The trade war has significantly weakened the global economy

12 Nov 2019 – Analysis – International economy


Pasi Ikonen
Senior Economist


Eeva Kerola
Senior Economist

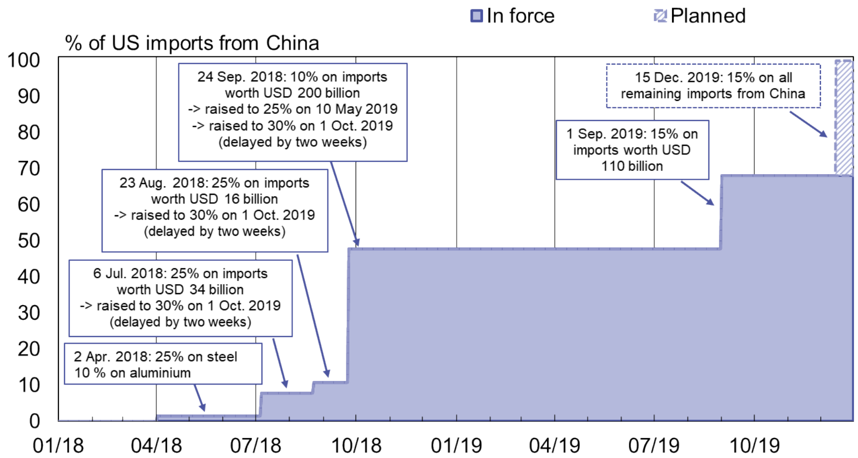

Lauri Vilmi
Senior Adviser

According to a model-based assessment by the Bank of Finland, tariff increases currently in place will slow global GDP growth by around 0.7 of a percentage point. The trade dispute has already diminished trade flows between the United States and China. The growth of uncertainty has been reflected in investment sentiment, and manufacturing purchasing manager indices have fallen globally. News updates on the current negotiation situation have caused volatility in share prices and securities market risk premia, but significant disruptions on the financial markets have so far been avoided. In an adverse scenario calculated by the Bank of Finland, further escalation of the trade war and subsequent widespread disruptions to the financial markets would slow global GDP growth by a further two percentage points.

To date, additional tariffs placed by the United States cover around 70% of total imports from China (Chart 1). China has countered by introducing its own additional tariffs, leading to a situation where the tariff increases cover a majority of trade in goods between the two countries. In addition to the tariffs imposed on China, the United States has announced that it is still considering an additional 25% tariff on the import of cars and car parts from countries outside the North American Free Trade Agreement.

Chart 1

Since the beginning of September, US tariff increases cover roughly 70% of imports from China



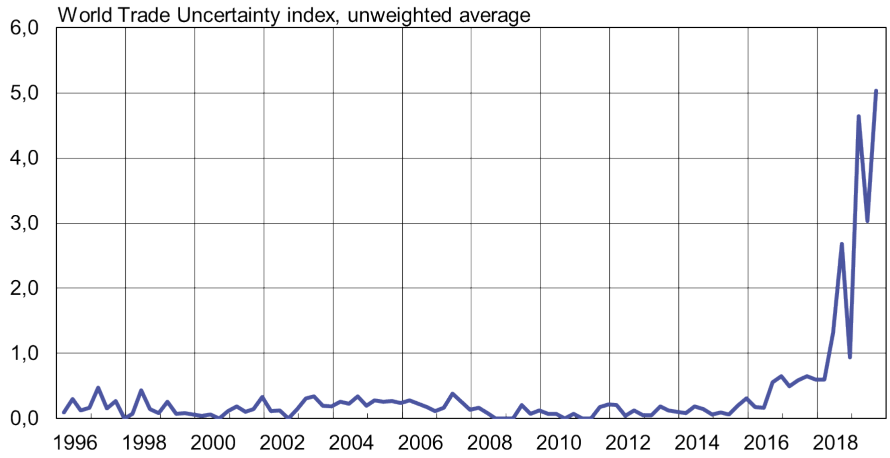
Sources: Macrobond and calculations by the Bank of Finland.
eurojatalous.fi / bofbulletin.fi
3.10.2019

The trade war escalated in May and flared up again in August. At the beginning of September, the United States introduced yet another round of additional tariffs on new product categories. Furthermore, in mid-December, the tariff increases will begin to apply to all remaining imports from China as well. The United States also plans to raise the majority of current additional tariffs by 5 percentage points in the middle of October. The trade dispute has spread from mere tariffs and now also encompass business restrictions on individual companies and accusations of currency manipulation. There is a possibility that the trade war will escalate into disputes over access to technology. Although a rapid improvement in the situation is increasingly unlikely, the United States and China are still pushing ahead with negotiations and publicly asserting their willingness to settle their trade disputes. However, the continuation of the trade war has increased uncertainty globally and has raised the World Trade Uncertainty index for trade policy uncertainty[1] to a record high this year (Chart 2).

