Boxes

1 Implications of rising trade tensions for the global economy

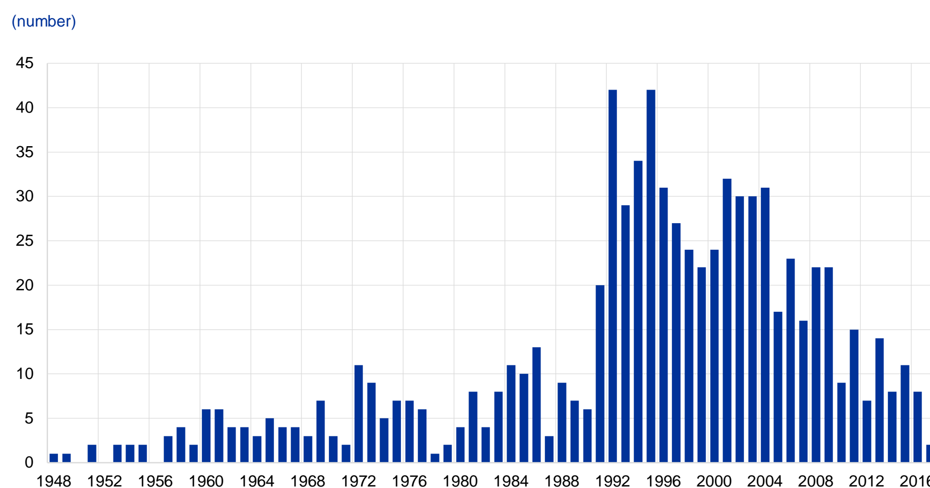
Prepared by Lucia Quaglietti

Public support for globalisation has declined over the past decade and trade reforms have slowed. Moreover, in recent weeks the risk of rising trade tensions has surged on the back of new sets of tariffs announced by the US administration. This box discusses the possible implications of rising trade tensions for the global economy.

The period prior to the financial crisis was characterised by a sharp increase in trade liberalisation. In the period between 1990 and 2010 more than 500 new preferential agreements were signed cumulatively (see Chart A) – three times more than in the previous two decades. The proliferation, which was in part favoured by the standstill of the Doha trade round as countries resorted to alternative forms of trade liberalisation,[1] led to a sharp and widespread fall in applied tariff rates among both advanced and emerging economies (see Chart B).

Chart A

Preferential trade agreements by year of signature

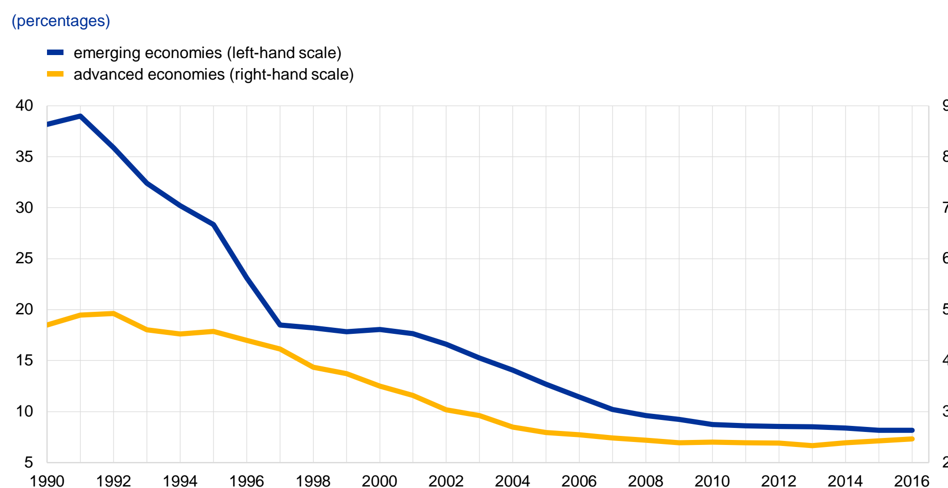


Source: Design of Trade Agreements Database.

[1] See, for example, Bhagwati, J. and Krueger, A., "The Dangerous Drift to Preferential Trade Agreements", American Enterprise Institute, Washington, 1995.

Chart B

Average tariffs in advanced economies and emerging market economies



Source: World Bank.
Notes: The simple mean of weighted tariff rates is shown. For each individual country, this is computed as the unweighted average of effectively applied tariff rates for all traded goods subject to tariffs. Aggregates are based on the 14 largest countries in the world (according to purchasing power parity GDP weights in 2010).

