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AN EMPIRICAL VIEW OF TRADE WAR THEORY

Trade War Definition

A situation in which countries try to damage each other's trade, typically by imposing tariffs and quota restrictions.

The main aim of a trade war is to restrict the free flow of goods and services between individual countries. This is done by raising tariffs or imposing other restrictions to dampen imports. Trade wars occur for any of the following reasons:

+ protecting local jobs or infant industries;
+ national security;
+ addressing unfair competition;
+ or as a bargaining tool.

The latest trade war between China and the United States is a side-effect of protectionism and also portrays characteristics of rent-seeking. Recent research has shown that despite the economic impact, protectionism does have political support from unskilled workers in import-competing sectors (like those who voted for Trump and Brexit). Because tariffs protect import-competing industries who have a greater share of unskilled workers, these industries are favoured relative to export-competing industries, who have a larger share of skilled workers. The composition of labour changes in the long-term,and in this manner unskilled workers enjoy long-term favour.

Trade war theory suggests that tariff trade wars reduce the quantity of imports in a local market. Empirically, this is one of the few theoretical constructs which is supported by data from the current trade war. Trade wars also impact jobs and wages, especially in the United States. Data from the International Monetary Fund (IMF) show that trade between the United States and China has decreased, although the trade balance has remained the same. Theory suggests that as tariffs increase the domestic prices for certain goods, this reduces the local demand for those goods but increases local supply. These changes result in a deadweight loss to society, specifically industries. But in practice, data suggests that the deadweight loss in the United States is only about $68.8 billion, or 0.37% of their GDP. The reason this loss is so small, is because the United States government can redistribute tariff revenue to those consumers/producers who are impacted by retaliation, for example Trump's current agriculture subsidies.

At this point most of the theoretical reasoning behind tariffs don't hold. Aggregate consumer prices (inflation) have not increased despite imperfect substitutability and supply frictions. Central banks therefore do not have to tighten monetary policy. Stable,real interest rates do not push down producer demand for capital, and in the end, investment has remained robust, in both the United States and China. Consumer spending has decreased somewhat, but both the United States and Chinese authorities have taken preventative measures to protect against an outright slowdown. Furthermore, unlike standard theory both the US dollar and Chinese yuan have remained strong relative to other major currencies. Once again, real-life is very different from the "all else equals" assumption we love imposing on theoretical debates. If "all else" were equal, these currencies might have depreciated, but the nature of current monetary policy, the relative strength of the United States economy, and currency manipulation in China, have all supported strong local currencies. Another possible reason for the strong US dollar is the risk-off and flight-to-quality environment which the trade tensions have created.

History has shown that tariffs can increase rapidly to levels above 40% in the United States, but even in a full-blown trade war (where tariffs reach 60%) most models show a meagre 2%-3% reduction in the global GDP. This is because of the nature of globalized trade. Countries can easily substitute away from more expensive goods, like the Chinese who reduced their imports of United States soybeans to zero and simply imported more from Brazil, almost overnight. An interesting argument was raised by the OECD, that without the trade wars global economic growth could have been greater. "All else equals": this might have been the case, but it might also have been the case that governments would not have introduced pre-emptive stimuli to their economies to support growth, had the trade war never started, in which case economic growth would not necessarily be greater.

Although empirical data does not (yet) support the theoretical concerns surrounding trade wars, the impact of these wars are being felt most notably by the Chinese economy and employment/wages in the United States. The trade war has emphasised the structural slowdown in the Chinese economy, as well as the structural slowdown in both jobs and payrolls in the United States. The trade war is also shifting the economy away from higher-skilled employees in export sectors (who now face tariffs in other countries) towards lower-skilled import-competing industries (who are now protected by higher local tariffs).

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