1. See https://www.policyuncertainty.com/.

Chart 2

Trade policy-related uncertainty has increased



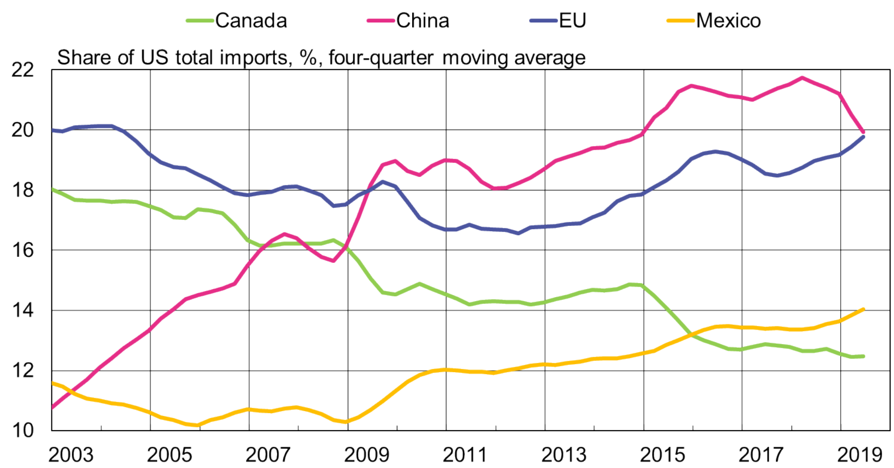
Source: Economic Policy Uncertainty.
eurojatalous.fi / bofbulletin.fi
3.10.2019

Trade war already reflected in trade flows, overall confidence and the financial markets

The tariffs will hit the foreign trade of both countries the hardest. Figures show that in 2019, US imports from China have dropped substantially from 2018. At the same time, the European Union has increased its market share on the US market (Chart 3). Trade flow changes have not been reflected in the United States' trade deficit, which has remained almost unchanged at around 3% of GDP.

