Global Economic Outlook: Risks from the Trade War

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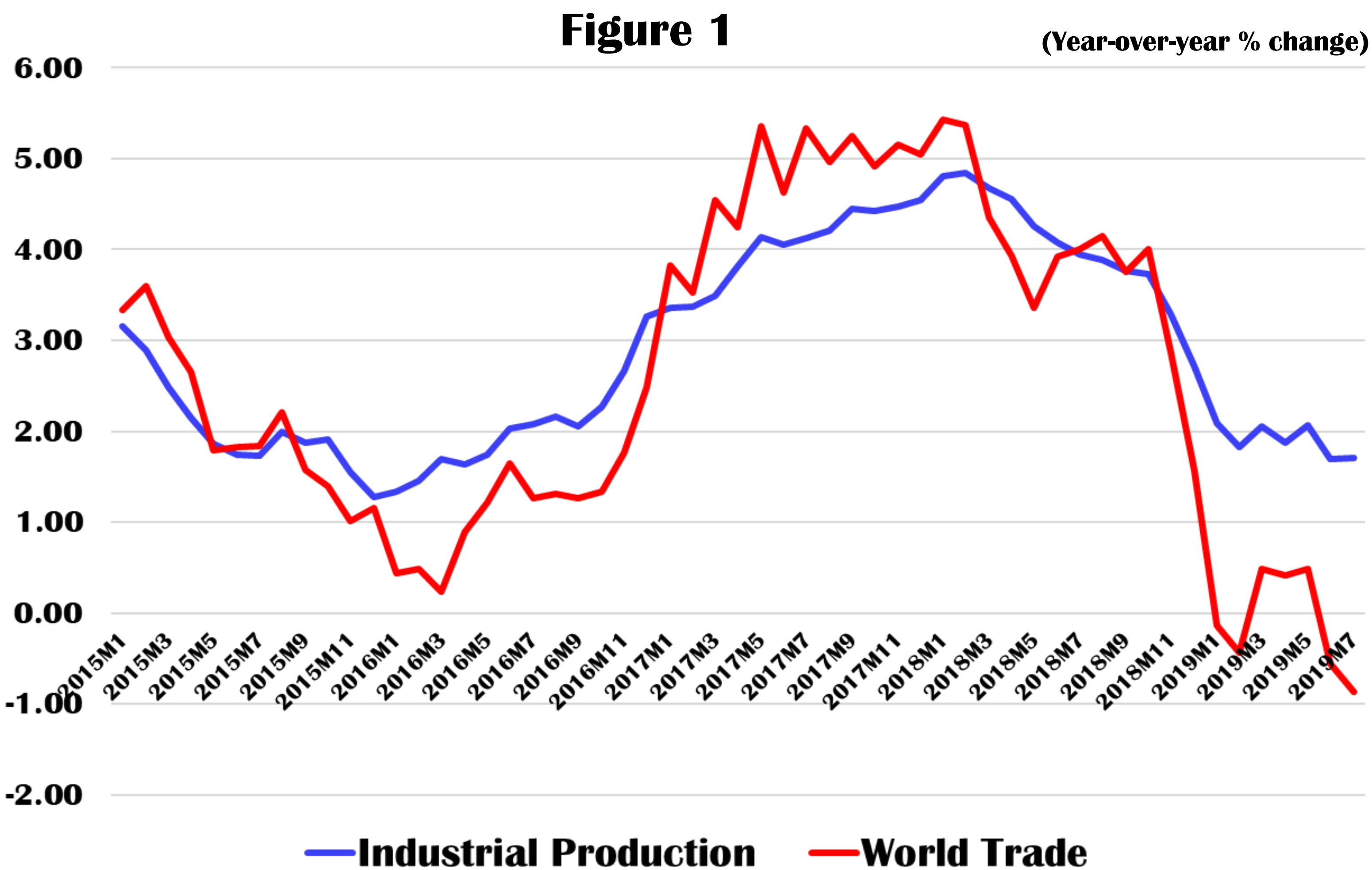
Global Economic Outlook

