The war on trade: beggar thy neighbour – beggar thyself?

A long-held and widespread consensus in economics is that free trade creates more benefits than costs. It allows countries to specialise in goods they are good at producing (Ricardo, 1817), opens markets for firms to exploit economies of scale and for consumers to enjoy a wider variety of products (Krugman, 1979) and exposes producers to international competition, raising the overall level of productivity (Melitz, 2003). However, under certain circumstances delaying opening up to trade can be beneficial. For instance, the once emerging markets of Asia, Japan, South Korea and China, only entered the world stage of trade once internationally competitive industries had developed. Existing barriers to trade continue to be held up in the developed and developing world to protect workers in less productive industries from painfully rapid disruptions, such as those described in Foliano and Riley (2017), consumers from low-quality imports and innovators from a theft of ideas. The question we raise in this box is: Who wins and who loses from erecting new barriers to trade? We focus in particular on the effect of tariff and non-tariff trade barriers on the international price system.

US President Trump’s protectionist rhetoric and imposition of tariffs on some products from the country’s trading partners together with the UK’s decision to leave the world’s most integrated trading block highlight the risk that international trade might become more costly in the future. Tariffs increase the cost of shipping goods across borders. This also holds for regulatory barriers that restrict, in particular, the trade in services. We use the National Institute’s Global Econometric Model (NiGEM) to run a stylised scenario, that could be thought of as a supply side shock, illustrating the impact of a 10 per cent increase in import prices worldwide.1 This could come as the result of the imposition of tariffs or a rise in trade costs due to regulatory barriers.2

Our analysis demonstrates that the share of trade in world GDP would fall by about 1 percentage point over a 5-year period, relative to baseline, if import prices were to rise substantially (see figure 1). To show the impact of the shock on a wide range of countries, we have chosen economies with differing characteristics: developed and developing; with different levels of openness; as well as varying degrees of trade linkages with the US.

As illustrated in figure 2, an increase in import prices raises inflation and depresses output in all countries, with the magnitude and persistence depending on the sensitivity of domestic prices to import prices, the stickiness of domestic prices as a result of labour market rigidities as well as differences in the reaction of monetary policy. The increase in trade costs leads to a fall in domestic demand in all economies, as both private consumption and investment suffer. Higher domestic prices depress real personal disposable income and hence private consumption, while increases in interest rates by central banks in response to rising inflation

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1 NiGEM simulation.

2 Note: GDP - percentage difference from base; inflation and current account-to-GDP ratio – absolute difference from base in percentage points; for the world the aggregate only impact on GDP and inflation is shown.
discourage investment. The effect on external current account balances varies across countries both in magnitude and sign – in the Euro Area and China the current account improves, while in the US and Brazil it deteriorates. The net effect in each economy will be determined, among other things, by the relative sensitivity of export and import volumes to changes in export and import prices as well as the relative share of exports and imports in total trade (see the article by Slopek in this Review).

Our results show that a global war on trade has the potential to make everyone worse off through adjustments in relative prices. However, some countries would have potentially more to lose than others depending on each economy’s reliance on imports and exports. The analysis builds on our earlier work (Carreras and Ramina, 2017; Liadze and Hacche, 2017), which shows that unilateral tariffs can have detrimental effects not just on others but also on the country that imposes them. In practice, a global wave of protectionism would likely affect economies through a range of additional channels, which have not been considered here, including risk premia in financial markets and productivity. The fact that we focus on aggregate outcomes further caveats our results, as we would expect substantial differences within countries across industries and along the income distribution.

Notes:
1 NiGEM version v1.18b was used for the simulation.
2 Shocks are applied to non-commodity export prices to deliver equivalent increases in non-commodity import prices.
3 The authors wish to thank Garry Young for helpful comments.

References:

This box was prepared by Arno Hantzsche and Iana Liadze.