Increasing trade openness contributed to the increase in global living standards. Cross-country evidence[2] indicates that a one percentage point increase in trade openness tends to raise real per capita income by 3 to 5% in the long run, though a smaller effect is detected in the years following the financial crisis. In addition, the integration of many emerging economies into global trade, including through participation in global value chains, has been identified as an important driver of poverty reduction.[3]

The overall pace of trade liberalisation has slowed down in recent years, while policy actions restricting trade have increased. The number of newly signed free trade agreements has dropped sharply over the last decade (see Chart A), although recent agreements have broader coverage regarding both the number of countries involved and the sectors targeted.[4] At the same time, the decline in tariff rates observed in the years preceding the crisis has come to a standstill (see Chart B). In addition, according to data from the Global Trade Alert Database encompassing traditional and non-traditional trade measures, the number of new discriminatory actions announced by G20 economies has increased steadily since 2012 (see Chart C[5]). Within these, anti-dumping measures and import tariffs were the two most predominant instruments used, accounting together for around 30% of all measures imposed in 2017. At the same time, non-tariff measures, such as state loans to exporting companies, have surged. Moreover, the evidence suggests that over the

[2] Cerdeiro, D. and Komaromi, A., "Trade and Income in the Long Run: Are There Really Gains, and Are They Widely Shared?", IMF Working Paper 17/231, International Monetary Fund, 2017. This analysis is based on reduced-form estimations and covers the period 1990-2015.

[3] *The role of trade in ending poverty*, World Bank and World Trade Organization, 2015.

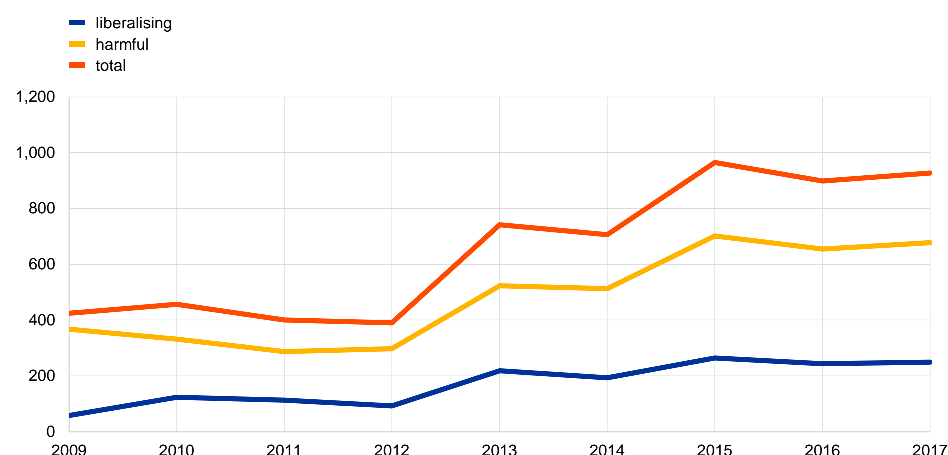
[4] *World Economic Outlook*, International Monetary Fund, October 2016.

[5] The author would like to thank Simon Evenett and Piotr Lukaszuk for sharing the data shown in Chart C.

period 2012-15, import growth in the sectors subject to large discriminatory trade measures recorded a sharper slowdown relative to sectors where no or only a few discriminatory measures were imposed.[6]

Chart C

New trade measures announced by G20 countries



Source: Global Trade Alert Database.
Notes: Data have been adjusted for reporting lags. The cut-off date in each year is 31 December.

Previous ECB analysis suggests that the slowdown in trade reforms might have been one factor weighing on trade growth in recent years.[7] Between 2012 and 2016 world imports expanded at an average pace of 3% per year – less than half the average of the previous two decades. The same weakness was not reflected in economic activity, which, while subdued, did not decelerate to the same extent. Having expanded at twice the rate of global GDP in the years before the global financial crisis, from 2012 the income elasticity of trade fell to around one.

Over the past one and a half years, however, global trade has staged a cyclical revival. World imports expanded by more than 5% in 2017, 1.5 percentage points higher than the 2011-16 average. In 2017 world imports outpaced economic activity for the first time in three years. The cyclical upswing in activity, particularly in investment, appears to have contributed to the recent pick-up in world trade. Global investment bottomed out from very low levels at the start of 2016 and in recent quarters it has been expanding at a rate close to its pre-crisis average.

