

# Globalization and the Escalation of Trade Tensions

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*For several decades, globalization and technological progress have left many in advanced economies with low-paid-low-quality jobs or no jobs at all. This has fueled inequality, social discontent, and distrust in establishments. Anti-trade sentiments have risen with the feeling that globalization has disproportionately benefited the few at the expense of the many, and countries that do not play by the rules of open and fair trade. Populist and nationalist politicians in Western democracies have benefited from this discontent, as reflected in Brexit, the rise of anti-Europe and extreme right parties in continental Europe, or the election of Donald Trump in the United States on the promise of an “America first” policy. As the trade tensions between the U.S. and China are escalating, this newsletter recalls that nationalist and protectionist policies will most likely fail to protect those that have been left behind by globalization and technological progress, and overall harm economic growth. The ultimate outcome of the current escalation in trade threats is, however, very open with both highly positive or negative scenarios still on the table. In the meantime, uncertainty and market volatility will prevail.*

## GLOBALIZATION HAS BEEN BROADLY BENEFICIAL, BUT HAS DISPLACED MANY JOBS IN ADVANCED ECONOMIES

Globalization is the process of economic and financial integration across different nations, driven by international trade and investment as well as technological change. It is not a new phenomenon. Historians date the first modern globalization wave from 1870 to 1914, during which world trade as a share of world GDP almost doubled (Figure 1), before abruptly ending with World War I and the rise of nationalism.<sup>1</sup> The current wave started after World War II as Western economies returned to free trade and investment policies, and technological advances helped reduce drastically transportation and communication costs. This second wave swelled in

the early 1990s when large emerging market economies (EMEs) such as China, India, and Russia turned to freer economic systems and started to open up to trade and foreign investment (Figure 2). Overall, world trade as a share of global GDP has more than tripled since WWII, while external financial positions have grown tenfold.

Global value chains (GVCs) dominated by large multinational corporations have played a major role and resulted in an international fragmentation of production: the export of one manufactured good now involves multiple border crossings of intermediate goods with incremental value added at each production stage. EMEs have been increasingly involved in these GVCs; according to the Bank for International Settlements (BIS), China alone accounts for 19% of GVC trade, up from 7% in 2001.

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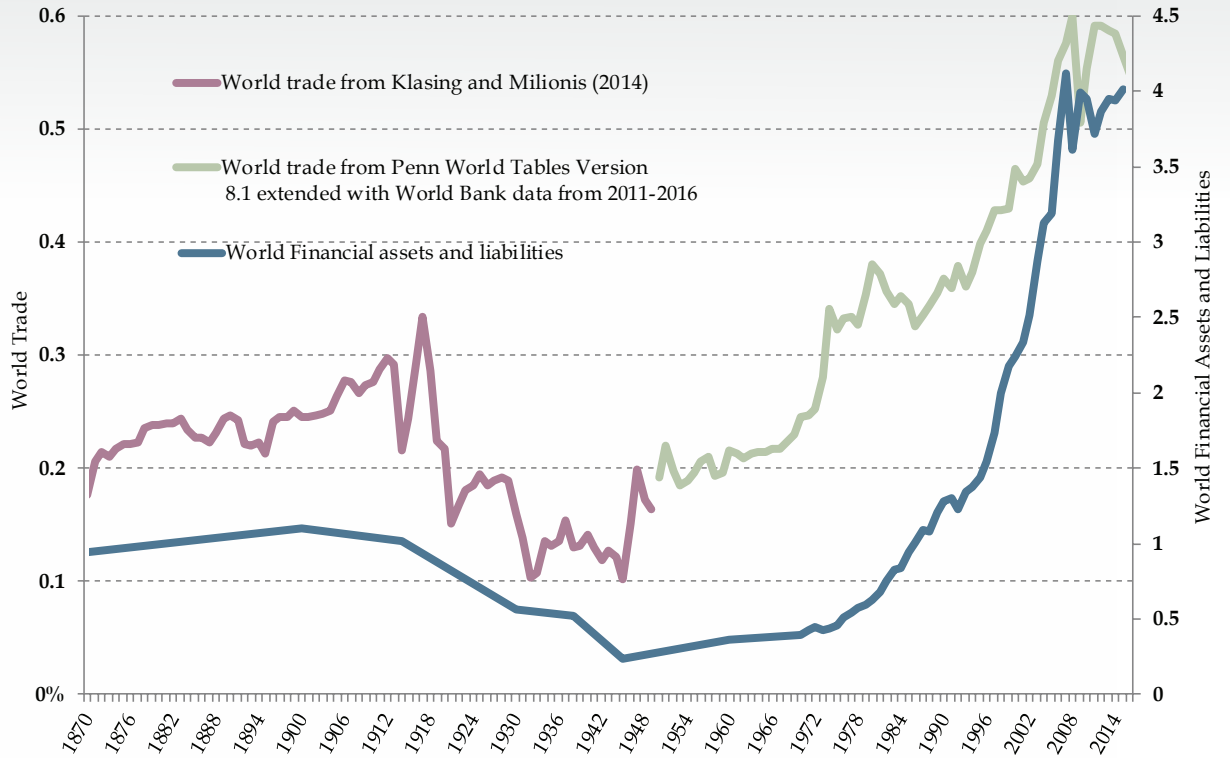
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<sup>1</sup> Laurence Chandy and Brina Seidel (2016) “Is globalization’s second wave about to break?” Brookings Report; Esteban Ortiz-Ospina and Max Roser (2018) - “International Trade”. Published online at OurWorldInData.org