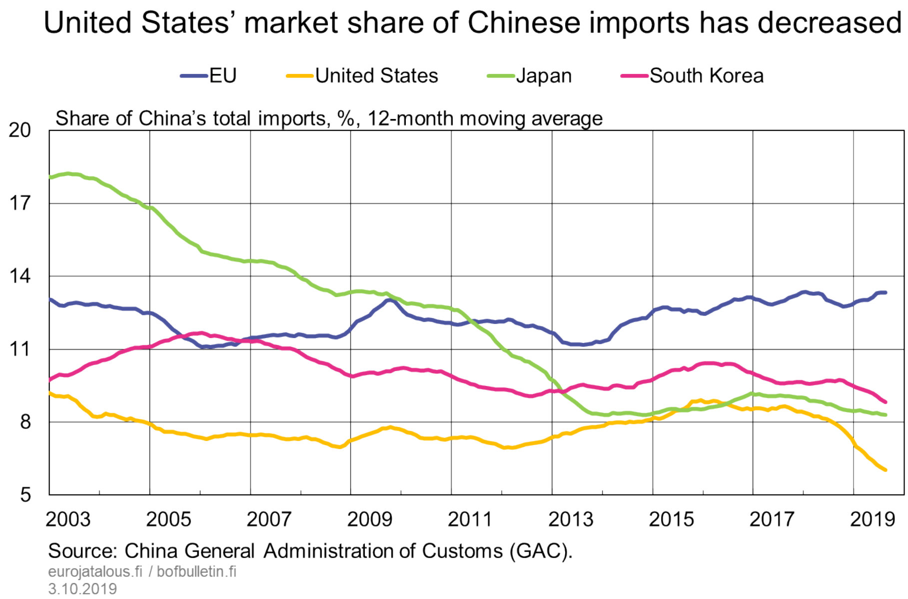
Chart 3

China's market share of US imports has decreased



Source: United States Census Bureau.
eurojatalous.fi / bofbulletin.fi
3.10.2019

Chart 4



The trade war that has been going on for more than a year and the weakened economic developments in China have been reflected particularly in the decline in foreign trade. China's goods imports have decreased from last year. Especially, the value of goods imports from the United States has dropped sharply and was more than 25% less in July 2019 than a year earlier. Lower demand and the fragmentation of production chains caused by the trade war have diminished the foreign trade flows of goods from China's neighbouring countries as well. In the current year, annual growth in the value of imports from the EU has almost come to a standstill, while just last year the value of imports grew by more than 10% year-on-year. The United States' share of Chinese imports has fallen sharply since early 2018, whereas the European Union's market share has recently increased slightly (Chart 4). In a survey[2] by the American Chambers of Commerce, three out of four American companies in China said that increases in US and Chinese tariffs are having a negative impact on their businesses. According to the same survey, around 40% of respondents are considering relocating or have already relocated manufacturing facilities outside China, mostly to other Asian countries or Mexico.

Manufacturing purchasing manager indices have weakened considerably in the major markets, and export order levels have been poor. The uncertainties and reduced confidence caused by the trade war are weakening the global economy more than the direct impacts on trade flows might suggest. This is particularly evident in the deteriorating investment outlook.

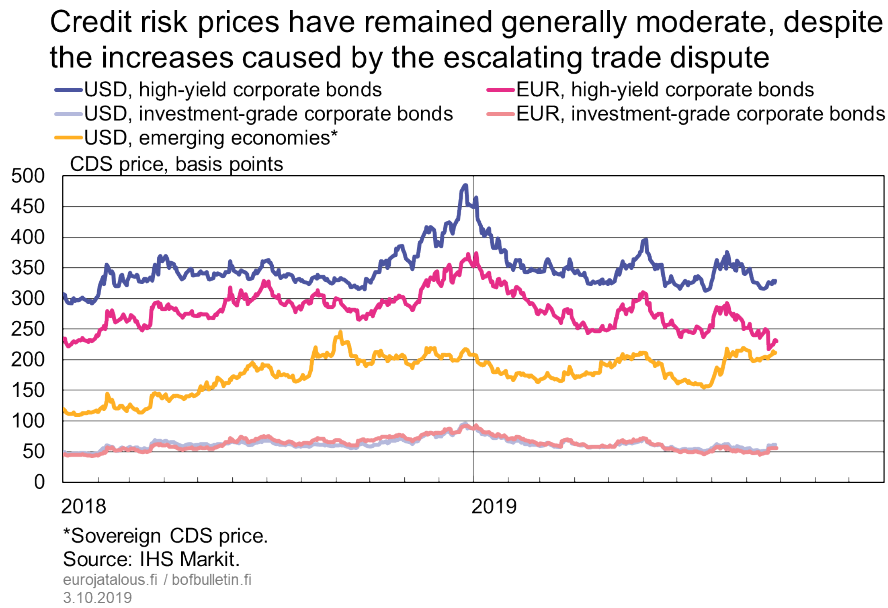
On the currency markets, the Chinese yuan has depreciated against the dollar, as China has allowed a slight depreciation of its currency in response to the new tariff increases by the United States. On the financial markets, news of a trade war has sparked anxiety and

---

2. The American Chambers of Commerce representing US companies in China (AmCham China and AmCham Shanghai) published the joint survey of their member companies in May 2019. The survey received nearly 250 responses. Link to the survey.

increased volatility on the stock market. The effects of the trade war have been particularly visible on the stock markets in emerging economies, and especially in China. Trade negotiation developments have also affected credit risk prices (Chart 5). Increases in credit risk prices coincided with escalations in the trade negotiations in May and August. In emerging economies, risk premia have increased slightly since early 2018, but in global terms they remain on a generally moderate level.

