GLOBAL ECONOMICS UPDATE

The implications of a collapse in US/China trade talks

- We think that the direct effects of President Trump’s threatened tariff hikes could reduce Chinese GDP by up to 0.5%* and that the associated retaliation would have only a marginal direct impact on the US. The effects on business confidence and financial markets around the world could be more significant, potentially adding to reasons for renewed policy looseness.

- To recap, progress towards a US/China trade deal has faltered as alleged backtracking by China has caused President Trump to state that he will raise the 10% tariff applied to $200bn worth of imports from China last year to 25% from Friday. He has also threatened to extend the 25% tariff to all imports from China in future. This might just be a strategy to get last minute concessions and a deal could yet be reached. But here, we answer four key questions to assess the implications if the threat is carried out.

- How have tariffs affected trade so far? Chinese exports to the US underperformed those to the rest of the world by 13 percentage points in Q1, we think due to the effect of tariffs. (See Chart 1 overleaf.) Since exports to the US account for 3.2% of China’s economy, this implies a drag on GDP of around 0.4ppt. (China Economics Update, “Four implications of the re-escalation in trade tensions”, 6th May.) US exports to China have underperformed exports to the rest of the world by 25ppt. (See Chart 2.) But goods exports to China account for only 0.6% of US GDP, so the effect has perhaps been to reduce GDP by up to 0.2ppt.

- What’s more, the impact on global GDP has been limited by both the US and China importing from other countries instead. Exports to the US from the rest of Asia picked up at the same time that those from China weakened. (See Chart 3.) And Brazil, for example, has seen a sharp rise in exports of soybeans to China.

- What have been the broader effects? The effects on confidence and on financial markets have arguably been bigger, although they are even harder to quantify. Chart 4 shows that the deterioration in business confidence in trade-dependent economies began at around the same time that tariffs were first increased. Equity prices were initially hit too, particularly those in Emerging Asia, along with Asian currencies. But most of this damage was undone as trade talks initially seemed to go well. (See Chart 5.)

- How have policymakers responded? In theory, if all else were unchanged the increase in tariffs would amount to a small fiscal tightening in China and the US. But both governments have avoided this by spending the proceeds on aid for the most affected parties. The US approved a package of $12bn for farmers last year and there were unconfirmed stories of the Chinese government rebating tariff revenues to affected firms. Central banks have also responded. Not only the Fed but also the ECB and the Bank of Japan have explicitly cited concerns over trade tensions as a reason for adopting a more dovish stance.

- What does this mean for the future? We think that the direct effect of an increase in the tariff on the $200bn list to 25% would be to hit Chinese GDP by around another 0.2ppt. If the 25% tariff were extended to the rest of Chinese exports to the US, that might knock a further 0.3ppt off GDP. The effects on the US would probably be minimal, due to the lesser importance of trade with China and the fact that China would struggle to retaliate as it is running out of imports to tax. The direct impacts on global GDP growth would be very small since there would be some substitution into exports from other countries.

- The effects on confidence and financial markets are potentially more worrying. While risky asset prices have fallen this week, they have not returned to the lows of last summer and we suspect that a lot of good news on trade talks is still discounted. (See yesterday’s Capital Daily.) The same probably applies to business confidence, which has stabilised in some of the trade-dependent economies in recent months.

- One consolation is that policy will continue to respond. Initially, any reaction from the Chinese authorities would be most likely to come in the form of targeted fiscal support for the affected parties, but the PBOC would act to counter sustained economic weakness. And at the margin, increased trade tensions could contribute to the US Fed and the ECB adopting a more cautious stance. (See Chart 6.)
In the original version of this Global Economics Update, we suggested a slightly smaller impact (0.4pts in total, with 0.1pts stemming from the higher 25% tariff on the $200bn list). Subsequent analysis led us to revise our estimate up.
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