

**RISING PROTECTIONISM BETWEEN THE UNITED STATES AND CHINA AND ITS EFFECTS ON THE GLOBAL ECONOMY**

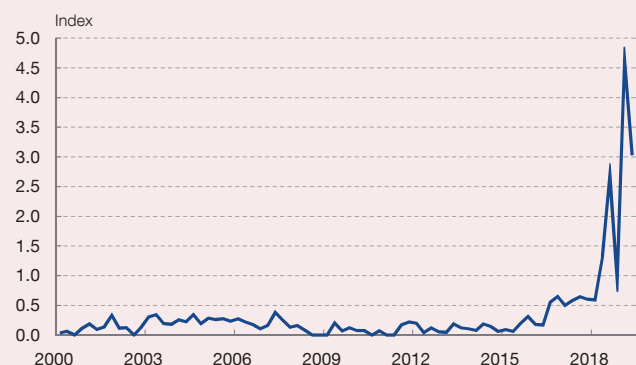
Trade tensions between the United States and China, materialised in several rounds of bilateral tariff increases between the two countries in the latest quarters, seem to be significantly affecting global economic activity. In addition to the impact on bilateral trade flows between these two countries, these tensions appear to be affecting

other countries through the fall in demand derived from lower global activity and as a result of the economic effects of greater global uncertainty (see Charts 1.1 and 1.2). The persistence of this situation over time could also significantly increase the adverse effects, given the integration of the different economies in global trade

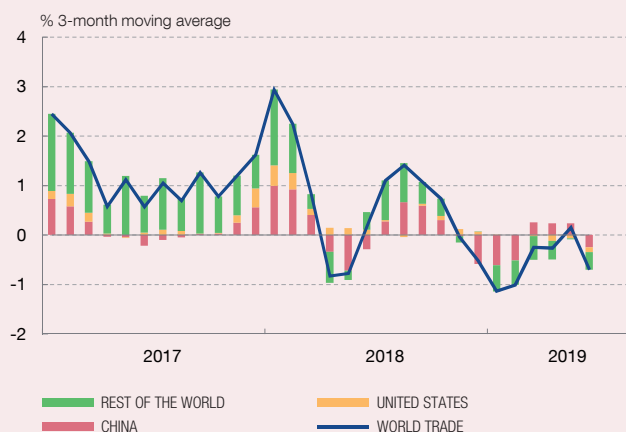
Chart 1  
RISING PROTECTIONISM HAS NOTICEABLE CONSEQUENCES ON GLOBAL ACTIVITY

The escalation of tariff-related tensions between the United States and China, both highly significant economies at the global level in terms of their share and high degree of interconnectedness, affects the activity of both countries and is transmitted to other countries through many real and financial channels.

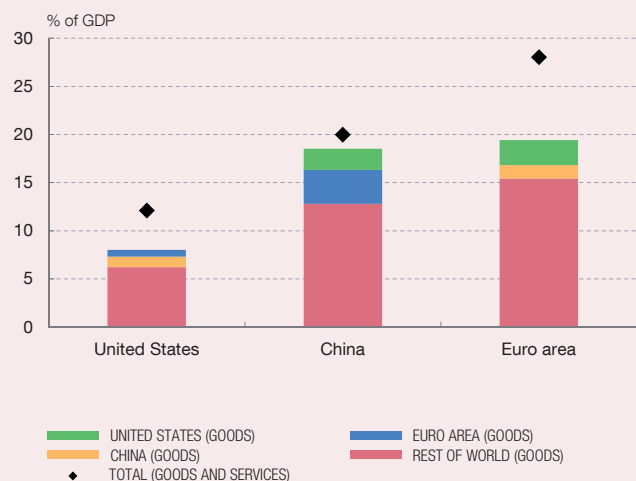
1 WORLD TRADE UNCERTAINTY INDEX (a)



