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Trade policy tensions casting shadow on economic horizon

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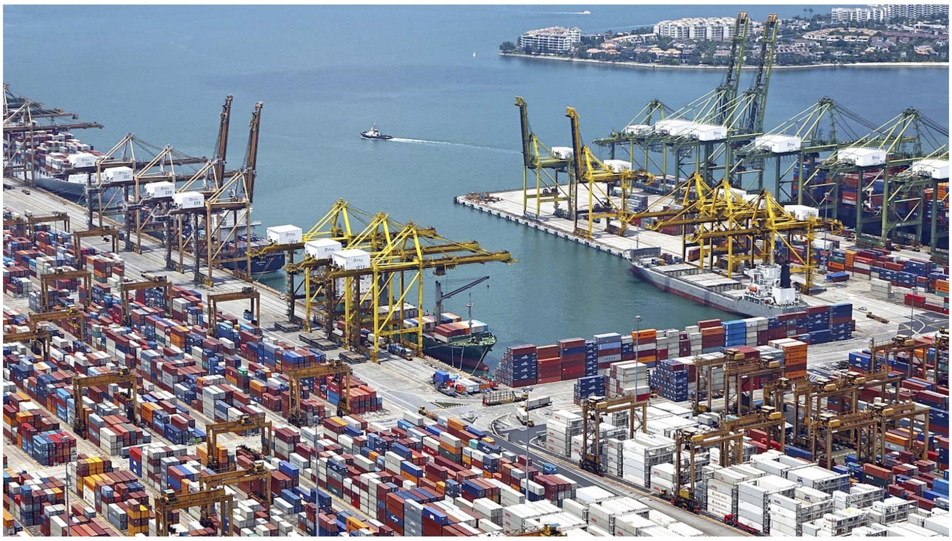
The trade policy of the United States has in the last year become increasingly protectionist, aiming to change the terms of international trade. However, protectionist measures may have unexpected and long-term repercussions as businesses' supply chains have become more complex and extending across national boundaries. Even if the higher tariffs were temporary, the global economy will grow more slowly, the more the tariff increases heighten uncertainty and postpone investments.



Heightened trade policy tension in the last 12 months

President Donald Trump's administration has not been satisfied with existing agreements on international trade. In late 2017, the United States pulled out of the Trans-Pacific Partnership (TPP) and wanted to re-negotiate the North American Free Trade Agreement (NAFTA) with Mexico and Canada. The United States has also demanded changes to the operation of the World Trade Organization.

In early 2018, the United States imposed global tariffs on solar panels and washing machines. These were followed by steel and aluminium tariffs, although some trade partners were temporarily exempted from them. In early April, the United States published a list of Chinese import goods, worth about USD 50 billion a year, subjected to a 25% increase in tariffs in two parts, in July and August. The list mainly consisted of Chinese technology products, machines and components. In September, the United States imposed an additional tariff of 10% on Chinese imports, worth an annual USD 200 billion, and announced that the tariffs would be increased to 25% as of the beginning of

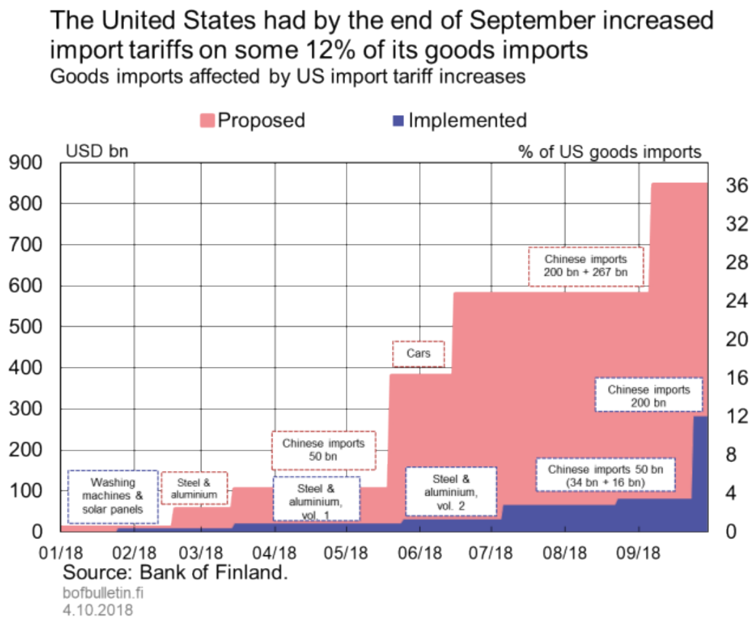
2019. The US administration is also preparing tariff increases on the entire remaining Chinese goods imports, worth more than USD 260 billion.