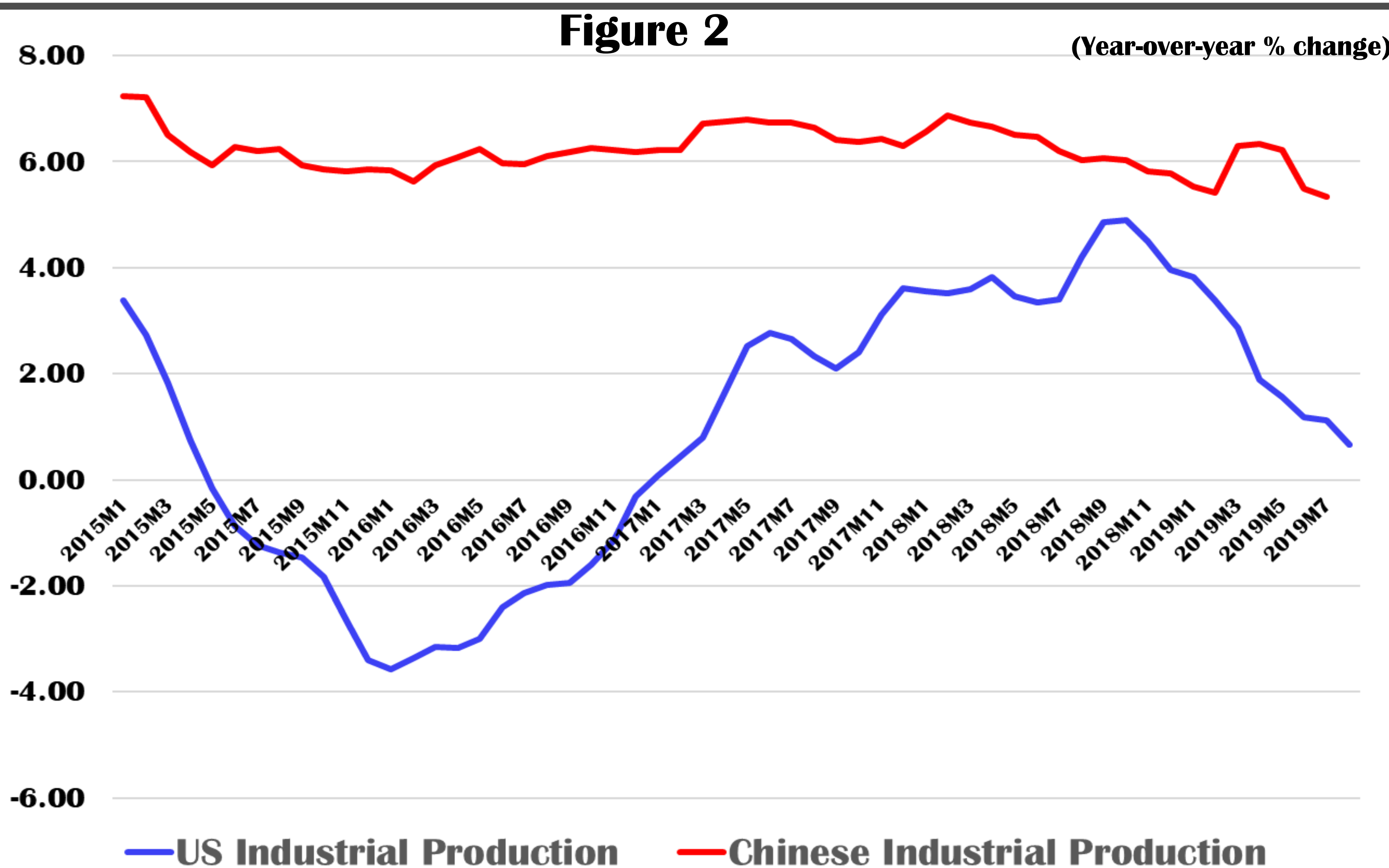
- Over past year, broad-based slowdown in global economy in terms of industrial production and trade (Figures 1 and 2)
- Driven by:
  - Downturn in auto production and sales
  - Weak business confidence due to US-China trade war
  - Slowdown in Chinese economy
- Slowdown in industrial production has fed into decline in trade growth (Figure 3) – although no reduction in US goods trade deficit (Figure 4)

