Global Economic Outlook: Risks from the Trade War

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Global Economic Outlook

- Over past year, broad-based slowdown in global economy in terms of industrial production and trade (Figures 1 and 2)

- Driven by:
  - Downturn in auto production and sales
  - Weak business confidence due to US-China trade war
  - Slowdown in Chinese economy

- Slowdown in industrial production has fed into decline in trade growth (Figure 3) – although no reduction in US goods trade deficit (Figure 4)
Industrial Production and Trade

Figure 1

(Year-over-year % change)

Source: IMF, October 2019
Industrial Production: US, China

Figure 2

(Year-over-year % change)

Source: IMF, October 2019
Contribution to Global Imports

Figure 3 (% contribution)

Source: IMF, October 2019
Inflation and Monetary Policy

- 2016-18 global expansion did not generate increases in inflation

- Core inflation: fallen below target rates: US 2.3%, EU 1.4%, Japan, 1.3%, China 2.4%

- Market volatility: trade war, supply chain disruption, Brexit uncertainty, and geopolitical strains

- Central banks, including Federal Reserve, have been accommodative (Figure 5)

- Policy shifts, along with growth concerns, have pushed down bond yields (Figure 6)
US Policy Rate Expectations

Figure 5

(% Federal funds rate futures)

Source: IMF, October 2019
10-Year Bond Yields

Figure 6

Source: IMF, October 2019
Risks Skewed to Downside

- Risks: (i) disruptions to trade/supply chains, (ii) declines in risk appetite/flight to safe assets, (iii) political uncertainty and conflict

- IMF forecasts that if US-China trade war continues, cost to global economy of $700 billion by end of 2020

- Both US and China affected by ratcheting up of trade war (Figures 7 and 8)

- General view: reduce trade tensions and return to solving issues via multilateral system, i.e., WTO
Impact on Real US GDP

Figure 7 (% Deviation from 2017 base)

Source: IMF, October 2019
Impact on Real Chinese GDP

FIGURE 8

(\% Deviation from 2017 base)

Source: IMF, October 2019

Tariffs at April 2019
Tariffs at May 2019
Tariffs announced August 2019
Confidence effect
Market reaction
Productivity effect
Why Take on China?

- Increase US market access – instigated trade war via “power-based bargaining” (Figure 9)

- Reduce US trade deficit – but tariffs very unlikely to succeed as it is a macroeconomic issue, i.e., low US savings rate and fiscal deficit

- Target exchange rate manipulation – currently, China does *not* meet key IMF criteria for this

- Concerns over Chinese trade practices

- US frustration with WTO
Trade War Intensifies

Figure 9

Average tariff rate, percent

2018

China's tariffs on US exports
8.0% six months
3.1% six months

US tariffs on Chinese exports
8.0% six months
3.1% six months

2019

+11.1pp in three months
16.3

+8.6pp in three months
12.4

+9.4pp in six months
16.5

+12.0pp in six months
25.9

Source: Bown, PIIE, 8/29/19
Chinese Trade Practices

- Concerns about China’s trade practices well-documented (USTR, 2018):
  - Forced technology transfer
  - Discriminatory licensing restrictions
  - Theft of intellectual property
  - Investment restrictions
  - Subsidies to state-owned enterprises (SOEs)

- Key issue: extent to which “China, Inc.” makes it difficult to prove Chinese state is breaking WTO rules (Wu, 2016)
Go to WTO with “Big Case”

- WTO case could be made under GATT Article XXIII that one or more Chinese measures “nullify or impair” benefits of US and other WTO members.
- Argued only way to approach this is through “grand coalition” of countries (Hillman, 2018).
- US frustrated with WTO dispute settlement.
- But problem with US unilateral approach:
  - “Shallow” deal
  - “Free-riding”
  - Potential to undermine WTO
Conclusions

- Trade war already imposing costs on US, which will increase as trade war intensifies
- Significant downside risk to global economy
- US-China trade deal likely to be “shallow”, targeted at trade deficit with little focus “behind the border” (except perhaps on IP protection)
- A coalition of WTO members would likely be more appropriate way to deal with China
- Failure of US to follow rules-based trading system runs risk China will not follow system if (when) it becomes dominant economic power