China reacted immediately once tariffs set exclusively on China entered into force. China's corresponding list of products, worth USD 50 billion, consists mainly of agricultural products and cars. The Chinese response to the product list worth USD 200 billion was to impose tariff increases on US imports worth of USD 60 billion.

When the United States imposed steel and aluminium tariffs in June 2018 on imports from the EU, the latter responded by increasing tariffs on a shipment of US imports worth USD 3 billion. Later in the summer, the United States began the processes for imposing global import tariffs on cars and car parts. The majority of imported cars into the United States originate from Japan, Mexico, Canada and the EU. NAFTA renegotiations have proceeded after this especially with Mexico.

According to the WTO, measures limiting international trade increased globally between October 2017 and May 2018. However, trade was liberalised more than any new barriers were imposed during this period.[1] But if the WTO's role is weakened, free trade could suffer, resulting in a permanent increase in both direct tariffs and other obstacles to trade.

Chart 1.



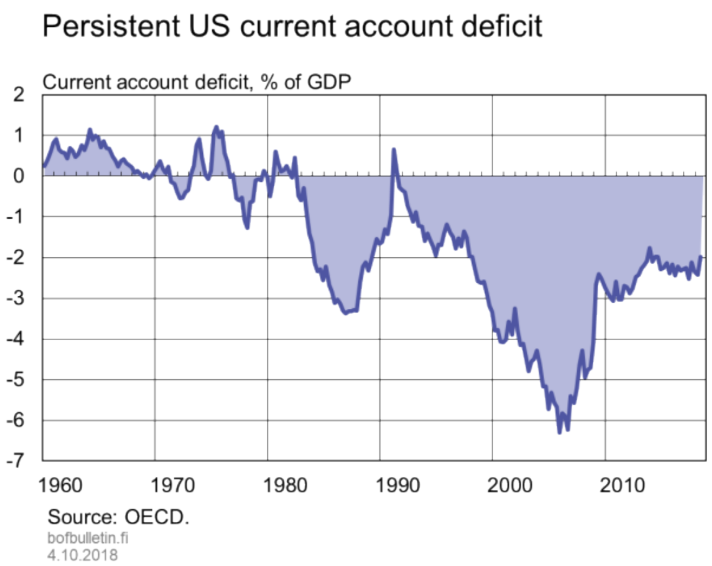
Import tariffs not expected to reduce persistent US current account deficit

The main reason the United States has implemented tariff increases is that the new administration feels that international trade is unfair, resulting, among other things, in the US current account deficit. Although the US current account deficit has shrunk from

1. WTO, Trade monitoring 25 July 2018.

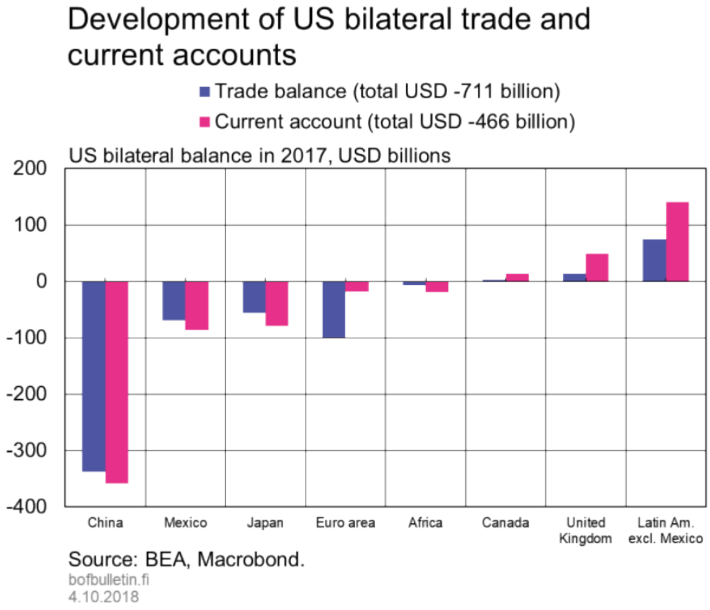
6% before the financial crisis to the current about 2%, when it comes to the trade balance, the United States still has a large bilateral deficit especially with China, Mexico and the euro area.