Industrial Production and Trade



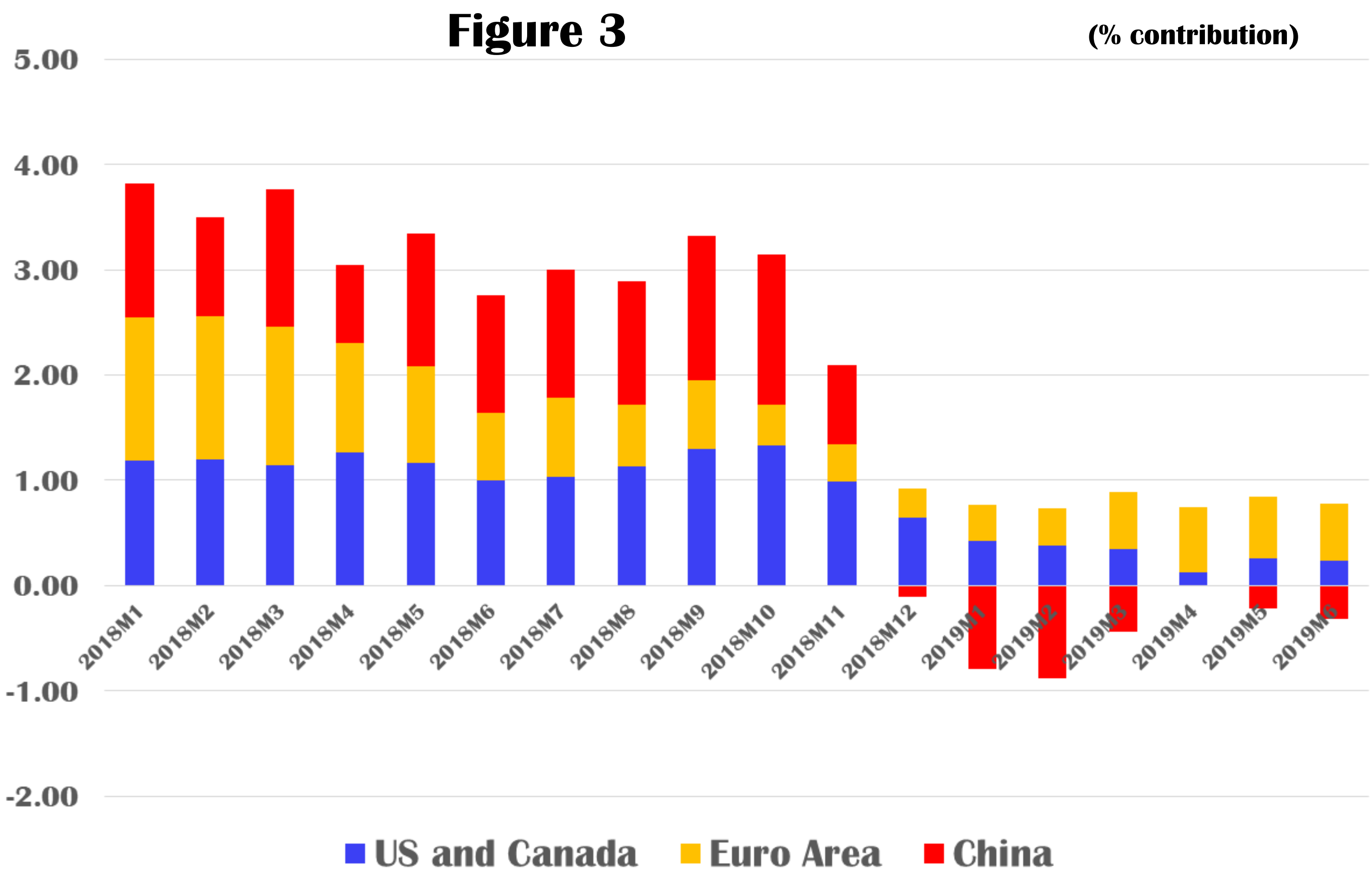
Source: IMF, October 2019

Industrial Production: US, China



Source: IMF, October 2019