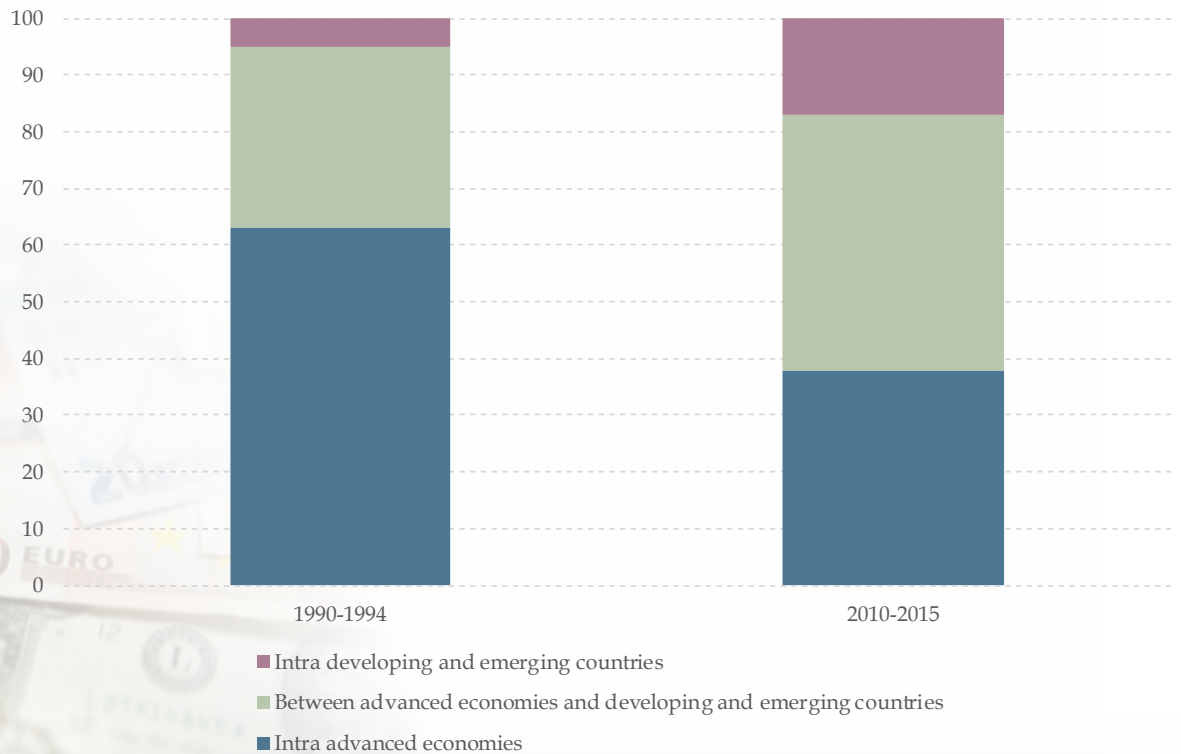
Figure 1. Trade and financial openness surged in 2 decades to the Global Financial Crisis.



