TRADE TENSIONS ON THE RISE JULY 2018

Risk to world growth from trade tensions escalating

NAB Group Economics

Trade tensions have been on the rise recently and a worrying cycle of retaliation and counter-retaliation is emerging. While measures currently being threatened would have some impact on the global economy, it would likely be manageable. However, if their implementation kicked off a further and more widespread cycle of retaliation it has the potential to lead to a more sizable shock to global growth, which would also impact on Australia.

Ever since the election of Donald Trump as US President a concern over the economic outlook has been the risk of a 'trade war'. While the perceived risk of this event has waxed and waned since the 2016 election, in recent months the risk has increased notably.

A crucial milestone will be 6 July, where a tariff of 25% on around $34b of Chinese imports into the US is scheduled to kick-in. This would immediately trigger retaliatory measures by China on imports from the US of an equivalent value. On top of this public hearings are underway over applying the same tariff to another $16b of imports (to which China has also indicated it will respond in-kind).

President Trump has already indicated that if China goes through with these retaliatory tariffs that a 10% tariff will be imposed on an additional $200b worth of imports from China. Moreover, if China were to respond again to this, tariffs on another $200b of imports would be imposed.

It is not just tariffs going up. Controls on foreign investment in key US sectors (particularly technology related) by China are also being tightened.

Nor is it solely a US/China dispute. US tariffs on steel and aluminium imports already imposed have led to retaliatory measures by Europe, Canada, and Mexico. The US is also considering imposing a tariff of 20% or more on auto imports - possibly just from Europe but maybe from all countries.

The European Union has already made it clear that it will retaliate against any US auto tariffs.

Where will it end up?

It is possible that the measures and threats are just part of the bargaining process where ultimately a deal is reached, with some concessions granted to each of the parties. Indeed it is still possible that the US tariffs due to go in place on 6 July could be shelved or delayed.

Announced & threatened US trade measures

Measure	Status	Overseas Retaliation?
20-50% on washing machines/solar panels	In-place	
Steel (25%) & aluminium (10%)	In-place	Yes
25% on $50b China imports	$34b 6 July $16b public hearings	Yes – if $50b goes ahead
10% on $200b China imports	Threatened if China retaliates to $50b tariff	Threatened
$200b China (rate unclear)	Threatened if China retaliates to $200b tariff	?
20-25% on autos (Europe or all, possibly includes parts)	US Section 232 investigation started 23 May - ongoing	Threatened

*Some countries granted exemptions including South Korea, Argentina, Australia, Brazil – but in some cases only after agreeing to a quota.

Nor is it outside the realms of possibility that the end result is a lowering of trade barriers globally, albeit the path to this result may see higher trade barriers in the interim. As part of earlier discussions, China had offered certain concessions including greater market access for foreign firms into the finance and insurance sector, and it recently lowered tariffs on motor vehicle imports. Press reports also indicated that German automakers were proposing a zero tariff on auto trade between the US and Europe as a solution to America's concern that the EU has a higher tariff.

However, the emerging pattern of retaliation-to-the-retaliation is very concerning. It would be less important if the size of the measures was getting smaller with each new announcement but instead they have been getting dramatically bigger. If this process continued for long then you would be in a major trade war with the end point unclear.

Even if the measures due to come into effect are delayed or withdrawn, this may well prove to be a temporary pause. The motivation of the US government is to reduce the US trade deficit. However, the current account deficit (of which the trade balance is an important part) simply reflects the difference in national savings and investment. The large tax cuts at the start of the year mean the US government is saving less, putting pressure on the current account deficit. So one of the main issues motivating US tariff action is unlikely to go away.

Another risk is that the trade dispute broadens out so that it is no longer just centred on the US and its trade counterparts. It is easy to see how this could happen – for example, reports already indicate that Canada and Europe are considering trade barriers to protect their steel industries as producers, facing reduced exports to the US, look for alternative markets. Moreover, there has been a general increase in trade protectionism since the GFC so the underlying supports for free trade is at a low ebb.

Consequence of a large rise in tariffs

While we remain hopeful that a major sustained rise in world trade barriers will be averted, it is certainly a growing risk. Given this, it is natural to ask what would be the impact of a significant rise in tariffs.

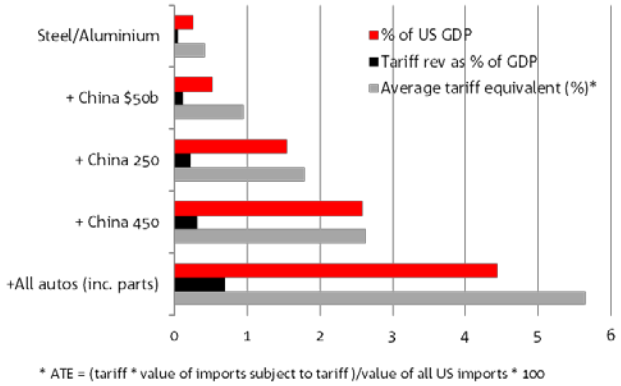
It is a standard result of economic analysis that the impact on economic growth of tariff increases will be negative. This is typically the case for a country raising tariffs even without retaliation from trading partners (which would make the effects worse). A tariff means that goods and services won't be produced in their most efficient locations, lowering productivity. Trade can also facilitate the spread of new ideas and technologies and tariffs will work against this. Tariffs also increase the cost of imported capital goods, which has a negative effect on investment (and hence productivity) over time.