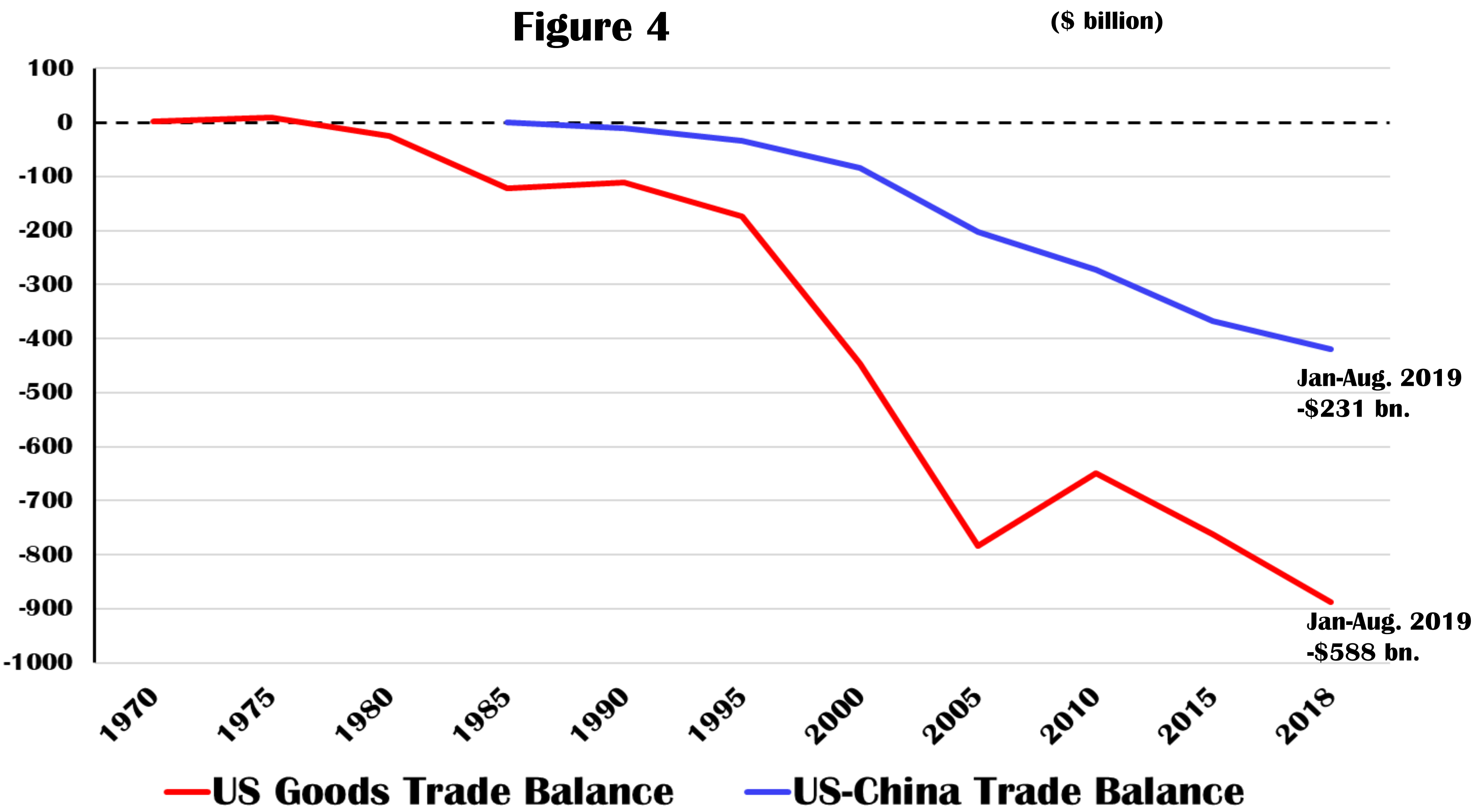
Contribution to Global Imports



Source: IMF, October 2019

US Goods Trade Balance

Figure 4



Source: US Census Bureau, October 2019

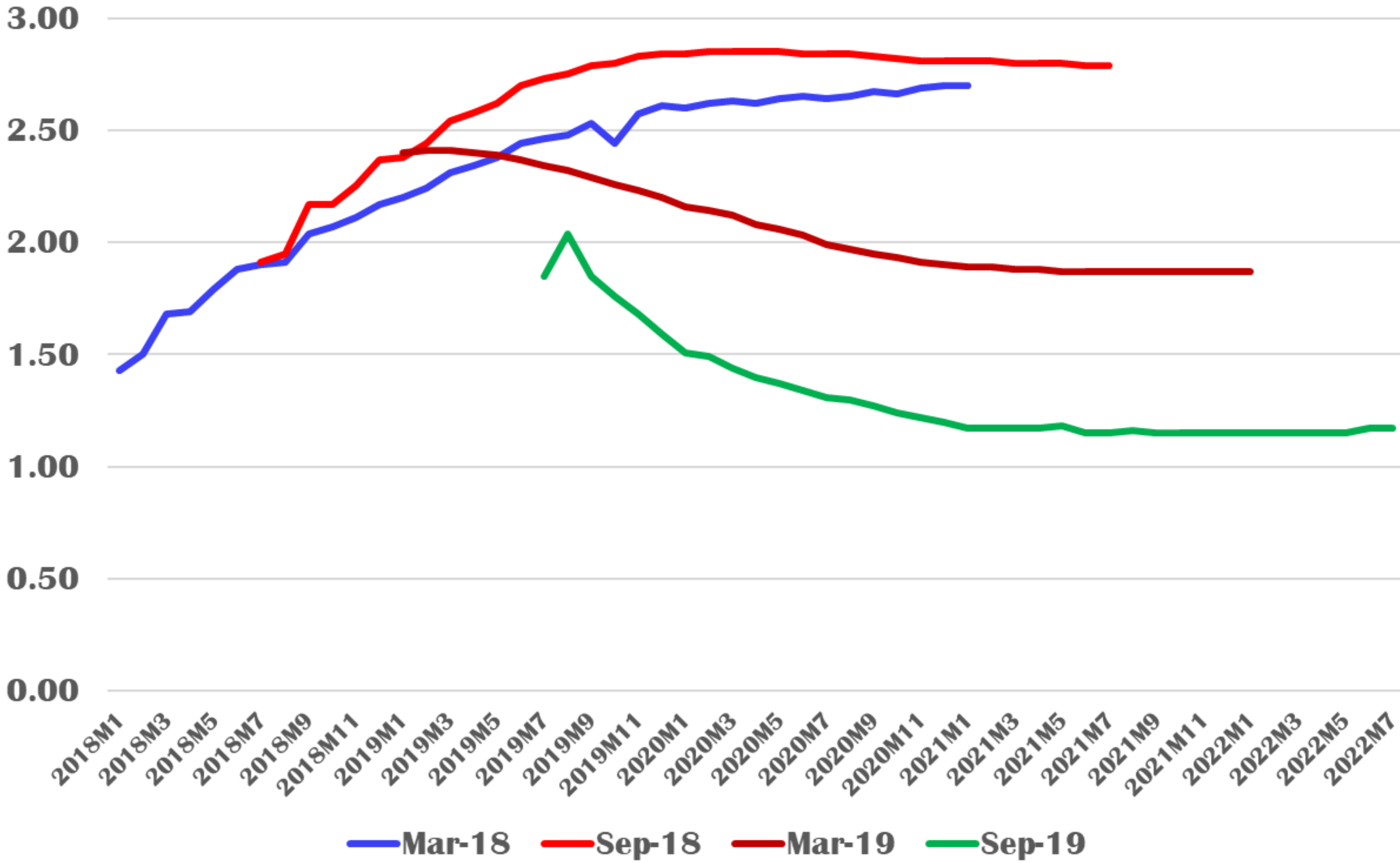