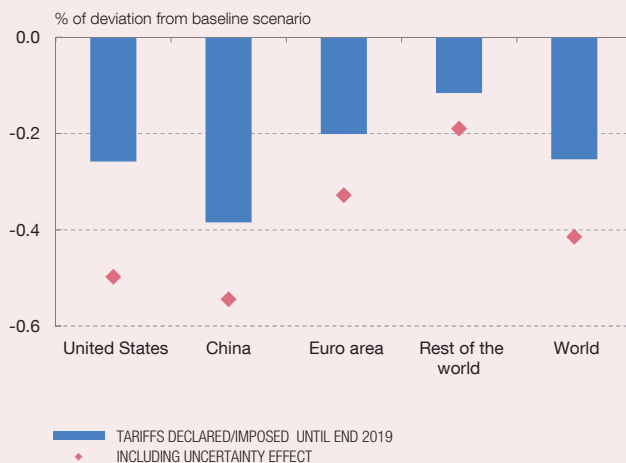
2 WORLD TRADE



3 EXPOSURE TO EXPORTS (2017) (b)



4 SIMULATIONS: EFFECT ON GDP IN THE FOURTH QUARTER OF 2021



**SOURCES:** Index of Ahir, Bloom and Furceri (2018), CPB, World Bank, European Central Bank and Banco de España.

- a The index is constructed by analysing how frequently concepts linked to uncertainty and trade appear in analysts' reports.
- b Intra-area trade is excluded for the euro area.

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through global value chains. This Box aims to summarise the developments in the trade conflict between the United States and China and to describe the main channels through which they seem to be affecting the world economy.

Several rounds of increases in tariffs on bilateral trade flows between the United States and China have been announced and applied since March 2018 (see Tables 1 and 2). Over the course of 2018, the measures adopted by the two countries resulted in the imposition of trade tariffs on different types of goods accounting for around 45% of US imports from China and 55% of Chinese imports from the United States. Following a truce which commenced in December 2018, the escalation of bilateral tariff increases entered a new phase in May 2019. Since then, new

decisions were made to increase tariffs, both on goods already affected by the measures adopted in 2018 and on other additional goods. As a consequence, all US imports from China and nearly three quarters of China's purchases from the United States would be subject to tariffs at the end of this year, in accordance with the scheduled dates for entry into force of the different tariffs. In addition to the tariff measures, announcements have been made of possible restrictions to the exchange of technology, although no specific actions have yet been determined.

Rising protectionism between these two economies, which are the largest worldwide and are increasingly interconnected with each other and the rest of the world, might have a substantial impact on the world economy through numerous direct and indirect channels. A direct

Table 1  
TARIFFS IMPOSED BY THE UNITED STATES ON CHINA

Volume of imports (\$bn)	Cumulative % of imports from China subject to tariffs	Change since May 2019, projected date of entry into force	Products affected
34	6	25 to 30% (15 Oct-19)	Machinery, capital goods
16	9	25 to 30% (15 Oct-19)	Electrical equipment, capital goods
200	46	10 to 30% (15 Oct-19)	Furniture, electronics, cars, leather, other intermediate and capital goods
115	78	New: 15% (1 Sept-19)	Clothing, footwear, electronic components
160	100	New: 15% (15 Dec-19)	Mobile telephones, toys, computers

SOURCE: US Census Bureau.

Table 2  
TARIFFS IMPOSED BY CHINA ON THE UNITED STATES

Volume of imports (\$bn)	Cumulative % of imports from US subject to tariffs	Change since May 2019, projected date of entry into force	Products affected
34	22	–	Agricultural products, car parts
16	32	–	Raw materials, medical equipment
60 (a)	56	5-10% to 5-25% (1 Jun-19)	Agricultural products, chemicals
75 (a)	71	New: 5-10% (1 Sept-19) New: 5-10% (15 Dec-19)	Agricultural products, chemicals, industrial machinery

SOURCES: CEIC and Peterson Institute for International Economics.

a There are overlaps regarding goods subject to tariffs in other rounds and, consequently, only the additional effect on the percentage of imports subject to tariffs is shown.

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channel runs through changes in demand and in the relative prices of goods. Specifically, an increase in tariffs leads to the erosion of consumer disposable income, which negatively affects consumption and investment. Conversely, it also makes domestic production more attractive than imported production. In any event, if trade reprisals take place, external demand decreases. In the specific case of China and the United States, the effect arising from the fall in commodity prices as a result of the dominant position of the two countries in oil and industrial metals demand worldwide is especially significant. An additional direct mechanism is one which operates through cross-border financial positions (although the limited openness of China's capital account restricts this channel's potential). Indirect channels are related to rising uncertainty, which hampers consumer and business confidence, weakening consumption and investment. From a financial standpoint, they are related to an increase in risk aversion and a decline in asset valuations.