Chart 5



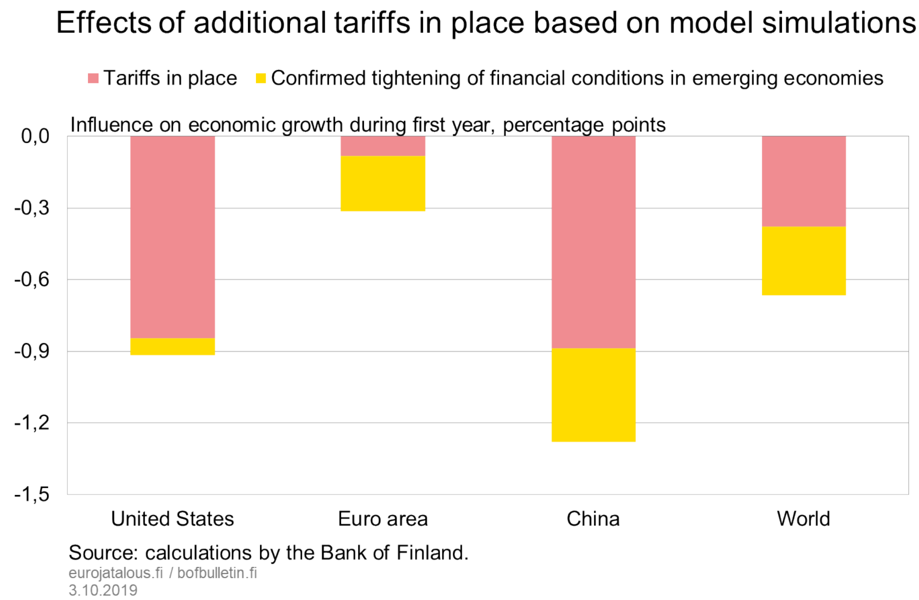
So far, the negative effect of the trade war on global growth is around 0.7 of a percentage point

At the beginning of September, the increased tariffs covered around 70% of bilateral trade between the United States and China. The investment outlook has deteriorated globally due to the increased uncertainty caused by the trade war. Several indicators also support an assessment that the dispute has tightened financial conditions in emerging economies, consequently raising risk premia on their corporate bonds by some 50 basis points.[3] However, to date there have been no significant disruptions on the financial markets. Chart 6 shows the actual GDP effects of the trade war in major economic areas based on model calculations.[4]

3. Risk premia are influenced by different factors and are globally correlated. The calculations assume that the trade war has not yet affected risk premia in the advanced economies. The increase in risk premia on corporate bonds in emerging economies caused by the trade war has been assessed by comparing their average growth against the average growth of risk premia on US investment-grade corporate bonds after 22 January 2018. On that date, the United States made the first official announcement on additional tariffs (washing machines and solar panels).

4. The calculations are based on a GIMF model simulation presented in the Bank of Finland Bulletin 1/2019.

Chart 6



According to calculations by the Bank of Finland, the trade war is currently slowing GDP growth the most in China (over 1 percentage point) and in the United States (around 0.9 of a percentage point). In the euro area, the downward impact of the trade war on GDP growth so far is around 0.3 of a percentage point. A major setback for euro area growth is the weakening growth in emerging economies. According to model simulations by the Bank of Finland, tariff increases currently in place will slow global GDP growth by around 0.7 of a percentage point.[5] A recent OECD analysis[6] points in the same direction, predicting that because of the trade war and increasing uncertainty, global GDP will be 0.6 of a percentage point lower by the end of 2021. The OECD calculations also conclude that the greatest effects will be felt in the economies of the United States and China.

Risk scenario: trade war escalates and the effects spread to the financial market

