No Winners From an Extended U.S.-China Trade War

An extended round of tariffs will adversely impact the global economy.

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Nikolaj Schmidt
Chief International Economist

Volatility returned to markets in mid-May after trade talks between the U.S. and China appeared to stall. If the current dispute between the two biggest contributors to global gross domestic product becomes a full-scale trade war, it will adversely impact not just the U.S. and China, but the entire world economy. Trade wars do not produce any winners in the long term.

Tariffs directly affect economies in two main ways: first, because they function as simple taxes on goods and, second, because they cause uncertainty, which impacts household and corporate decision-making. Let's look at each of these in turn.

Although taxes on goods increase the tax revenues of governments, they also lead to a misallocation of resources, which drives the overall economy into an inefficient equilibrium. In economics jargon, this is known as the "deadweight loss" of taxation. Because tariffs raise the price of consumption, the purchasing power of households is reduced and fewer goods are bought. At the same time, households and companies try to substitute away from the tariffed goods, thereby ending up consuming a basket of goods that has been distorted by the tax. This new basket of goods represents an inferior choice to the consumer.

When President Donald Trump tweets that the U.S. will win the tariff war, he assumes that U.S. households and companies will substitute toward a domestically produced basket of goods and that this will indirectly create new American jobs. I'm skeptical. In my view, it is more likely that U.S. households and companies will shift their consumption to goods produced in Vietnam or Mexico rather than back to American-produced goods and that U.S. jobs which have been outsourced to China will not be repatriated before the production process has become entirely automated. American-produced goods would be a viable alternative if either the U.S. was the most cost-efficient producer after China (which it is not) or if the U.S. harbored the production facilities required to produce electronic gizmos it currently imports from China. In an unsettled trade regime, U.S. companies are unlikely to build onshore production facilities to cater to this potential demand.

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The second way that tariffs reduce consumption is by creating uncertainty, which causes households to postpone consumption and companies to defer capital expenditures. The impact of uncertainty on an economy is akin to monetary tightening (which is clearly not part of President Trump's agenda). As the U.S. and China are the two biggest economies in the world, any uncertainty created by a prolonged trade war between the two will affect the global economy. The few countries that might benefit are those, such as Vietnam and Mexico, that can deliver substitutes for tariffed Chinese goods in a cost-efficient manner.

Trade wars do not just hit consumption, they also impact inflation, central bank policies, and exchange rates. As tariffs function largely like consumption tax hikes they are likely to cause headline inflation to rise initially, but just like any other form of fiscal tightening, they will eventually cause growth to slow. This will lead to an increase in output gaps, which reduce core inflationary pressures. As U.S. households and consumers substitute away from goods produced in China, China is likely to respond by trying to export its excess capacity to the rest of the non-U.S. world. This is how the disinflationary shock of tariffs is transmitted across the globe.

The impact of tariffs on central bank policies will differ by region. For a developed economy central bank, the monetary policy implications of tariffs are straightforward: Tariffs lead to slower growth and lower core inflation pressures, so the appropriate monetary policy response is dovish. In emerging markets, however, rising uncertainty is more likely to trigger capital outflows, putting downward pressure on growth and upward pressure on inflation. To keep capital onshore, emerging market central banks may be forced to respond with monetary tightening.

How tariffs affect exchange rates is a complex function of demand elasticities. Usually, the country whose output gap is most adversely affected by tariffs is likely to see its currency depreciate the most. In the current environment, this would mean that emerging market currencies would depreciate versus the U.S. dollar and the U.S. dollar would lose ground against other major currencies.

Given the negative overall impacts of tariffs, it is tempting to conclude that sanity will prevail and that the U.S. and China will step back from the brink and walk away from a situation that will only serve to harm the economies of both countries. However, President Trump seeks to be reelected next year and may decide that the political gains from an outright fight with China outweigh the political cost of slower economic growth. Indeed, support for populist parties across the world continues to grow on the back of rising inequality and concerns about the impact of globalization. Tariffs may not be a good idea economically, but it is politics, not economics, that wins elections. Consequently, we are unlikely to see the back of tariffs anytime soon.

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