S&P Global Ratings

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Economic Research:

The U.S.-China Trade War: The Global Economic Fallout

May 22, 2019

Key Takeaways

- If the tariffs the U.S. and China have applied against one another remain in place for the rest of the year, the direct, short-term macroeconomic consequences in either country are likely to be minimal--unless household and business confidence tanks. That said, the more profound risks may lurk elsewhere.
- A meaningful slowdown in U.S. domestic demand from the trade dispute may lead to rate cuts. The Federal Reserve is in wait-and-see mode, but the chance of an "insurance" rate cut has increased.
- For China, the key risk is that the combined effects of investment restrictions, export controls, and tariffs will rewire supply chains and weaken manufacturing investment, particularly in the technology sectors driving growth.
- In Europe, the direct effects of U.S.-China trade friction will be felt in sectors with medium to high technological content like transport equipment, motor vehicles, rubber and plastics, chemical products, and pharmaceuticals.
- The indirect effects in Europe could be more detrimental, not least because it is increasingly dependent on trade, unlike China, and much more dependent than the U.S.

U.S. CHIEF ECONOMIST

Beth Ann Bovino

New York

(1) 212-438-1652

bethann.bovino
@spglobal.com

ASIA-PACIFIC CHIEF ECONOMIST

Shaun Roache

Singapore

(65) 6597-6137

shaun.roache
@spglobal.com

EMEA CHIEF ECONOMIST

Sylvain Broyer

Frankfurt

(49) 69-33-999-156

sylvain.broyer
@spglobal.com

In a first look at trade tariffs the U.S. and China have recently slapped on each other, economists at S&P Global Ratings believe the direct effects on the world's two largest economies are likely to be minimal—if the levies remain in place for the rest of 2019. However, the indirect macroeconomic effects are likely to be many, varied, and capture other trade-dependent economies in their nets like Europe and Canada. Beyond the macro level, the direct hits on specific sectors, lower-income consumers, and small and midsize enterprises (SMEs) with exposure to tariffs are likely to be sizable.

The U.S. Is Still Weathering The Storm

While the trade war brewing between the U.S. and China will likely have minimal direct macroeconomic effects on either country in the near future, the longer-term consequences for global supply chains, U.S. business sentiment, and consumers' purchasing power are growing.

For now, S&P Global Ratings' economists believe the increase in tariffs laid out by U.S. President Donald Trump will boost overall U.S. consumer price inflation modestly—even companies such as Walmart and Macy's are warning that shoppers will almost certainly soon pay higher prices.

This will help bring the overall inflation reading closer to the U.S. Federal Reserve's target. However, the Fed would likely see any increase in inflation caused by a one-off increase in tariff rates as temporary. However, a meaningful slowdown in domestic demand from the trade dispute will likely lead to rate cuts. For now, the central bank is in wait-and-see mode, but the chance of an "insurance" rate cut has increased.

We expect the 25% tariffs, combined with reciprocal retaliation from China, if they hold for the year, will directly shave off only about 30 basis points from growth in the next 12 months but perhaps a bit more in secondary effects such as tighter financial conditions and increased uncertainty reducing business appetite for investment. While that will slow growth, it is not enough to threaten recession in the world's largest economy.