Inflation and Monetary Policy

- 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

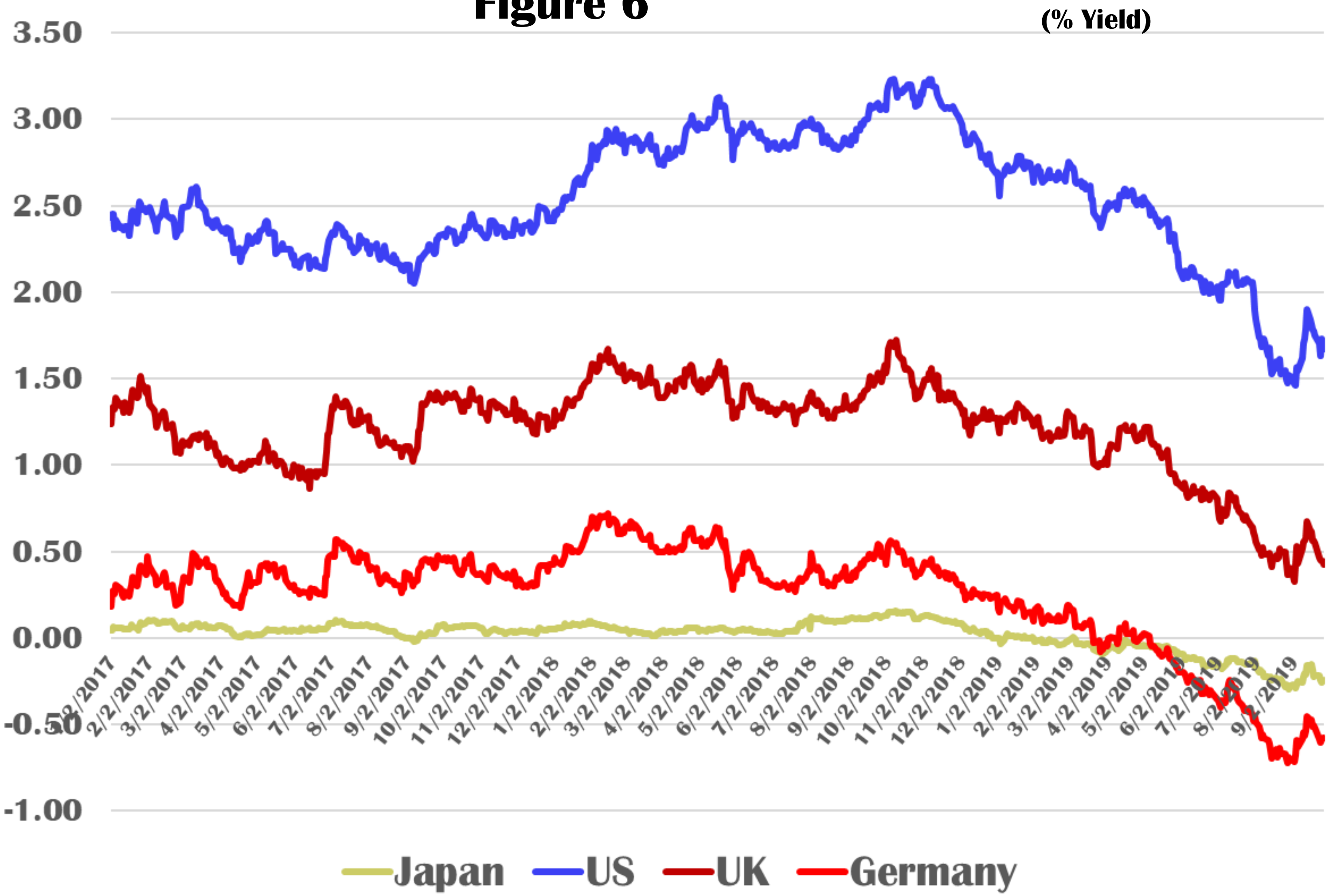
(% Federal funds rate futures)