Sources: Esteban Ortiz-Ospina and Max Roser (2018), BIS 87th Annual Report.

Figure 2. Emerging and developing economies account for a growing share of global merchandise trade flows.

Decomposition of World Trade Flows (%)



Source: IMF.



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Overall, globalization has benefited the world economy, notably by improving living standards in emerging and developing economies, where it contributed to the reduction in extreme poverty and strongly benefitted fast growing middle classes.<sup>2</sup> In advanced economies, globalization has improved the allocation of capital, supported productivity gains, and reduced the prices of many consumer goods (hence supporting households' purchasing power).

However, globalization has also deeply shaken some sectors and industries, and displaced many jobs, especially affecting blue-collar workers in advanced economies. Some recent research suggests that imports from China may have led to the loss of over 2 million jobs in the U.S. manufacturing sector from 1999 to 2011.<sup>3</sup> Moreover, advanced economies have not been able to ensure these displaced workers are not left behind and that gains from globalization are evenly distributed.

Since the mid-90s, in these economies, the higher income groups have gotten richer, lower income groups poorer, and the real income of some large parts

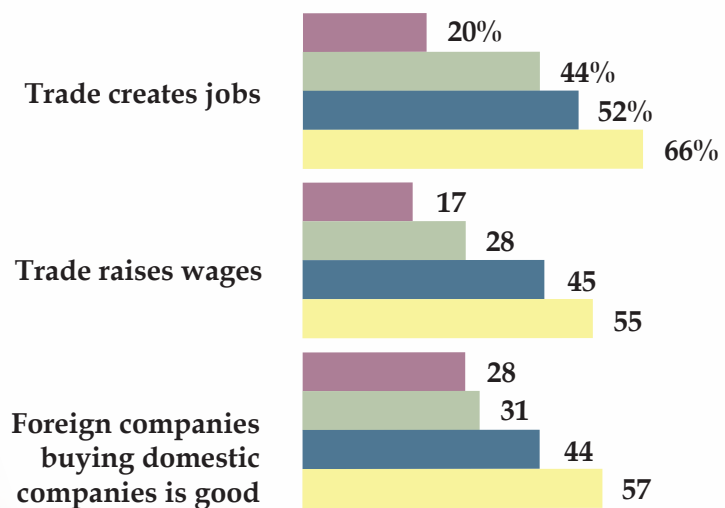
of the middle classes has stagnated. It is not clear how much of the job displacement and rising inequality is due to globalization or to automation and technological progress, as both phenomena are intertwined. However, globalization has become the scapegoat for rising inequality, low income growth, and job losses. Anti-trade sentiment has grown, especially in the U.S. (Figure 3), together with the feeling that some countries like China are taking disproportionately high benefits from globalization while not playing by the same rules.

Some practices, especially by large EMEs pursuing nationalist economic policies, still strongly limit capital and trade flows or unfairly support local industries. The World Trade Organization (WTO) and Group of 20 (G20 - the largest advanced and emerging economies) have organized efforts to move towards a global level playing field and open markets in these countries, such as tackling global steel excess capacity. Still, and despite pledges to avoid protectionism, since the Global Financial Crisis, there has been an increase in trade and investment protection.<sup>3</sup>

Figure 3. Americans are not convinced trade is a good thing.  
Views on Trade Benefits



■ U.S.  
■ Advanced  
■ Emerging  
■ Developing



Note: Medians by country economic categorization. Advanced median excludes U.S.

Source: Spring 2014 Global Attitudes survey. Q28, Q29 & Q31.

<sup>1</sup> IMF, World Economic Outlook, April 2018.

<sup>2</sup> See for instance the overview by the BIS (2017) "Understanding globalisation" BIS 87th Annual Report.

<sup>3</sup> Daron Acemoglu, David Autor, David Dorn, Gordon H. Hanson, and Brendan Price, "Import Competition and the Great US Employment Sag of the 2000s," Journal of Labor Economics 34, no. S1 (Part 2, January 2016): S141-S198.