In recent weeks the risk of a worsening of trade tensions has increased on the back of new sets of tariffs announced by the US administration. In late March President Trump signed an order to impose tariffs of 25% on steel and 10% on aluminium for imports, although exemptions were granted to several economies (including the EU, albeit on a temporary basis). China has responded with a pledge to increase tariffs on USD 3 billion of US imports. A further announcement by the US

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[6] *World Economic Outlook*, International Monetary Fund, October 2016.

[7] See, for example, "Understanding the weakness in global trade: what is the new normal?", *Occasional Paper Series*, No 178, ECB, September 2016.

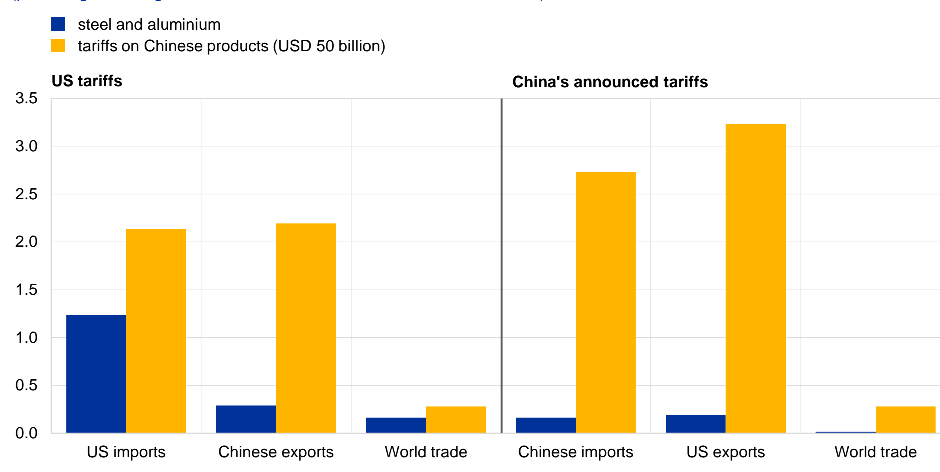
administration to raise tariffs on USD 50 billion of Chinese goods was met by a pledge by China to raise tariffs on a similar amount of imports from the United States.

The announced tariffs affect only a small part of US trade or world trade, and their impact is likely to be modest. The goods affected by the measures represent only around 2% of US imports and Chinese exports and less than ½% of world trade (see Chart D). Viewed in isolation, the direct impact is unlikely to be very significant. However, the risks associated with an escalation of trade tensions and a broader reversal of globalisation have clearly increased. This may affect investment decisions around the world, testing the resilience of the global trade momentum.

Chart D

US tariffs and China's retaliation: shares of US, Chinese and global goods trade

(percentage of total goods trade for the United States, China and the world)



Sources: US Census, IMF Direction of Trade Statistics and ECB staff calculations.

A significant escalation of trade tensions risks derailing the ongoing recovery in global trade and activity. Simulations carried out by ECB staff indicate that in the event of a significant increase in protectionism, the impact on global trade and output could be material. In a scenario in which the US increases tariffs markedly on imported goods from all trading partners that retaliate symmetrically against it, the outcome for the world economy would be clearly negative; global trade and activity could fall relative to the baseline. In such a scenario, the impact could be particularly severe in the United States.[8] The precise impact on individual countries would primarily depend on their size, openness and trade intensity with the tariff-imposing country. Overall, countries with the closest trade relations with that country would be the most negatively affected, and participation in global value chains could further amplify these effects. Only a few open economies with little exposure to the tariff-imposing country may benefit from trade diversion effects, as they would gain competitiveness in third markets.

[8] A number of assumptions underlie the results. For example, it is assumed that the trade disputes last only two years and that additional revenues generated by tariff increases are used to lower deficits, rather than being used to support demand. In addition, monetary policy and exchange rates are assumed to react endogenously in all countries.

The impact of an escalation of trade tensions could be felt via a number of channels. In the case of a generalised global increase in tariffs, higher import prices could increase firms' production costs and reduce households' purchasing power, particularly if domestic and imported goods cannot be substituted for each other easily. This could affect consumption, investment and employment. Moreover, an escalation of trade tensions would fuel economic uncertainty, leading consumers to delay expenditure and businesses to postpone investment.[9] In response to higher uncertainty, financial investors could also reduce their exposure to equities, reduce credit supply and require a higher compensation for risk. Moreover, through close financial linkages, heightened uncertainty could spill over more broadly, adding to volatility in global financial markets. In the longer term, by hindering productivity growth, a shift towards a more protectionist regime could also negatively affect potential output growth.

[9] See, for example, Bloom, N., "The impact of uncertainty shocks", *Econometrica*, Vol. 77(3), 2009, pp. 623-685.