Source: IMF, October 2019

10-Year Bond Yields

Figure 6

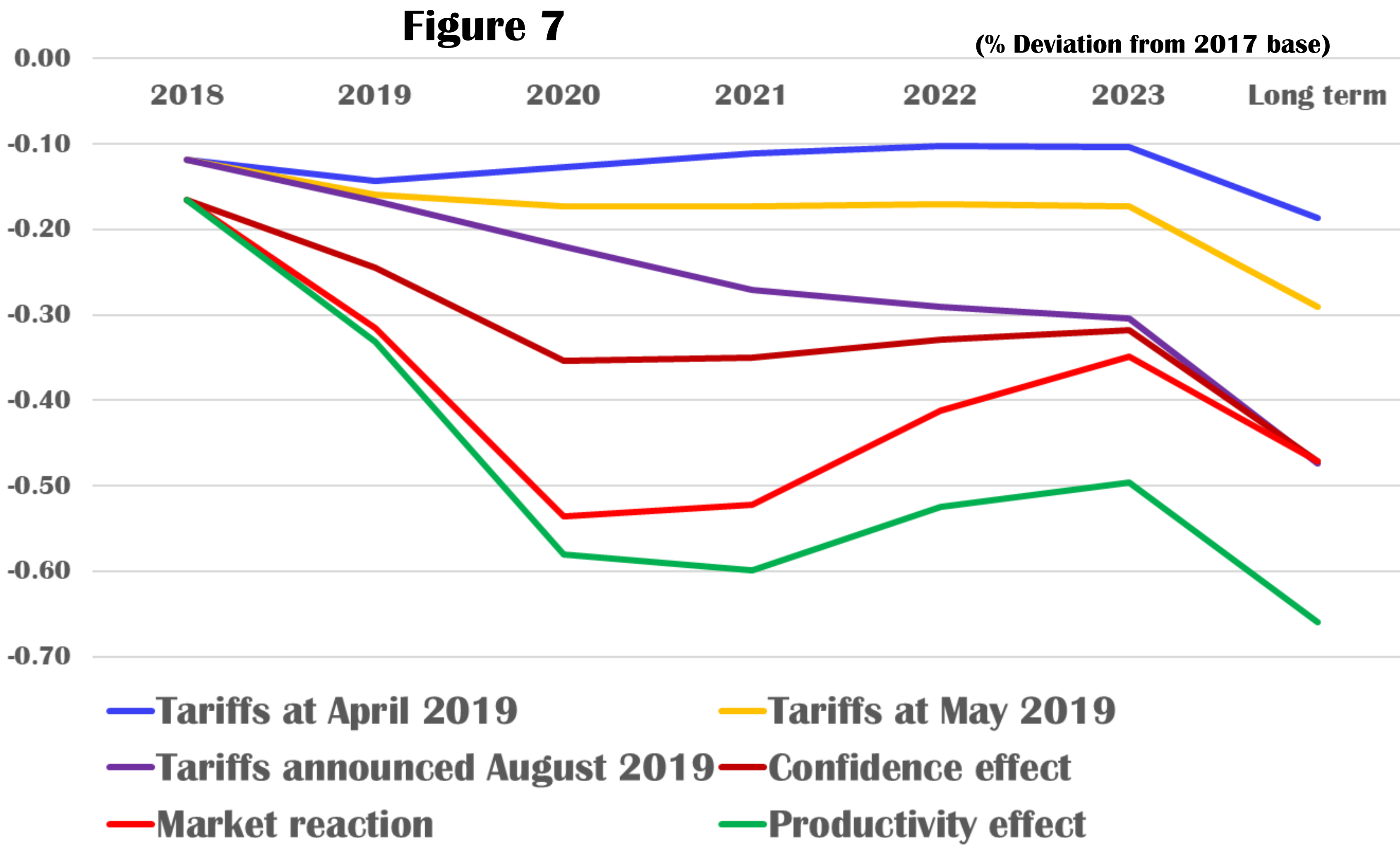


Source: IMF, October 2019

Risks Skewed to Downside

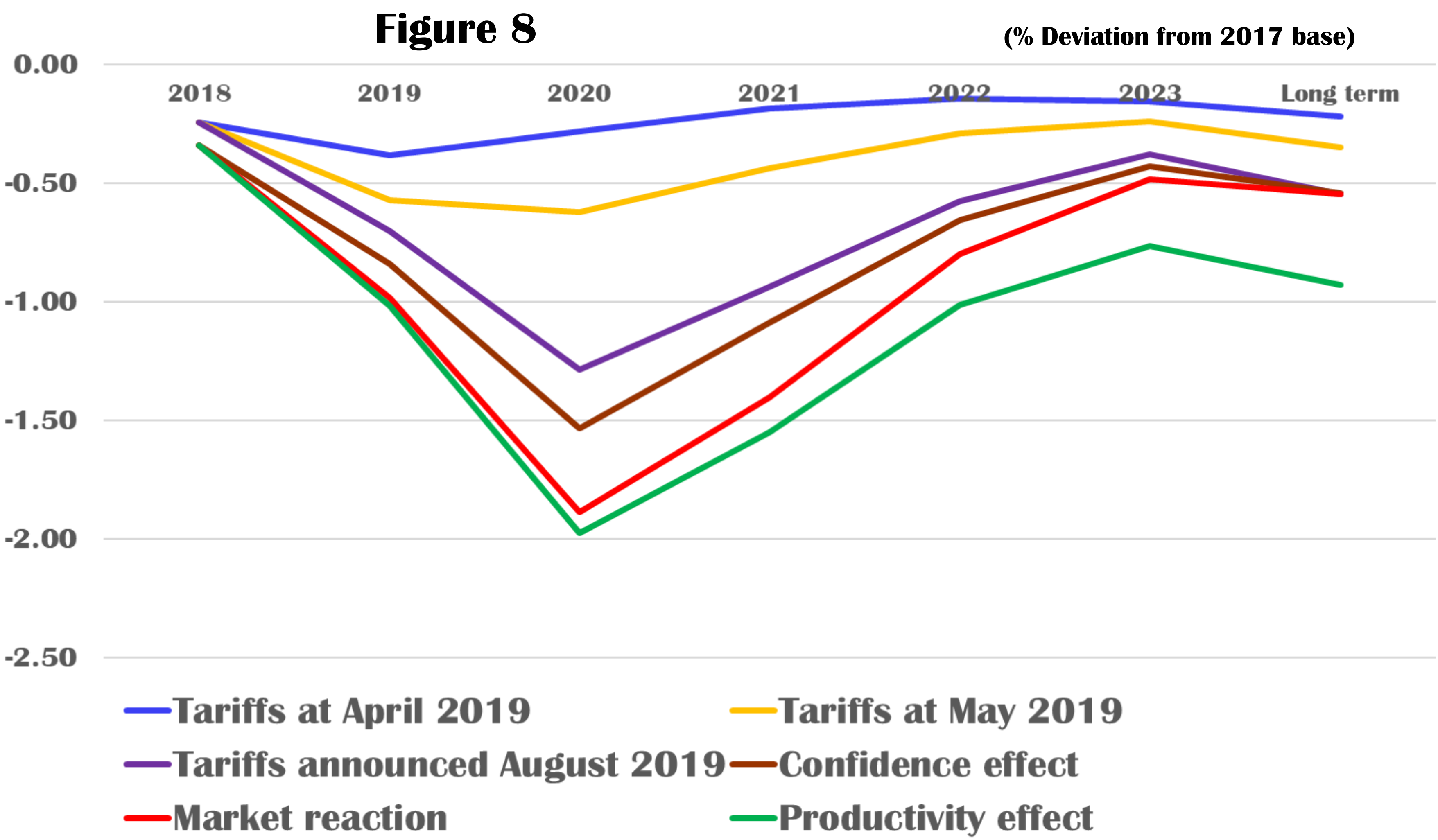
- Risks: (i) disruptions to trade/supply chains, (ii) declines in risk appetite/flight to safe assets, (iii) political uncertainty and conflict
- IMF forecasts that if US-China trade war continues, cost to global economy of $700 billion by end of 2020
- Both US and China affected by ratcheting up of 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