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*THE U.S. TRADE AND INVESTMENT  
POLICY HAS TAKEN A MORE  
NATIONALISTIC STANCE, LEADING TO AN  
ESCALATION OF TENSIONS WITH CHINA*

The U.S. stance on trade and capital liberalization has hardened. In 2017, the U.S. pulled out of the Trans-Pacific Partnership<sup>1</sup> and initiated a renegotiation of the North American Free Trade Agreement (NAFTA) with Canada and Mexico. In January 2018, it increased tariffs on imported washing machines and solar panels. Two months later, it announced a unilateral increase of tariffs on steel and aluminum imports, but then temporarily exempted NAFTA countries (conditional on the results of future NAFTA negotiations) and other major allies like the EU countries or South Korea. The U.S. administration also issued a blocking order on Singapore-based Broadcom's bid for Qualcomm on the grounds that it could threaten national security; this is the fifth such deal ever blocked in post-war history, and by far the largest.

Even though China is not one of the largest exporters of steel to the U.S., China announced retaliations to the steel tariffs, which have triggered new trade measures by the U.S. concentrated on Chinese imports and led to an escalation of tariff threats between the two countries. They have each produced successive lists of goods imported from the other country on which they are considering imposing tariffs. Key to the tensions is the issue of U.S. intellectual property appropriation by Chinese companies, as foreign companies are often required to transfer their technology to China to be able to do business there.

<sup>1</sup> The TPP, now called CPTPP, was signed early March 2018 by 11 Asia-Pacific economies—Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, and Vietnam.

<sup>2</sup> Organization for Economic Co-operation and Development (OECD) data shows, for instance, that over 40% of US imports are intermediate inputs.

<sup>3</sup> See U.S. International Trade Commission (ITC): [https://www.usitc.gov/publications/332/3632/pub3632\\_vol3\\_all.pdf](https://www.usitc.gov/publications/332/3632/pub3632_vol3_all.pdf).

<sup>4</sup> The tire tariffs are estimated to have cost at least \$900,000 a year for each job saved and were associated with three times as many job losses in other sectors. See Gary Clyde Hufbauer and Sean Lowry (2012) "U.S. Tire Tariffs: Saving Few Jobs at High Cost" Peterson Institute for International Economics, Policy Brief 12-9.

<sup>5</sup> <https://piie.com/blogs/trade-investment-policy-watch/trumps-long-awaited-steel-and-aluminum-tariffs-are-just>

*THE CURRENT FLAVOR OF ECONOMIC  
PROTECTIONISM WILL LIKELY FAIL TO  
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ECONOMIC GROWTH*

Another stated objective of the more nationalist stance of U.S. foreign trade and investment policy is to protect jobs and workers from unfair competition, especially from China, and more broadly to safeguard U.S. economic interests.

There is a chance the outcome of the current tensions will be a fairer and more open global trade and investment system, but it is important to recall that higher trade barriers would harm those they are supposed to protect. Higher U.S. tariffs first mean that American consumers will pay higher prices for consumption goods. This is true for the goods on which tariffs are imposed; for instance, LG announced price increases on the washing machines it sells in the U.S. following the January imposition of tariffs. It is also true for goods produced in the U.S. but using foreign inputs that are subjected to higher tariffs.<sup>2</sup> This loss in purchasing power will mostly hurt the lower income groups and may cancel altogether the gains from the recent tax cuts on households' consumption. Consumers will also have access to fewer goods.

Moreover, higher tariffs, while potentially supporting jobs and output in the targeted sectors, could lead to net job and output losses, as was the case with the steel tariffs imposed by the Bush administration<sup>3</sup> or the tariffs on Chinese tires by the Obama administration.<sup>4</sup> The integration of world production along GVCs imply that tariffs have a widespread impact on the domestic economy. For instance, even if following the series of exemptions, the tariffs on steel and aluminum apply to only one-third of steel and less than half of aluminum import products, they will hurt local producers (especially automobile and construction sectors) that rely on these imports.<sup>5</sup>



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This will also potentially harm export competitiveness as, according to the OECD, 30% of U.S. metal imports are indeed embodied in exports. Hence, tariffs may increase, rather than reduce, the trade deficit. Moreover, protection and, hence, more expensive inputs may reduce the attractiveness of the U.S. for Foreign Direct Investment (“FDI”). More fundamentally, the current account deficit in the U.S. will not be solved by higher tariffs. It arguably results largely from lack of U.S. savings, which the recent tax cuts and increasing federal deficit will likely worsen.

