saving, we spend, including on goods that we bring in from abroad. In some instances, trade deficits aren't necessarily bad for the United States, because the deficits help to finance investment projects or some of the money that goes overseas comes back as investments in U.S. Treasuries and other investments. If we were truly intent on reducing our overall deficit, the best way would be through policies that encourage national savings. Thanks to the government's budget deficit and the new tax law that encourages consumer spending rather than saving, I wouldn't be surprised in a year or two if we find that our overall deficit has widened rather than narrowed.

OUTLOOK: What new trade measures might we see in the weeks and months ahead?

Baier: The administration is currently discussing a 25 percent tariff on imported automobiles and auto parts. The goal, of course, is to boost domestic car manufacturers. What's really interesting here is that you would expect the industry that's being protected to be wildly in favor of it, because it would increase prices of imported cars from their competitors. Yet the auto industry is almost uniformly against the tariffs. That has to do with global supply chains and how complex and integrated world markets are these days, especially in the auto industry. Whether an automaker is domestic or foreign, cars today roll off assembly lines with parts sourced from around the world. So a 25 percent tariff on imported auto parts could be quite disruptive to that industry.

OUTLOOK: Is there a danger that the United States might lose some trade permanently?

Baier: It's too early to say for sure and, clearly, the United States is and will remain a major force in international trade. Still, losing partners is always a risk when you get involved in trade wars. Trade is about relationships that take considerable time and effort to develop. When tariffs result in countries importing goods from non-U.S. sources, those countries and businesses will become the familiar supplier that may continue to be used even if tariffs go away. Once those connections are made, they can be difficult to reverse.

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 9/30/18. They are intended to provide rate or cost indications only and are for notional amounts in excess of $5 million except for forward fixed rates.

KEY ECONOMIC INDICATORS

Gross Domestic Product (GDP) measures the change in total output of the U.S. economy. The Consumer Price Index (CPI) is a measure of consumer inflation. The federal funds rate is the rate charged by banks to one another on overnight funds. The target federal funds rate is set by the Federal Reserve as one of the tools of monetary policy. The interest rate on the 10-year U.S. Treasury Note is considered a reflection of the market's view of longer-term macroeconomic performance; the 2-year projection provides a view of more near-term economic performance.

ECONOMIC AND INTEREST RATE PROJECTIONS

Forecasts courtesy of Bloomberg and Blue Chip Economic Indicators

				U.S. Treasury Securities	
2018	**GDP**	**CPI**	**Funds**	**2-year**	**10-year**
Q4	2.80%	2.60%	2.27%	2.89%	3.17%
2019	**GDP**	**CPI**	**Funds**	**2-year**	**10-year**
Q1	2.30%	2.50%	2.45%	3.02%	3.26%
Q2	2.50%	2.20%	2.61%	3.13%	3.33%
Q3	2.20%	2.10%	2.74%	3.21%	3.36%
Q4	2.00%	2.20%	2.82%	3.26%	3.41%

PROJECTIONS OF FUTURE INTEREST RATES

The table below reflects current market expectations about interest rates at given points in the future. Implied forward rates are the most commonly used measure of the outlook for interest rates. The forward rates listed are derived from the current interest rate curve using a mathematical formula to project future interest rate levels.

IMPLIED FORWARD SWAP RATES

Years Forward	3-month LIBOR	1-year Swap	3-year Swap	5-year Swap	7-year Swap	10-year Swap
Today	2.45%	2.78%	3.05%	3.07%	3.09%	3.12%
0.25	2.71%	2.94%	3.11%	3.08%	3.07%	3.12%
0.50	2.86%	3.06%	3.14%	3.10%	3.13%	3.13%
0.75	3.07%	3.16%	3.16%	3.14%	3.14%	3.17%
1.00	3.09%	3.19%	3.14%	3.12%	3.10%	3.15%
1.50	3.19%	3.17%	3.15%	3.13%	3.15%	3.17%
2.00	3.15%	3.18%	3.11%	3.12%	3.12%	3.18%
2.50	3.11%	3.14%	3.10%	3.11%	3.13%	3.17%
3.00	3.08%	3.09%	3.08%	3.10%	3.13%	3.16%
4.00	3.03%	3.07%	3.09%	3.12%	3.14%	3.17%
5.00	3.12%	3.11%	3.12%	3.18%	3.18%	3.19%

HEDGING THE COST OF FUTURE LOANS

A forward fixed rate is a fixed loan rate on a specified balance that can be drawn on or before a predetermined future date. The table below lists the additional cost incurred today to fix a loan at a future date.

FORWARD FIXED RATES

Cost of Forward Funds

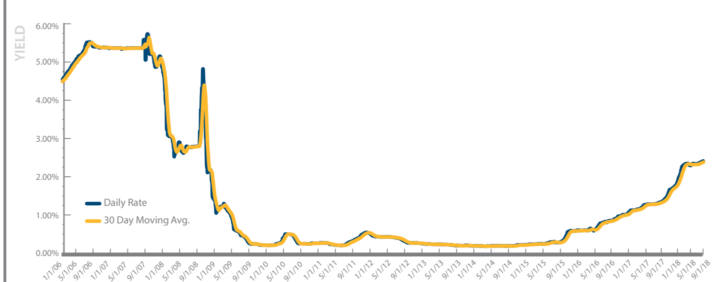
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	5	5	5	5
90	11	8	8	6
180	19	13	13	10
365	24	17	21	16

Costs are stated in basis points per year.