Chart 2.



Analysing bilateral trade and current account deficits is not unproblematic, because each country's current account deficit is determined on the basis of its savings and investments. If investments are higher than savings, the current account has a deficit. Foreign investors have been eager to invest in the United States for a long time, and that is why investments have exceeded domestic savings. Since the 1990s, higher productivity and more open international financial markets increased investments, wealth and consumption in the United States, thereby reducing the savings rate. In addition to this, bilateral trade may show a considerable deficit, but this can be compensated with any surplus with other countries.

Chart 3.



The IMF's estimates on the current accounts consistent with medium-term fundamentals and desired policies (that is, 'norms') attempt to explain what is a justified level of the current account. Such a level may vary, for example, between a country that exports raw materials and a country that focuses on final assembly. According to a 2018 IMF estimate, the norm for the United States is a current account deficit of about 1%.[2] According to this estimate, saving was insufficient in the United States by what accounts for more than one percentage point of the GDP. The US deficit is partly explained by the dollar's role as a reserve currency, the country's advantageous population age structure compared to other developed economies, and the fact that the United States carries a low investment risk.

It is difficult to reduce a current account deficit with import tariffs, and what is more, the current US financial policy does not support the objective of reducing the current account deficit. Even if more was saved of the output of industries protected by tariff barriers, the extremely expansive fiscal policy applied will push towards a current account deficit[3].

Objectives with China partly justified

One of the key objectives of the US trade policy is to make China give up what the United States considers unfair and discriminatory practices, such as alleged copyright breaches and forced technology transfer. US tariff increases are specifically targeted against the Made in China 2025 industrial plan. Launched in 2015, the plan aims to make China self-sufficient in terms of both technology and innovation, supporting various sectors extensively and assisting them financially to expand abroad, for example, and to acquire ownership in high-technology companies. The United States is not alone with its

2. IMF (2018) External Sector Report: Tackling Global Imbalances amid Rising Trade Tensions, July 2018.

3. The annual US budget deficit is about 5% of GDP, and debt accounts for well over 100% of GDP.

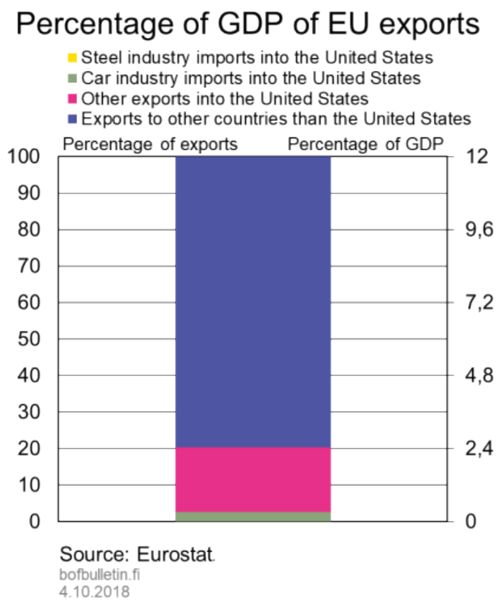
demands. For example, European Union and United States chambers of commerce in China have been complaining for years about unfair practices against foreign companies.

Europe's current account surplus due to low investment

The United States has justified its protectionist measures also against imports from the EU with a heavy bilateral trade and current account deficit. Last year, the EU's current account had a surplus of USD 220 billion (1.4% of GDP), because the investment level has been low, especially after the financial crisis. On the other hand, the EU's current account surplus and low level of investment can be partly explained by the quick ageing of the population. Indeed, the EU's population is forecast to age much more quickly than that of the United States. According to the IMF's 2018 norm estimates, the desired level of the current account for the key EU Member States would show a clear surplus.