Source: IMF, October 2019

Impact on Real Chinese GDP



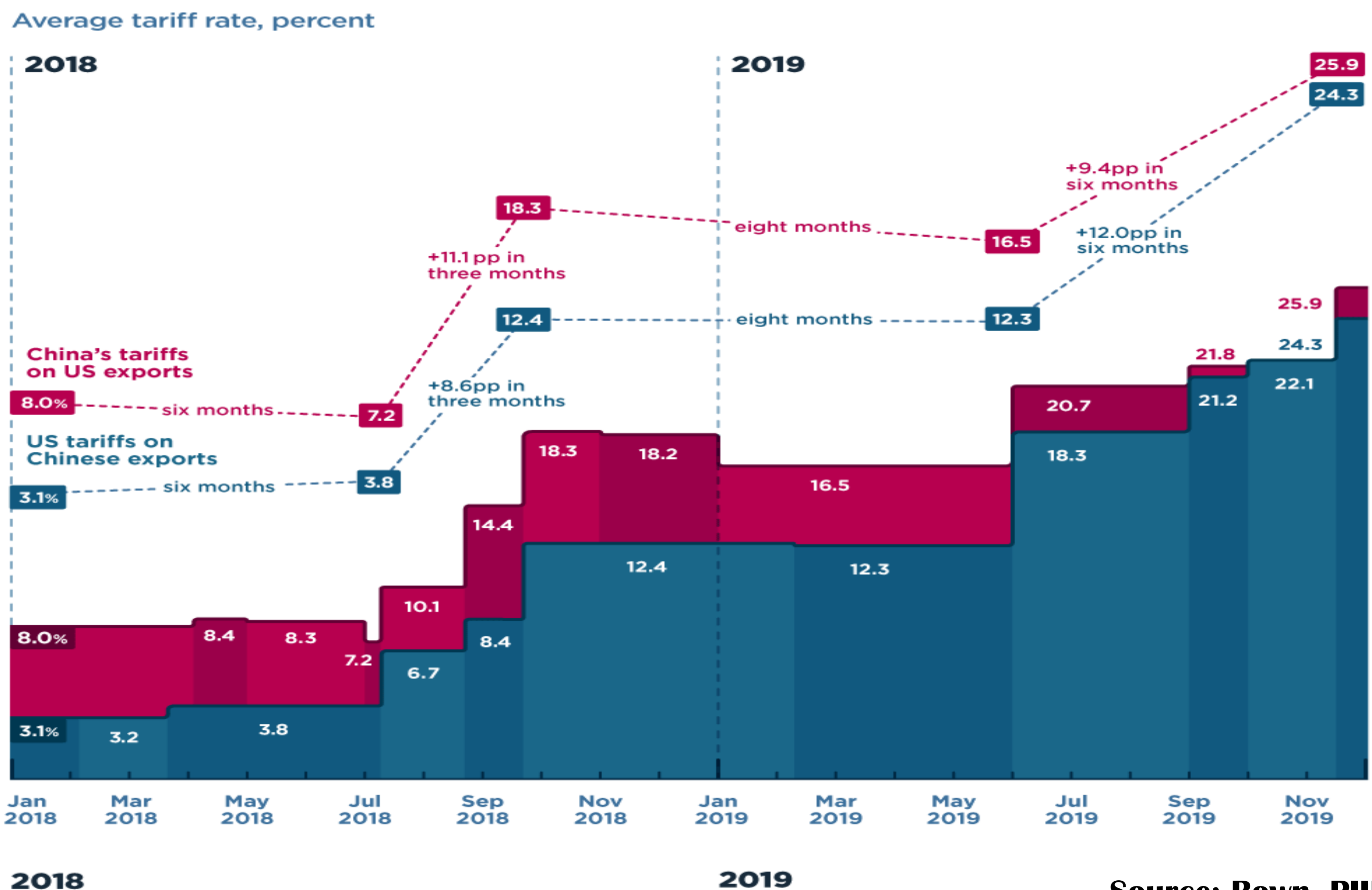
Source: IMF, October 2019

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



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