SHORT-TERM INTEREST RATES

This graph depicts the recent history of the cost to fund floating rate loans. Three-month LIBOR is the most commonly used index for short-term financing.

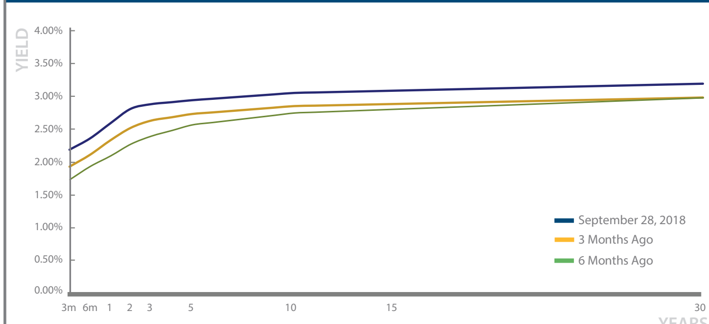
3-MONTH LIBOR



RELATION OF INTEREST RATE TO MATURITY

The yield curve depicts the relation between the cost of borrowing and the time to maturity of debt for a given borrower in a given currency. Typically, interest rates on long-term securities are higher than rates on short-term securities. Long-term securities generally require a risk premium for inflation uncertainty, for liquidity and for potential default risk.

TREASURY YIELD CURVE



COBANK UPDATE

CoBank Commits $450,000 in Support of Relief Efforts Following Recent Natural Disasters

As a responsible corporate citizen, and in alignment with our mission to serve rural America, CoBank recognizes the need to help our rural communities that have been hardest hit by natural disasters. With that in mind, the bank has committed a total of $450,000 to support relief efforts resulting from recent disasters.

Tom Halverson

"The impact of Hurricane Michael and other recent storms will be felt for years to come," said Tom Halverson, CoBank CEO. "At CoBank, we have personally heard about the effect these storms have had on our customers, their businesses and their communities and we are committed to doing our part to make the recovery process a little easier."

On October 10, the Category 4 Hurricane Michael made landfall and caused extensive damage throughout Florida, Georgia, Alabama and North Carolina. A week later, communications systems and electrical power had still not been restored in some locations, complicating the task of assessing the damage and beginning the recovery process. As of October 19, 35 deaths had been attributed to the storm. CoBank committed $100,000 to support disaster relief efforts in the wake of this devastating event, establishing a fund that matches the disaster relief contributions of its customers on a dollar-for-dollar basis.

Less than a month before, Hurricane Florence (at its height a Category 5 hurricane) caused significant damage throughout the Carolinas in large part due to the slow-moving nature of the storm. Widespread flooding occured in the region, leaving more than 9 million people under flood warning. More than 50 deaths were attributed to the storm. CoBank made an immediate contribution of $100,000 to the American Red Cross to support its relief efforts related to this storm and also created a $150,000 fund to match disaster relief contributions made by its customers.

About CoBank

CoBank is a $131 billion cooperative bank serving vital industries across rural America. The bank provides loans, leases, export financing and other financial services to agribusinesses and rural power, water and communications providers in all 50 states. The bank also provides wholesale loans and other financial services to affiliated Farm Credit associations serving more than 70,000 farmers, ranchers and other rural borrowers in 23 states around the country.

CoBank is a member of the Farm Credit System, a nationwide network of banks and retail lending associations chartered to support the borrowing needs of U.S. agriculture, rural infrastructure and rural communities. Headquartered outside Denver, Colorado, CoBank serves customers from regional banking centers across the U.S. and also maintains an international representative office in Singapore.

For more information about CoBank, visit www.cobank.com.

Also during the year, more than 100 wildfires burned more than 1.6 million acres across 14 states, including Alaska, California, Colorado, Idaho, Oregon and Washington. In California, the Carr fire killed seven people and destroyed nearly 1,100 homes, growing to approximately 160,000 acres; the Mendocino Complex fire became the largest wildfire in California history. To support wildfire relief efforts, CoBank made a $100,000 contribution to the American Red Cross. The grant included $5,000 earmarked toward the Carr fire to match a local contribution to the Red Cross by Golden State Farm Credit, one of CoBank's affiliated Farm Credit associations in California, and the remaining $95,000 designated for the Red Cross wildfire relief efforts nationwide.

"The 2018 wildfire season created tremendous damage throughout the country," said Halverson. "The devastation has been indiscriminate, impacting urban, suburban and rural communities alike. CoBank is proud to have partnered with our customers, affiliated Farm Credit Associations, and relief organizations like the American Red Cross to help relieve the suffering of those impacted by these fires."