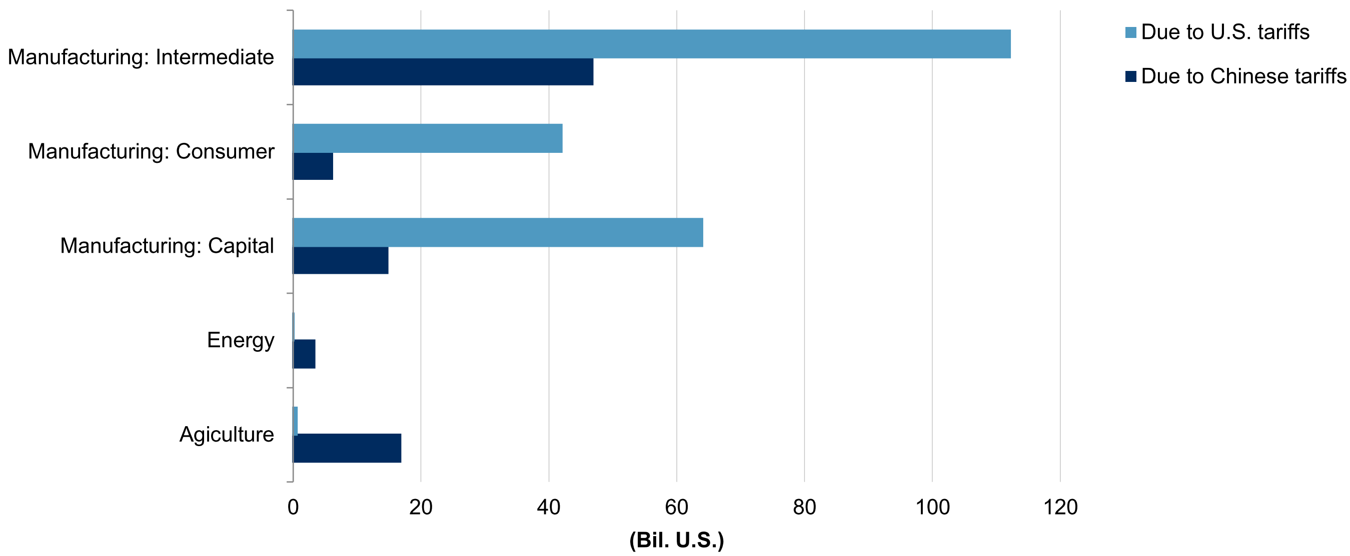
Typically, U.S. strategy in such a dispute is to force a trade partner to drop restraints on American goods, raise the value of its currency (thus making U.S. products more competitive), or to buy some time to reach certain domestic production capacity levels. And some economists espouse the view that U.S. tariffs on China could have longer-term benefits if they lead, for example, to a further opening of its financial services and insurance markets to American entities. The question is whether this reward offsets the risk (see "Global Trade At A Crossroads: U.S. And China Exchange Tariff Blows," published May 14, 2019, on RatingsDirect).

Though headlines focus on tariffs on goods, the real story is on less tangible issues such as reaching an agreement on reciprocal bilateral investment opportunities, intellectual property protection, and level playing fields for domestic and foreign firms. The question has always been: Will U.S. levers on China, such as investment restrictions, export controls and, to a lesser extent, tariffs lead to a new strategic economic dialogue between the two titans? The worry is that stubbornness will win the day.

The tariffs that the U.S. and China have levied cover a wide range of products, with most focused on the manufacturing sector (see chart 1). This time, the U.S. extended tariffs to consumer products, so households will suffer higher prices at the mall, and the U.S. farmer—the poster child when it comes to trade wars—will take yet another blow to his bottom line.

Chart 1

Economic Sectors Hurt By U.S. And Chinese Tariffs



Source: Peterson Institute for International Economics. S&P Global Ratings Economics calculations.

Either way, SMEs tend to suffer more from tariffs and other trade barriers than large multinational firms do, with profit margins squeezed by rising costs. To the extent that businesses can pass on these costs, consumers would see rising prices, with low-income households suffering the most.

We expect a modest increase in consumer prices of 20-30 basis points (bps). Still, that would erase, at least partially, the boost that last year's tax cuts gave to households' spending power—with the average family of four facing a roughly $2,200 increase in annual costs, according to a study from consulting firm the Trade Partnership Worldwide.

Compared with a no-tariff baseline, the 25% tariffs on $200 billion of Chinese imports, combined with retaliation by China, would likely shave off 30 bps from U.S. GDP growth in the next 12 months. But to better understand the potential economic effects of the current dispute, consider that when the Obama Administration increased levies on tires from China in 2009, the Chinese government retaliated with significant tariffs on U.S. poultry, which, according to one estimate, shaved $1 billion from U.S. poultry exports.