Of any individual European country, Germany's current account surplus has remained high for more than a decade. During the first quarter of 2018, it was 8.7% of GDP. This is much higher than the 3% norm estimated by the IMF, which is why the IMF has encouraged Germany to focus on public investments that improve long-term growth prospects and to increase incentives for private investment.[4]

Chart 4.



Considering its large size as a market area, the EU is relatively closed (goods export in relation to GDP is about 12%), which helps to restrict the economic effects of US import tariffs. On the whole, the United States is nevertheless an important trading partner to the EU, with exports to the United States accounting for about 20% of the EU's entire goods exports. Tariffs so far imposed or threatened against European steel, aluminium and car industries only account for 2.5% of all EU exports, but the effects may be

4. IMF (2018) Germany, Staff Report for the 2018 Article IV Consultation, June 2018.

significant to individual sectors of industry. To counter US protectionism, the EU has been actively promoting trade with other economies. The EU's free trade negotiations with Japan and Singapore have been concluded, and an agreement with Canada is awaiting ratification by the EU Member States to enter into force.

Economic effects of protectionist measures

Chart 1 shows the Bank of Finland's alternative calculations based on the Global Integrated Monetary and Fiscal Model (GIMF) concerning the effects of any expanding trade policy measures. In these calculations, the effects are caused through both the trade and confidence channels. Higher tariffs increase foreign trade expenses through the traditional trade channel, thereby reducing trading. Obstacles to trade will also have an effect through the confidence channel, breaking up global supply chains, eroding economic confidence and reducing businesses' willingness for long-term investments.

The effects are viewed in two scenarios. In both scenarios, weakened trust has been accounted for in the form of a single shock effect that reduces investment. Any tariffs imposed are expected to remain in force for two years[5].

- **In the first scenario**, the trade disagreement between the United States and China will come to a head so that the 25% tariff increases will concern all bilateral trade of both countries. In addition to that, the United States will impose a 25% import tariff increase on cars imported from the EU, and the EU will respond with an import tariff increase of 25%, corresponding to the same amount in dollars for US imports. In the calculations, there will be a one-off 1.25% reduction in investments in the countries that impose such trade restrictions.
- **In the second scenario, involving more serious protectionist measures**, the United States will impose global 10% import tariff increases on all imported goods, which their trading partners will counter in equal proportion. This would result in a quadrupling of the average import tariffs in the United States. Correspondingly, the euro area would triple and China would more than double its average tariffs on US imports[6]. In this scenario, investments will shrink globally by 5%, which corresponds in magnitude to what took place in the euro area in the 2012 recession.

The effects of the more moderate scenario would remain small for the global economy, but in the more serious scenario, import tariffs would shrink global GDP by 1.3% in the first year and 0.6% in the second in proportion to the output level without any trade measures, that is, the baseline. This means that if global GDP grew on a baseline at about 4%, growth would be reduced in the first year to 2.7%. Although import tariff increases are assumed to be temporary, weakened confidence and collapsing investments would affect calculations on the global economy for much longer.[7] The mere possibility of

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5. The calculations also assume that any tariff income is primarily used to reduce public debt.
6. According to the WTO, average 2017 import tariffs in the United States were 3.5%. Import tariffs on US products averaged 5% in the euro area and 7% in China.

trade policy measures could increase uncertainty, be reflected in investment and therefore stunt world trade growth.

The United States in particular would suffer from protectionist measures, because as a result of counter tariffs imposed by other countries, it would become isolated from international trade and its exports would shrink considerably. However, the macroeconomic effects would be reduced by a higher share of domestic demand than in other countries. Whichever scenario were to be realised, the United States would not be able to reduce its current account deficit and in fact, the reverse could happen, because exports would be shrinking at a higher rate than imports.