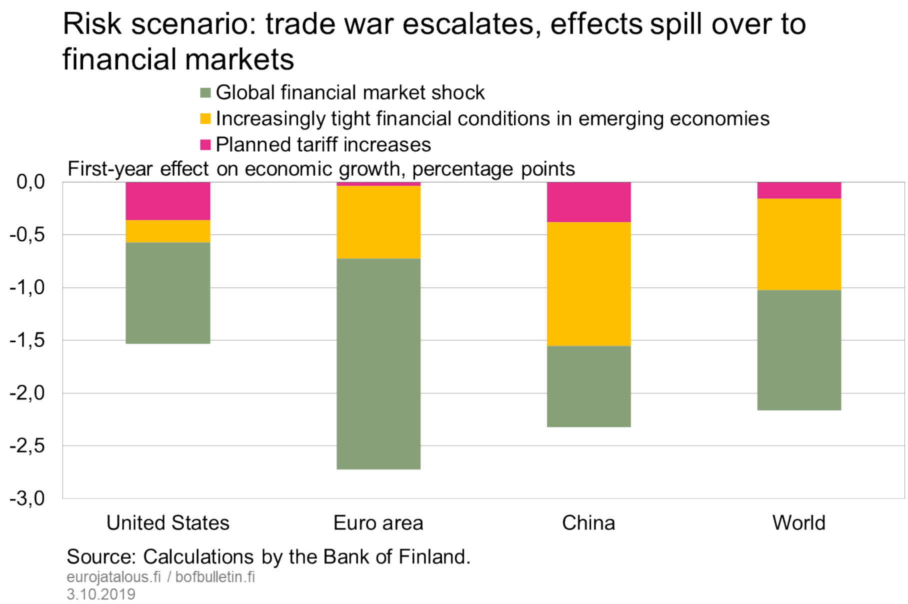
In the Bank of Finland's adverse scenario[7] the trade war escalates to the point where 25% tariff increases will affect all bilateral trade between the United States and China. In this scenario, 25 % tariff increases are implemented on all of the remaining 30% of the United States' imports from China. In addition to that, the United States imposes a 25% import tariff increase on cars imported from the EU, and the EU responds with an

---

5. The calculations are based on a scenario where all effects are immediate and reflect in the growth numbers for the first year. In practice, however, the tariffs have been implemented gradually and the impact of the increased uncertainty on investment may be reflected in actual investments with a delay. Thus, the effect on economic growth may be spread over several years in the observed data.
6. The OECD calculations take into account the tariff increases planned for the remainder of the year and a global rise of 50 basis points in investment risk premia. See OECD Interim Economic Outlook, 19 September 2019.
7. The confirmed effects of the trade war presented in the previous chapter combined with the calculated effects of the adverse scenario correspond the total effects of the trade war according to the adverse scenario presented in Bank of Finland Bulletin 1/2019. The calculations are based on analogous simulation assumptions.

import tariff increase of 25%, imposed on the same amount in dollars for US imports. The risk scenario assumes that the trade war leads to a two-phased tightening of financial conditions. In the first phase, risk premia on corporate loans in emerging economies rise by an additional 150 basis points on the previously estimated rise of 50 basis points. In the second phase, the financial market disturbances extend into the global economy, consequently raising risk premia on corporate loans in advanced economies as well, and on sovereign bonds all over the world.[8] Due to the financial market disturbances, the impacts on the global economy in the risk scenario may grow to be far greater than the effects materialising through the direct trade channel or uncertainty-related reduced investment.

Chart 7



In the risk scenario, the new tariffs would slow growth during the first year directly by around 0.4 of a percentage point in both the United States and China (pink columns in Chart 7). Additional and considerable global consequences would follow if the trade disagreement triggers financial market disturbances in emerging and advanced economies (Chart 7, yellow and green columns). As a result, GDP would grow in the first year around 1.5 percentage points less in the United States and almost 2.5 percentage points less in China than without escalated trade tensions and substantial market disturbances (Chart 7). The financial disturbances would have much larger consequences in the euro area than in these two countries, mostly because the calculations assume that the euro area has limited space for monetary policy to respond. In the case of severe financial market disturbances as depicted in this scenario, euro area GDP growth would be more than 2.5 percentage points slower in the first year.

In the model calculations, the extent of slowdown in global growth is also influenced by

8. The calculations presented in Bank of Finland Bulletin 1/2019 assumed that the risk premia on corporate loans will rise by 200 basis points in emerging economies and by 100 basis points in advanced economies. Further, the risk/term premia on sovereign bonds were assumed to be subject to a global increase of 100 basis points.

economic policy reactions, i.e. the degree to which monetary and fiscal stimulus are assumed to support the economy. The calculations assume that in the euro area and Japan the space for monetary policy to respond is limited, and that expansionary discretionary fiscal policy is not used. In this sense, the model calculations may exaggerate the economic impacts of financial market disturbances, especially in the euro area.[9] If the policy measures in response to slowdown are stronger than assumed in the simulations, the escalation of the trade war and financial market disturbances would have a smaller negative impact on global growth than presented here.

Tags

economic outlook, trade flows, trade war

9. The calculations are also subject to modelling uncertainties. For example, the model's parameters may not capture all real-world channels correctly, and the extent and persistency of the shocks may deviate from the assumptions.