In similar fashion, Chinese buyers recently canceled a large order for American pork, according to the U.S. Department of Agriculture, and American farmers' fears of a significant hit are making headlines. The earlier $12 billion bailout package the White House put together for all farmers has reportedly done little to cushion the blow. Many also view a new bailout proposal of $15 billion to $20 billion as a day late and a dollar short.

The secondary effects of potential financial market volatility, too, pose a downside risk to our growth forecast. Investors have proven to be sensitive to heightened political and economic uncertainty, and the effects on already slow business investment could be significant. Add to this potential job losses in certain industries—with many American jobs at risk because of U.S. and

Chinese tariffs—and it's clear that the escalation in tensions between the two countries will have notable real-world ramifications.

Implicit in our calculation is that U.S. importers will bear the full costs of the tariffs, that domestic producers step up supply—with a full pass-through of cost to consumers—and that the tariffs are not short-lived. In reality, these assumptions wouldn't necessarily hold true for all products in the same way, and price changes would vary by degree of reliance on Chinese imports. Moreover, while American farmers would lose export business, higher supply at home would drive down domestic prices. The effect on prices also depends on the so-called "elasticity" of demand for a product. The more elastic a product, the more easily shoppers can find a substitute. Moreover, businesses may decide to eat the extra cost rather than risk losing market share, under the assumption that the tariffs will be short-lived.

Fed policymakers, too, would likely view any increase in inflation as temporary. However, a meaningful slowdown in domestic demand could lead the central bank to lower its benchmark interest rates. For now, the Fed is in wait-and-see mode, but the chance of an "insurance" rate cut has increased.

This comes as the U.S. deficit is growing. Government spending likely gave American households and businesses a near-term incentive to consume. Given that the output gap is positive, and with no meaningful supply-driven boost to growth expected from fiscal spending, this likely means a lift to consumption with only modest productivity gains. The stronger economy also signals a higher dollar, meaning more money could end up overseas, purchasing relatively cheaper products than in the U.S. and adding to an already wide trade deficit.

At a time when the world's biggest economy is at or near full employment, and the output gap is positive, we expect increased spending from tax reform and the bipartisan budget agreement will widen the deficit to $1.2 trillion by next year.

For China, Weaker Manufacturing Investment Is A Warning Sign

At any rate, the latest tariff hikes are just a small manifestation of wider trade and investment frictions. While the direct hit from higher U.S. levies is unlikely to jeopardize China's outlook for the next year or so, the effects on household and business confidence are a wildcard that may amplify the short-term hit, with more profound risks lurking elsewhere. In particular, together with other manifestations of friction—including investment and export restrictions—the risks of disruptions to China's supply chains in the medium term are rising, particularly in technology sectors.

However, we don't see much movement in China's macro needle coming directly from tariffs. We estimate that China's value-added exports to the U.S. accounted for a little more than 3% of GDP last year. In turn, we estimate that the direct effects of the latest round of tariff hikes will shave just 0.1 percentage point from China's GDP in the next 12 months.