Overall, higher tariffs on U.S. imports likely mean higher U.S. inflation and lower growth, net job losses, and not necessarily a lower trade deficit. It is possible though that public policy could help those jobs affected including infrastructure spending, job training, and relocation support.

Retaliation would also hurt: some estimations suggest that the tariffs under consideration by China could affect companies that employ over 2 million people in 40 different industries.<sup>1</sup>

The impact of increased U.S. protection on the rest of the world is uneven. In general, lower U.S. growth is bad news for everyone, as are higher uncertainties on our policy stance. However, some countries may benefit from the U.S. being out of trade agreements, as is the case with Canada in the CTPPT being spared by tariffs (or, Canada and Mexico, depending on how NAFTA negotiations go). Some countries (e.g., Vietnam) may benefit from trade redirections if they are able to substitute their products for the imports from China that the tariffs target. Others, such as the small steel and aluminum producers affected by the tariffs, may be very negatively impacted.

<sup>1</sup> <https://www.brookings.edu/blog/the-avenue/2018/04/09/how-chinas-tariffs-could-affect-u-s-workers-and-industries/>

<sup>2</sup> <https://voxeu.org/article/trade-war-will-increase-average-tariffs-32-percentage-points>

<sup>3</sup> OECD (2016) Economic Outlook, November.

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Where the current escalation of tensions will lead to is still an open question as the situation is evolving by the day, with very different implications for growth, jobs, and inflation, but also different paths for the future of globalization and the balance of power.

On the one hand, the combination of a harder U.S. stance on China and behind-the-scenes negotiations may result in a successful change in Chinese trade and investment policy towards more open markets and fairer practices. Successful negotiations would strengthen the position of the U.S. on the international scene, mean more open markets globally, stronger growth, and more jobs. It still, however, does not reduce the need for accompanying policies to better share growth and support displaced blue-collar workers.

At the other extreme, tensions may lead to a full-fledged trade war between the U.S. and China, spreading to the rest of the world, as countries give up their commitments to the WTO. Recent research estimates that a switch to a “non-cooperative tariff setting outside the WTO” could mean an average 32% increase in the tariffs faced by exporters globally, with American exporters facing a 27% increase (from 3% to 30%).<sup>2</sup> This could derail the long-awaited recovery in world trade growth and durably disrupt GVC, leading to substantial losses in production and jobs around the world. OECD analysis of a less dramatic hypothetical scenario, in which Europe, the U.S., and China raised trade costs for all partners on all goods by 10%, suggests a lowering of world GDP by 1.4% and of global trade by 6%, with the countries imposing the trade barriers suffering the most.<sup>3</sup> In such a scenario, multilateralism and

international cooperation, as well as the trade policies and agreements set up since WWII would be strongly affected. Chinese retaliation could also take the form of sales of U.S. bonds weighing on the U.S. dollar, increasing U.S. interest rates and likely causing global financial markets to decline. At the same time, the Chinese yuan would likely rise, making Chinese exports less competitive, which is not in China's best interest.

Between these two extremes, many paths are possible, including a "cold trade war," where the escalation of threats continues together with formal WTO complaint filings, but only affecting, in practice, a few sectors. This would still have overall negative effects on global growth, U.S. growth, and inflation as described above. Such a scenario would likely be bad for both

stocks and bonds, and potentially support real assets.

Moreover, a more inward-looking U.S. would further reduce the share of the U.S. in global trade, affecting the domination of the dollar. U.S. merchandise exports account already for less than 10% of world exports (12.6% in 1993), while China accounts for over 14% (2.5 % in 1993). In terms of balance of power, it may mean a step further towards a multipolar world, with China playing a stronger role in setting global trade and investment rules.

We will need to wait and see where the tensions lead. The only certainty we have for now is that continued policy uncertainty will likely lead to further market volatility compounding the late economic cycle fears already plaguing the market.



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