The uncertainty caused by threatened future action may also lead to investment decisions being deferred (anecdotally this is already occurring), and if there were to be significant disruptions in financial markets this could also affect growth by causing a broad based tightening in financial conditions.

The measures announced so far (steel/aluminium/tariff on $50b of imports from China), or due to come into effect in July, are relatively insignificant. The value of the goods subject to additional tariffs are only around ½% of US GDP and, assuming no change in the level of imports, the tariff revenue is only 0.1% of US GDP.

However, if all the measures being threatened were to come into place, the magnitudes involved are much larger. Goods subject to additional tariffs would be around 4½% of GDP, and the implied tariff revenue around 0.7% of GDP - a tax increase equal to around half of the start of the year's tax cuts.

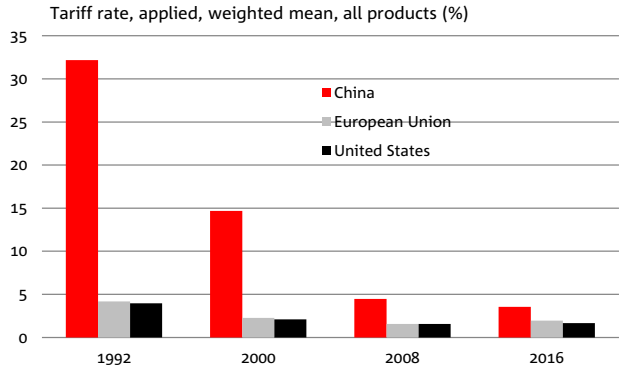
Significance of announced/threatened US tariffs



* ATE = (tariff * value of imports subject to tariff)/value of all US imports * 100

Tariffs implemented or threatened by the US cover around $850b of imports. If all these measures were implemented the average tariff rate on US imports would increase by over 5 ppts. The average US tariff rate in 2016 was around 1.7% - so this would represent a tripling of US tariffs, more than reversing the reductions in tariffs seen since the early 1990s.

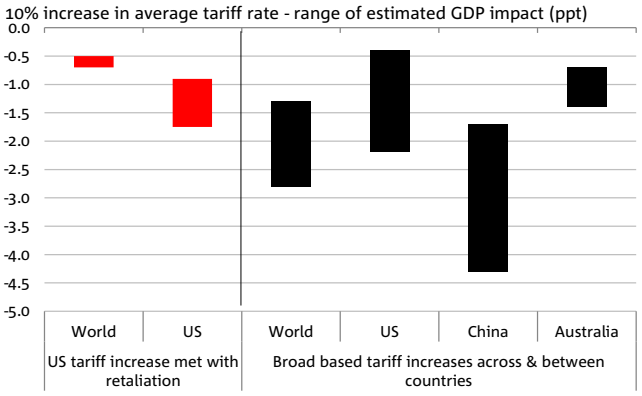
US tariffs on the table are significant



Source: World Bank

Estimates of the impacts of large increases in tariffs have been made by a range of modellers (see chart below). Often the scenarios being modelled differ, but as much as possible we have standardised the results to be based on a tariff increase of 10ppts.

Impact of large scale tariff increases



Sources: Various studies including by the IMF, OECD, Tax Foundation, OECD, Productivity Commission, ANU Centre for Applied Macroeconomic Analysis, NAB calculations. Long-run estimates used where available.

We have split the studies into two – in one an increase in US tariffs is matched by affected trading

partners (left hand side of chart). The second group of studies looks at the impact of all countries (or a significant number) raising tariffs against all other countries (e.g. Europe raises tariffs not just on US imports but also on imports from Asia).

As noted above, if all the tariffs currently threatened by the US (as well as those already implemented) were put in place there would be an increase in the average tariff rate on US imports of around 5ppts. The studies suggest that an increase in tariffs of this scale (with trading partner retaliation) would have an impact of world growth of ¼ to ½ ppts and on US growth of 0.4 to 0.9ppts. While this would represent a noticeable jolt to world growth, it would be spread over several years, and would likely be manageable in an environment where the global economy is currently growing at an above average rate.

However, if threatened trade actions are implemented, there could be further rounds of retaliation and the impact could become more significant. This would particularly be so if tariffs were raised between countries other than the US. A 10 ppts broad based rise in tariffs could knock 1¼ to 2¾ ppts off global activity over time. This would be a sizeable shock and lead to rising unemployment across many regions.