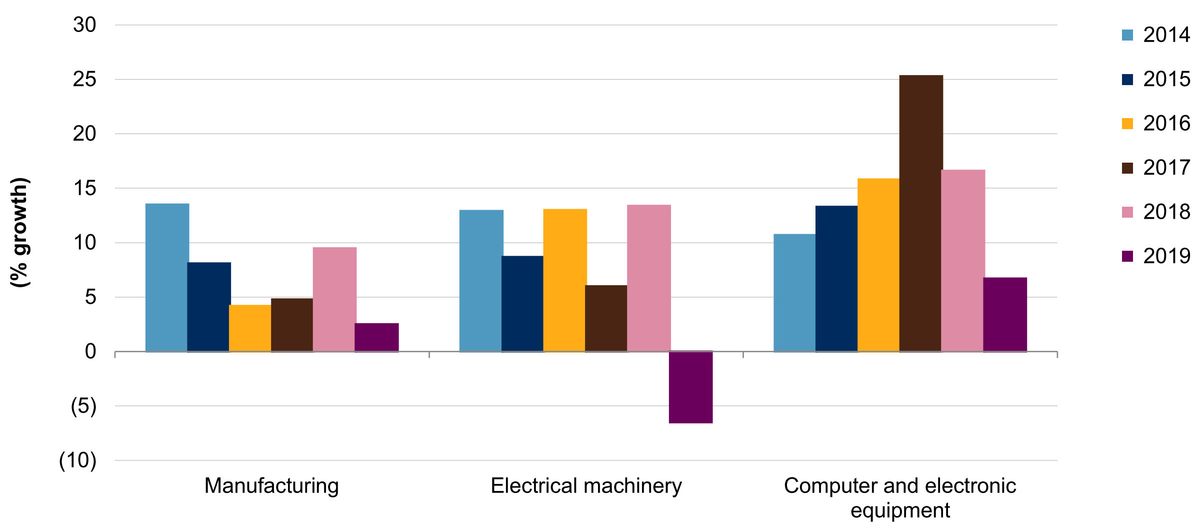
Our estimate assumes that Chinese exporters fully pass the tariffs on and that U.S. consumers—both firms and households—will be slow to find substitutes for higher-priced Chinese goods. (Specifically, we assume real demand will fall by half the incremental tariff hike, or 7.5%.) We also assume that China's value-added share of exports to the U.S, which nets out parts that China imports from other countries, is about 90%. China's retaliatory tariff increases are unlikely to change this picture, given that they affect only $60 billion of imports from the U.S.

The short-term effect on China's economy may be amplified if higher tariffs weaken confidence and reduce spending by firms and households. Softer household spending growth in recent quarters has turned the focus on the consumer, but we think the impact on firms' investment plans are more important. Expected future returns on capital are likely to be highly sensitive to not only the level of tariffs but also the lingering uncertainty surrounding trade policies.

Manufacturing investment should be a key focus. Manufacturing investment growth, particularly in sectors exposed to tariffs—including electrical machinery and computer equipment—had a weak start this year (see chart 2). Investment in the electrical machinery sector for the year to April is now falling compared to the same period last year—the first time this has ever happened since at least 2004. Lower investment would mean a larger short-term demand hit to the economy, with manufacturing accounting for about 30% of total fixed-asset investment and more than 20% of China's GDP.

Chart 2

China: Manufacturing Investment Is Slowing In Sectors Hit By Tariffs



Note: 2019 is year-to-April compared with the same period in 2018. All other data is as of Dec. 1. Sources: CEIC and S&P Global Ratings Economists.

Weaker manufacturing investment would affect jobs and potential output. If manufacturing investment growth for the full year were to fall to just under 3%—from near 10% last year and close to recent mid-2016 lows—this would trim a further 1 percentage point off GDP growth. This would also likely lead to job losses in manufacturing, hurting household incomes and consumption. Note that the purchasing managers' reading on manufacturing employment is already at a seven-year low. Weaker manufacturing investment would also lower future output capacity, particularly in the faster-growing technology sectors of the economy.

While the risks of a pronounced investment slowdown are rising, we expect a gradual adjustment in firms' investment plans. The implications of weaker manufacturing investment are serious, but we don't expect a hard landing for capital spending, unless financial conditions also tightened substantially. Given that many manufacturers are from the private sector, which sometime find it more difficult to borrow during times of stress, this isn't a trivial risk. Still, we expect the effect on manufacturing investment to be gradual as firms take time to diversify their supply-chain risks—even as finding alternatives to the scale and sophistication of China's manufacturing ecosystems will be hard.

For China's policymakers, we think they can offset the direct effect of tariffs without resorting to major stimulus. We estimate that allowing the real effective exchange rate to decline by 2%-3% would improve China's competitiveness and take care of much of the hit to net exports—this depreciation is, of course, already happening. The renminbi may have to weaken somewhat more against the U.S. dollar if the currencies of partners that participate in China's supply chain also depreciate. If policymakers wish to avoid the currency carrying the full burden of adjustment, they could combine depreciation with moderate fiscal stimulus.