Based on the available data it is difficult to accurately estimate the specific impact which the different waves of tariff hikes may have had on global economic activity. This consideration particularly affects the latest actions announced within the escalation which started in May this year, since most of them have not yet come into force (they will in October and December) or have done so very recently (in September). To approximate the possible economic impact of these actions on global activity a simulation exercise using a macroeconometric model has been conducted.<sup>1</sup> Specifically, the effect of the tariffs announced by the United States and China since May this year, regardless of whether they had been applied yet, was simulated. These measures affect all US imports from China and 71% of the reciprocal flow. Chart 1.4 shows two

scenarios, reflecting the transmission channels described previously. The first scenario relates to the real direct channels, i.e. those which run through changes in bilateral trade between the two countries and the global effects of the second round owing to the decline in global demand. The second scenario also adds the possible effects arising from the fall in confidence and the increase in uncertainty. This channel is approximated through an ad hoc investment risk premium increase of 25 bp in the US and China combined with a 10 bp rise in the rest of economies, a smaller shock than that seen in August this year.<sup>2,3</sup>

According to the simulations, the increase in tariffs (scenario 1) would entail a significant contraction in activity in the United States, China and also in the euro area, taking global GDP 0.25% below the baseline scenario in cumulative terms in 2019-2021, with declines in the GDP of the United States and China of 0.26% and 0.38%, respectively. The greater impact on the Chinese economy reflects the fact that the volume of imports subject to US tariffs as a share of China's GDP is higher than the volume on which the Chinese authorities imposed tariffs in retaliation. GDP of the euro area is estimated to contract by 0.2%, reflecting its high degree of trade openness, which makes it more vulnerable to the fall in global activity (see Chart 1.3). The second scenario shows how the confidence effect could ultimately generate significant adverse impacts in relation to those arising from the real channels. This is not only due to the direct impact from higher investment risk premia but also due to the second-round effect on global activity, which has a considerable repercussion on the euro area. However, it is difficult to calibrate the effect of the trade war on uncertainty and, consequently, its impacts should be regarded with more caution than those of the real channels.<sup>4</sup>

1 Specifically, the NiGEM model of the *British National Institute of Economic and Social Research*. The documentation for the model is available at <https://nimodel.niesr.ac.uk/>.

2 The magnitude of the investment risk premia shock is somewhat lower than that seen in reaction to those recorded in the corporate spreads in August 2019, at the height of the trade tensions.

3 A number of assumptions are used in the simulation. Specifically, it is considered that expectations are rational, monetary policy is exogenous and fiscal policy acts as an automatic stabiliser (simultaneously maintaining a medium-term budgetary target). The monetary policy assumption is introduced to prevent the increase in imported goods prices from triggering an increase in interest rates in the United States, as this would be contrary to the Federal Reserve's reaction.

4 The simulations show effects of the same order of magnitude as other studies, although they are not directly comparable due to the different nature of the shocks included. In the World Economic Outlook of October 2018, the IMF shows impacts on the pure trade scenario of -0.3% in the United States and -0.6% in China in 2021. Also, in the OECD's exercise included in the *Economic Outlook* of April 2019, the impact of an adverse scenario in which confidence deteriorates sharply is -0.8% for the United States and -1.2% for China in 2021.

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Nevertheless, there are several factors which could produce different effects to those considered in these simulations. First, the exercise undertaken does not take into account the expansionary reaction of monetary policies globally, which has already begun and would tend to reduce the magnitude of the impact. Second, trade tensions may lead to changes in the location of global production chains, in which China has a dominant

position, affecting activity in third countries, positively or negatively, according to the case at hand, depending on its complementarity or substitutability with respect to China's production. Another factor not considered in the simulations, given the limitations of the model used, is trade potentially being diverted to third economies, such as the euro area, which could benefit in terms of their exports of certain types of products and services.