Of course the results of studies of this nature need to be used with caution. Post-Brexit predictions of a UK recession proved to be ill-founded, although model predictions of slower growth over time have held up.

Not all the possible consequences of a trade shock are easy to model. In particular, the impact on today's highly integrated global supply chains is hard to predict. Companies are already announcing intentions to relocate production to minimise the impact of tariffs, including a number of US companies which will move some production out of the US.

Similarly, the impact of a major bout of risk aversion and a broad loss of confidence - leading to consumers and businesses delaying spending plans – is hard to tie down. Nor, would resources move seamlessly to another use if there were major changes to production location or reduced demand for certain goods (i.e. those now facing large tariffs); if an industry in a country is substantially affected many of its workers may not be able to find another job.

Policy response important

The policy response – both fiscal and monetary - is also important.

Many macro models use a Taylor Rule approach to determining the central bank's policy response to a change in the economy – in this case, as tariffs would cause a temporary rise in inflation, such a rule would indicate monetary tightening at least initially.

More realistically central banks in economies with well-anchored inflation expectations are more likely to look through the temporary inflation increase and leave policy rates on hold, or they may actually cut rates in an attempt to head off an economic downturn. Not all central banks may be able to take this approach; in some emerging economies, with inflation expectations less well entrenched and perhaps even facing capital flight induced by risk aversion, there may be a need to raise interest rates.

Similarly the ability of the fiscal authorities to respond with stimulus will also vary from country to country. A tariff is just a tax and will raise revenue, so if governments do nothing, it represents a fiscal contraction. That said, It is likely that they would spend at least some (if not more) of any revenue generated – the US is already signalling that it will provide support to counteract the impact of some of the trade retaliation that has been imposed.

While policy can potentially ameliorate the consequences of a trade war, it can't do so completely. The fundamental cost is that resources are no longer being put to their best use and other benefits of trade are diminished and fiscal/monetary policy cannot change this.

What this means for Australia

Clearly a trade dispute centred on the US and China, is a concern for Australia. Not only is the US the world's second largest economy and so a major trend setter, but it has the world's largest financial markets and any shocks to it will flow to the rest of the world through changes in financial conditions.

China is not only Australia's major trading partner, but a major consumer of commodities and so any downturn in its economy will impact on Australia. It's not just commodities, key services exports – such as tourism or education may also feel an impact as a reduction in China's income bites. In addition, major East Asian exporters (also key markets for Australia) will also be impacted by US tariffs on China. This reflects the integrated East-Asia supply chain, as much of the value-added in China's exports comes from other countries within the region.

That said, as with the world economy, Australia should be able to weather the US steel and aluminium tariffs, as well as the tariffs on imports from China due to take effect on 6 July if it stops at that. Not only would the global impact from such measures be manageable, but Australia has an exemption from the steel and aluminium tariffs and the bulk of Australia's exports to China are consumed within its domestic economy (rather than being inputs to exported goods).

However, a major escalation of trade barriers would be far more concerning. Not only would there be a general noticeable slowdown in the global economy,

but China is likely to be hit harder in such an environment.

The study that found the largest impact on China from a 10ppt increase in tariffs by all countries was done at the ANU Centre for Applied Macroeconomic Analysis (by W. McKibbin and A. Stoeckel). It estimated a reduction in Australian GDP of 1.3ppts in the first year. A GDP impact of this magnitude would be a significant jolt to the economy, and would likely lead to an increase in unemployment.

The impact on national income and living standards would probably be even greater than that on production volumes (GDP). A substantial shock to the global economy would significantly lower international commodity prices received by Australian exporters, placing additional downwards pressure on national income.

Lower commodity prices would be expected to produce a weaker AUD given the strong historical relationship between Australia's terms of trade and the trade weighted value of the AUD. Moreover, weakness in the currency would likely be compounded by the deterioration in risk sentiment associated with downgraded global growth estimates. On one level this is already playing out via the use of the AUD as a proxy for China/Emerging Asia financial and economic risk, linked in part to concerns over an escalation in Sino-US trade protectionism.

A lower AUD would offset (to some extent) the impact of falling international commodity prices for domestic exporters. However, a lower currency would also raise import prices (as would the tariffs being put in place) cutting into Australian living standards.

Consistent with this, the Productivity Commission (PC) last year modelled the impact of an increase in tariffs by all countries. The PC estimated that if there were a 15ppt increase in tariffs in all countries, Australian GDP would decline by around 1% but that the impact to our living standards would be greater (around -1¾ppts).

Australia does have some room to move on both the fiscal policy side (given our relatively low debt to GDP ratio) as well as monetary policy. Moreover, the likely decline in the AUD noted above, by improving our trade competitiveness, would cushion the impact on economic activity.

We are still a way off a scenario of this nature (world wide increases in tariffs) but it highlights the risk involved if the tit-for-tat retaliatory measures we have seen recently continue to expand.

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