If the effects on manufacturing investment and household spending amplify the direct effects, more stimulus would likely be required if the government wants to keep official GDP growth above 6%. There are few good options here. While taxes could be cut again, firms and consumers may decide to save rather than spend the proceeds, given an uncertain outlook. The historically reliable option would be more infrastructure investment and relaxed housing market policies, all facilitated by an easing in credit. This would likely prove effective in the short term, but by adding to well-known vulnerabilities, it would clearly erode the government's room for maneuver down the road.

Our broader view remains that while the short-term effects of higher U.S. tariffs are manageable for China, the longer-term ramifications for growth are more serious and largely underestimated. This is more a supply than a demand shock. The technology sector is where the combined effects of investment restrictions, export controls, and tariffs will be felt. And it's on technology and its ability to raise China's stumbling productivity growth that the country's prospects for a smooth rebalancing depend (see "A New Great Game--China, The U.S., And Technology," published May 14, 2019).

Europe Is Not Immune

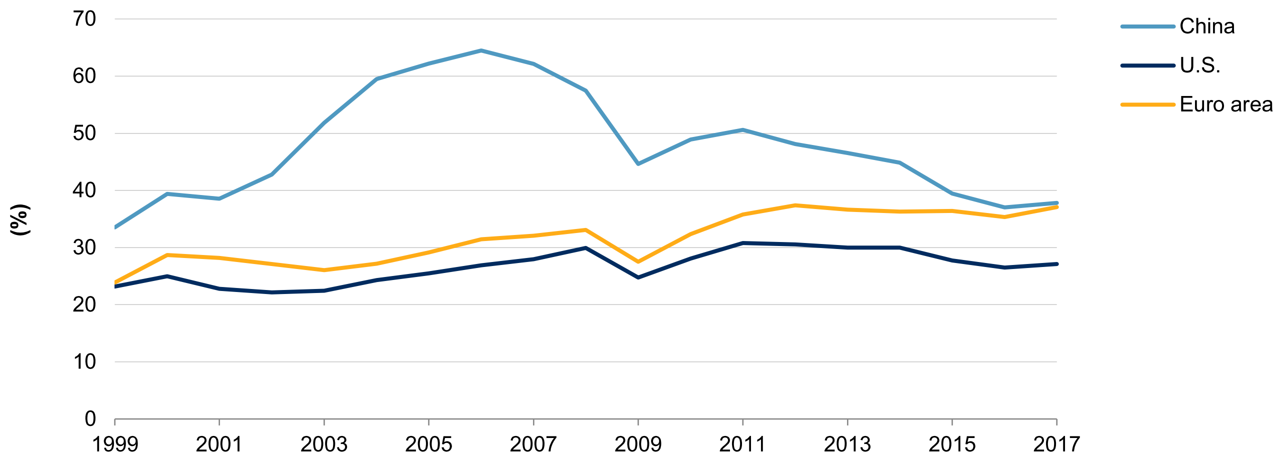
At first glance, it appears that the European economy has more to fear from Chinese retaliation against American exports than from U.S. tariffs on Chinese goods and services. This is because the share of European content in U.S. production is twice as high as it is in Chinese production. This sharp difference is no surprise, once we consider that the opening of the Chinese economy is a recent development compared to the historical links that tie the European and U.S. economies.

For the EU as a whole, involvement in U.S. and Chinese production represents a bit more than $400 billion, or 2.4% of GDP. The European sectors that are most exposed—that is, those whose involvement in U.S. and Chinese production far exceed the EU average—are transport equipment, motor vehicles, rubber and plastics, chemical products, and pharmaceuticals. All of these sectors have medium to high technological content. So, countries such as Germany, France, the U.K., and some Nordic nations will see the direct effects of U.S.-China trade friction.

The indirect effects could be more detrimental, not least because the European economy is increasingly dependent on trade, unlike China, and much more dependent on trade than the U.S. (see chart 3). The world's two biggest national economies are also the two biggest trading partners for the EU, with the sum of EU trade (both exports and imports) with the two countries representing 8% of EU GDP.

Chart 3

The Importance of China, U.S., And Euro Area Trade To Their Economies
Sum of exports and imports as a share of GDP



Sources: World Bank, Datastream, S&P Global Ratings.

