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US: The import tariff boomerang

- Import tariffs have a negative impact on the targeted country. Retaliation will in turn have negative consequences for the country which started the tariff hikes
- Even in the absence of retaliation, there will be negative consequences
- Household spending will suffer from a loss of spending power due to an increase in inflation following higher import prices and/or a switch to domestically produced goods
- For the same reason, aggregate corporate profits may suffer. Companies may also cut back their investment because of increased uncertainty
- Empirical research confirms these outcomes

The “little squabble”¹ between the US and China on trade has moved back to the front page. It has been there before, causing havoc in markets, before becoming less of an issue, following the truce between Trump and Xi Jinping on the occasion of the G20 in Buenos Aires in December last year. Understandably, investors are eagerly hoping, with increasing impatience, for a new meeting, with a similar outcome, at the G20 on 28-29 June in Osaka. The softness of data this week in China and the US (in both cases, retail sales and industrial production were disappointingly weak) show that the negotiating parties are not exactly in a strong cyclical position. As a reminder, US Q1 growth was strong but of poor quality² whereas China only managed to surprise positively in the same quarter because it had taken enough measures to stop the growth slowdown.

Import tariffs, by construction, have a negative impact on the country which is targeted: export volumes and/or profit margins suffer³. Retaliation measures will in return hit the country which started the tariff hikes and third countries may also be hurt due to trade diversion. However, even in the absence of retaliation, the country which started will face negative consequences.

Consider US households: unless the price elasticity of their demand would be huge, they will lose spending power because of more expensive imports from China.

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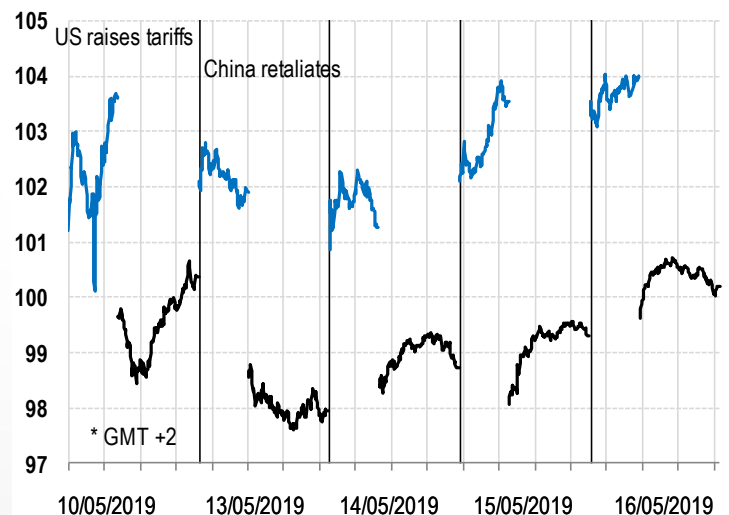
¹ “Trump calls trade war with China ‘little squabble’”, Reuters, 14 May 2019

² United States: Strong growth but questions about quality, BNP Paribas, EcoWeek n° 19-18, 3 May 2019

³ Profit margins suffer when exporting companies hit by tariffs decide to lower their prices. A weakening of their currency would cushion the impact, but imported inputs would become more expensive and weigh on profit margins.

STOCK MARKET SESSIONS

— Shanghai index, 09/05/2019 09:00:00 *= 100
— S&P500, 09/05/2019 22:00:00* = 100



Source: Bloomberg, BNP Paribas

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Switching to consumer goods produced in the US will have a similar impact: they were more expensive than imports from China to start with and increased domestic demand may entice US producers to raise their prices. As a consequence, households may even be forced to switch to other, cheaper brands, in order to avoid having to pay more, something which would lower their consumer satisfaction.

Turning to US companies, higher import prices of finished products may weigh on sales volume whereas increased prices of intermediate inputs would reduce profit margins. This may force companies to change their global value chains –e.g. moving from China to e.g. Vietnam or Mexico- but this entails an opportunity cost: the money could have been spent on productivity enhancing investments. Supply bottlenecks due to a demand shift to domestically produced goods can cause wage and price increases. When profits are under pressure this may change the risk profile of companies and end up increasing their financing cost. Finally, a high level of tariff uncertainty on a protracted basis will end up weighing on growth.

Empirical research confirms these theoretical relationships. According to Amiti et al.⁴ the import tariff measures taken last year “were costing U.S. consumers and the firms that import foreign goods an additional \$3 billion per month in added tax costs and another 1.4 billion dollars per month in deadweight welfare (efficiency) losses.”⁵ ECB research shows that non-financial companies of the Dow Jones Euro Stoxx 300 index which are negatively affected by tariffs have cut back their investment: the investment to net asset ratio declined, whereas it increased for those benefitting from tariffs⁶. Research by Kyle Handley and Nuno Limão shows that China’s accession to the WTO in 2001 led to a reduction in US trade policy uncertainty which stimulated Chinese companies to invest in technology upgrading and export entry into the US⁷. It seems safe to assume that US companies would not act differently than their European or Chinese peers when faced with tariff policy uncertainty on a sustained basis.

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⁴ Mary Amiti, Stephen J. Redding and David Weinstein, *The impact of the 2018 trade war on US prices and welfare*, National Bureau of Economic Research, working paper 25672, March 2019

⁵ The deadweight welfare loss refers to the tariff-induced distortion of consumers choices between domestically produced versus imported products.

⁶ ECB, *The economic implications of rising protectionism: a euro area and global perspective*, Vanessa Gunnella and Lucia Quaglietti, ECB Bulletin 3/2019

⁷ Kyle Handley and Nuno Limão, *Policy Uncertainty, Trade, and Welfare: Theory and Evidence for China and the United States*, American Economic Review 2017, 107(9).

