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ECONOMIC INSIGHTS

Trade War Impacts Are All in Your Head

An economist's tool kit works well for some purposes, but is wholly inadequate at other times. These are such times, since the question of the day is the complex impact of a China-U.S. trade war. Or if that one gets settled, a looming U.S.-EU scuffle.

Who pays the U.S. tariff? The maddening answer in economic theory is: it depends. Where China is a price taker in the U.S. due to competition from elsewhere, it can't pass the tariff on in its prices. But if Chinese producers are effectively price setters, they can not only pass on the tariff, but U.S. buyers could also be hit with matching hikes from non-Chinese suppliers.

At the macro level, one also has to think about the cushioning impacts of policy and market responses. To the extent that a trade war dampens growth, monetary and fiscal policy makers could provide offsetting stimulus, and look through the one-time price-level impacts from the tariffs. China has already done so, and its currency has also weakened to counter some of the shock for exporters. Many studies simply exclude these adjustments.

Economists are inclined to favor liberalized trade, with retraining, labor market policies and progressive taxation preferred to protectionism as a means of supporting those who lose out. Despite that bias, some estimates in the literature point to modest U.S. economic costs of a bilateral trade war. After all, American exports to China are only on the order of 1% of GDP. An IMF study found that a 25% tariff on all U.S.-China trade cuts American growth by merely 0.2%-0.3% in the first year, with growth in subsequent years similarly pared back.

But while there are exceptions, many such studies miss the real costs of a trade war, which are all in our heads. Just eyeballing the S&P 500's response to the headlines, in investors' eyes, and likely CEOs as well, the uncertainties and adjustment costs inherent in trade disruptions are no small matter for confidence. It's not just a U.S.-China story, as a threat to impose U.S. tariffs on European and Japanese vehicles was only delayed to pursue talks rather than definitively set aside.

“Animal spirits,” the unquantifiable mood swings that impact business capital spending and hiring decisions, are a key business cycle driver. With global growth already decelerating last year, it would take less of an additional shock to put the whole expansion at risk.

That leaves us sticking to our core scenario in which this trade war won’t last that long. Donald Trump professes to like a good trade fight, but he also likes a rising equity market, and needs to win rural farm states hurt by Chinese retaliatory measures. China can temporarily pump up GDP with excessive lending and questionable capital spending, but open trade is needed to justify the capacity additions that come with all those loans and capital plans.

The tumble in equity markets wasn’t much fun for investors. But if its message gets into the heads of the two leaders who need to sign on to a compromise, it could prove to be short-term pain for longer-term gain. ■

Source: CIBC Chief Economist Avery Shenfeld.

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