If a rise in U.S. and Chinese protectionism dampens long-term growth—via the indirect channels of confidence and asset-price volatility weighing on capital formation—European trade will suffer. As the slowdown in Europe's GDP growth in the second half of last year made clear, the region's economy relies on world trade dynamics. For many European economies, trade carries almost as much weight as domestic activity. For eurozone countries, the average rate of economic openness (the sum of exports and imports relative to GDP) is close to 37%—10 percentage points higher than in the U.S.

At the corporate level, the U.S.-China dispute could lead European companies to rethink their global processes. Companies of the region went global in two waves: First in the 1990s to take advantage of lower labor costs by extending the value chain to emerging markets in Eastern Europe, Eastern Asia, and Latin America; and then about a decade later, to take advantage of rising demand in China and the U.S. This led to complex European value chains, which need several factors to work well for them to be optimal: not only labor costs and demand, but also taxes and tariffs. A change in the U.S.-China relationship may alter the geographical organization of some European industrial processes.

And Europe Can't Free Ride The Trade Dispute

It is probably fair to say that the trade interests of Europe align more with those of the U.S. than those of China. The continent shares questions with the U.S. like access to the Chinese market, ensuring a level playing field for European companies, and controlling the transfer of European technologies in Chinese acquisitions. Only the content of strategic technologies to be protected differs between the U.S. and Europe.

Concretely, the industrial strategy China is following in developing key industrial sectors could elevate the country as a direct competitor to core European industries such as renewable energy equipment, industrial robots, and high-performance medical devices. China's molting from main export destination for European production to main competitor requires a strategic response that forces Europe to rethink its economic policy.

Until now, the monitoring of free and fair competition has been at the heart of European economic policy. But faced with China's industrial ambitions, policymakers are starting to debate whether and how Europe should protect itself from Chinese acquisitions, and whether Europe should adopt an industrial policy aimed at developing European champions. It will be necessary to wait until after the European elections later in May and the formation of a new European Commission to know the future direction of the continent's economic governance. But it already seems clear that protection of European technological prowess would be more easily acceptable to the EU-28 than an all-out industrial policy, whose effectiveness has often been questioned and that would require agreeing on economic sectors to prioritize. If we think of the lack of success of the "Lisbon agenda," which aimed to make the EU the world's leading power in terms of information technology, it is fair to say that the region's track record regarding industrial policy is not an argument for renewed European industrial dirigisme.

Moreover, Europe follows its own commercial and financial drummer, which makes it likely to favor the U.S. side only somewhat. In fact, an initiative launched by European Commission President Jean-Claude Juncker last year is looking at ways to strengthen the internationalization of the euro to protect Europe's interests against the extraterritoriality of U.S. laws.

Can Canada Capitalize?

North of the U.S., the escalation of the U.S.-China dispute could help certain manufacturers and suppliers, as U.S. buyers look for domestic substitutes, or those from suppliers in a third country. Since the U.S. buys machinery and plastics from both Canadian and Chinese exporters, the new tariffs could divert trade in favor of Canadian suppliers. A U.N. study suggests countries not directly hit with bilateral tariffs benefit most from trade diversion, and sees Canada's exports to the U.S. jumping as much as $20 billion.

The bad news is that Canada will likely suffer collateral damage as the tariffs sour business sentiment and put planned investment at risk—though there will probably be little effect on Canadian GDP growth, according to Rob Palombi, S&P Global Ratings' Canadian Chief Economist.

However, we do see direct effects on countries that have a high share of exports to China, such as Chile and Peru, as the renminbi weakens and Chinese demand slows—and some of this has already played out. Chilean copper exports fell 8% in the first quarter, and Peru's exports of the commodity metal tumbled more than 15%. To be sure, there is a price effect at play—but copper exports also contracted marginally in volume terms. At the same time, fixed investment contracted in nearly every Latin American economy in the fourth quarter of last year and the first three months of 2019. S&P Global Ratings' Latin American Senior Economist Elijah Oliveros-Rosen thinks the trade dispute, if it lasts, will continue to weigh on fixed investment through year-end.

Writer: Joe Maguire

This report does not constitute a rating action.