In these calculations, effects materialising through the trade channel would be minor on the euro area. In the more moderate scenario, tariff increases on car exports concern a very limited part of the euro area's foreign trade. The euro area could also increase trading with other countries, which would diminish the effects. In the more serious scenario, tariff increases would affect a fifth of euro area exports, with the effects becoming even greater if confidence waned and investment decreased. A dip in confidence would affect the calculations in the form of more negative repercussions on economic growth. Many assumptions have to be made in modelling the confidence channel. Higher uncertainty would probably increase financing costs and could affect economic confidence more than expected. This means that economic growth could slow down a lot more than what is presented in the scenarios.

Also other published impact calculations suggest that the macroeconomic effects of the current measures would remain relatively small. The greatest impact will be felt through the confidence channel, and the negative effects will hit the United States hardest[8]. According to calculations made by the Research Institute of the Finnish Economy (ETLA),[9] if the 25% tariff increases between China and the United States affecting all their bilateral trade remained in force for three years, both countries' total output would shrink by more than a per cent by 2023. GDP within the euro area will contract much less than this, by no more than 0.3% from the baseline.

Tariff changes in line with the second scenario presented in this box would, according to calculations presented in the ECB's Economic Bulletin in September,[10] lead to a global GDP contraction approaching 1 per cent in the first year. In the worst-case scenario, yet an unlikely one, by the Bank of France, in which all parties in international trade were to impose 10% import tariffs on each other, global GDP would be almost 3% lower than the baseline in the second year.

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7. If the tariff increases remained permanent, their effects would be more serious. For example, the negative effects in the euro area on GDP would be some 0.2 percentage points higher than presented here.
8. See, for example ECB Bulletin (3/2018) Implications of rising trade tensions for the global economy; M. Obstfeld IMF Blog (9/2017) Tariffs do more harm than good at home; Banque de France (7/2018) Quantifying the losses from a global trade war; CPB Background Document (6/2018) Trade wars: economic impacts of US tariff increases and retaliations: An international perspective. These impact assessments differ from each other in terms of the scenarios used and the way the confidence channel has been modelled.
9. Research Institute of the Finnish Economy, ETLA: Kansainvälinen suhdannekehitys 2/2018.
10. ECB Economic Bulletin 6 / 2018. The confidence channel has been modelled in this calculation by means of an increase in covered bond risk premiums and a stock market fall.

Table.
Model calculations on the impact of protectionist measures

		Scenario 1: USA and China will impose 25% imports tariffs of each other and USA will impose import tariffs on cars from the EU, with EU imposing symmetrical counter measures		**Scenario 2:** USA imposes 10% global import tariff increases, with its trading partners countering them with equal measure	
		Effects, deviation is percentage from the baseline			
		1st year	2nd year	1st year	2nd year
Euro area	GDP overall effect	0.0	0.0	–0.6	–0.3
	Current account/GDP	0.2	0.1	0.4	0.2
United States	GDP overall effect	–0.9	–0.4	–2.3	–1.1
	Current account/GDP	–0.3	–0.1	–0.7	–0.4
China	GDP overall effect	–1.5	–1.0	–1.0	–0.6
	Current account/GDP	–0.5	–0.4	0.4	0.3
World	GDP overall effect	–0.3	–0.2	–1.3	–0.6

Source: Bank of Finland calculations.

International supply chains have become more complex, and also extending into many countries. The proportion of services in trade has also grown. Model calculations cannot fully take into account the effect of tariffs on supply chains. Import tariffs would significantly erode companies' profitability and perhaps also affect their product development and investment decisions. In the long term, this could erode productivity. Many sectors use imported products as intermediate goods for their own production. As the tariffs push up the price of such intermediate goods, the competitiveness of companies in these sectors is weakened. Companies can protect their market shares by settling for a lower profit margin, but often it is the consumer who suffers from tariffs in the form of higher prices. For China in particular, import tariff increases are estimated to have a negative effect also on the production and supply chains of international companies.

Protectionism and a harder trade policy rhetoric can indeed have unexpected consequences. This box has only considered the effects of trade obstacles of added direct tariffs, although international trade is also restricted in a number of other political ways. The WTO has played a key role in the monitoring of also these other obstacles to trade. If the WTO's position were to become weaker as a result of protectionist measures, the monitoring and arbitration of trade disputes would become more complex and impede international trade.

Tags

supply chains, protectionism, import tariffs, current account