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INTERNATIONAL ECONOMIC REPORT

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US BROADENS TARIFFS ON CHINESE IMPORTS, FUELING A ONE-OFF INCREASE IN INFLATION AND CREATING DOWNSIDE RISKS TO GROWTH

SUMMARY

- The US broadened tariffs to apply to one-half of US goods imports from China, which is retaliating in kind.
- Tariffs will cause a meaningful but temporary increase in US inflation.
- Other negative repercussions from the tariffs include foreign retaliation against US exports and businesses, the US becoming a less attractive locale for global supply chains, and a resulting fall in inbound foreign investment.
- China is very unlikely to capitulate quickly in the conflict, so the tariffs are likely to persist for some time.
- Tariffs help US businesses competing against imports, but impose larger costs on the rest of the economy, so they will be a net drag on growth and employment.
- Tariffs have cross-cutting implications for monetary policy: Raising inflation temporarily, but also adding to downside risks to medium- and long-term growth.

The US will begin charging US importers a 10 percent incremental tariff—a type of tax—on purchases of $200 billion of Chinese goods starting September 24. Unlike earlier tariffs on industrial products, this round applies to many types of consumer goods. The tariff rate will increase to 25 percent on January 1 if China does not satisfy US demands to alter economic and trade policies and reduce its trade surplus with the US. The Trump administration has threatened to place tariffs on all Chinese goods imports if China retaliates against US escalation. This escalation follows 25 percent tariffs the US put in place earlier this year on $50 billion in Chinese goods imports, as well as tariffs on imported Chinese steel and aluminum. China, for its part, has reiterated pledges to retaliate with tariffs of their own on $60 billion of US exports to China. China's president hinted at unspecific non-tariff retaliation as well: China might encourage its consumers and businesses to boycott American brands; permit Chinese businesses to violate sanctions against Iran, North Korea, and others sanctioned by the US government; or signal open seasons on violations of US intellectual property and theft of US trade secrets.

The latest tariffs will have a meaningful one-off impact on US inflation. Holding trade patterns unchanged, 10 percent tariffs on $200 billion of imports would raise US prices by $20 billion, equivalent to about 0.15 percent of US consumers' annual spending of $14 trillion. If such a price increase was realized in a single quarter, it would add about 0.5 percentage point to annualized consumer inflation. But US prices will rise by less than this, since American importers will substitute non-Chinese products for tariffed imports, make offsetting cuts to other operating costs, and allow profit margins to narrow if they think end consumers are unable or unwilling to pay higher prices. US demand for Chinese imports will fall as prices rise. Chinese exporters will lower prices on sales to the US somewhat to preserve market share.

Tariffs will have other repercussions. In addition to foreign retaliation against US exports, tariffs make the US a less attractive locale for global supply chains. This effect is already visible in plummeting foreign direct investment into the United States, which fell by more than one-half from 2015 to the first quarter of 2018.

FDI is the canary in the coalmine, warning that global companies, the channel that spreads the most advanced technological and organizational innovations through the global economy, are looking elsewhere for their long-term growth.

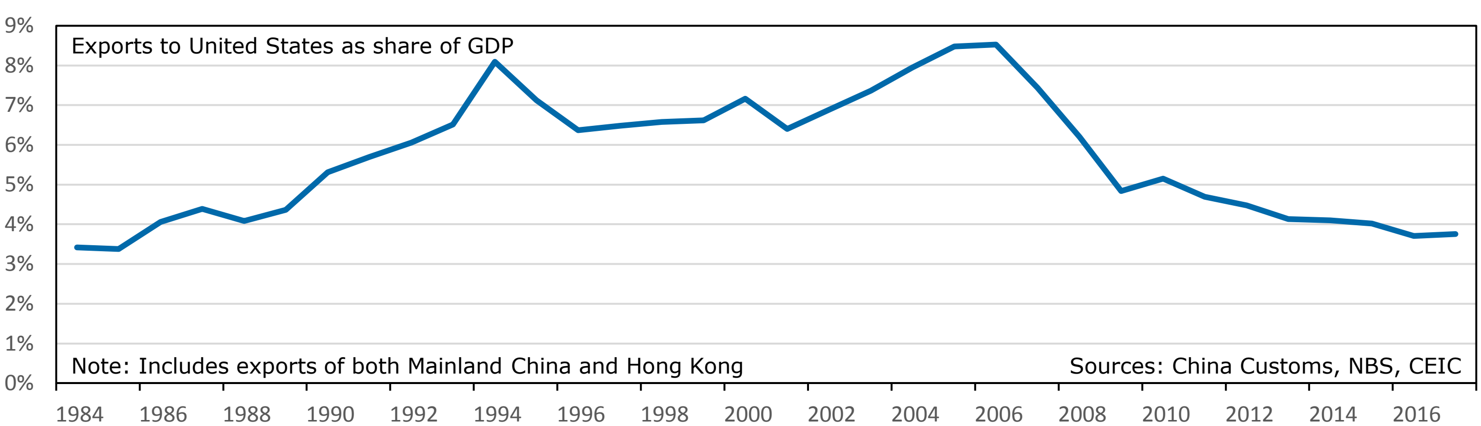
The Trump administration describes tariffs as a tactic to force China to remove unfair support to its businesses and reduce the trade imbalance, and says China will soon capitulate since US tariffs will apply to a larger share of Chinese GDP than China's retaliation can to the US economy. If so, it would be a breakthrough in economic relations that has eluded previous presidents. But this seems highly unlikely. Contrary to popular perception, Chinese exports to the United States are not a large enough part of their economy, nor is the Chinese economy weak enough, to force China into fast concessions on trade and economic policy. Even counting exports routed through Hong Kong, Chinese sales to the US are less than 4 percent of Chinese GDP—a measure of how China has diversified away from dependence on the US since the global financial crisis (see chart). China's economy is cooling in mid-2018, but more because of China's government tightening credit growth (inflation-adjusted money supply grew at the slowest pace in two decades in 2018) than tariffs.

While Chinese sales to the US are a larger share of Chinese GDP than US sales are in the other direction, the US democratic system is much more sensitive to the economic repercussions of trade frictions than China's authoritarian state, which spends more on internal security than on external-facing defense. China's legislature cancelled term limits on the presidency this year so Xi Jinping could rule for life. He will probably play the long game. If the conflict persists, Chinese propaganda will argue that it is another US plot to contain China's rise and perpetuate a global system that unfairly benefits the US: the dollar as global reserve currency and medium of exchange for world trade, disproportionate US representation in the IMF and World Bank, US-defined rules governing the WTO and other trade agreements, and so on. For these reasons, tariffs on Chinese goods will likely persist for some time. The US's unilateral approach to trade policy also means the US is not at the table negotiating multilateral trade agreements. As one example of how this matters, when the US withdrew from the Trans-Pacific Partnership, its other members removed provisions especially favorable to US businesses, like those protecting IP-intensive pharmaceuticals, media products, and telecom services, before ratifying the modified agreement as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership.

Tariffs on Chinese imports will benefit US businesses that compete against them. These businesses have a good year ahead of them. But the tailwinds to protected industries will be less than the headwinds to the rest of the economy, so tariffs will be a net drag on US employment and GDP growth.

Tariffs have cross-cutting implications for US monetary policy. They will increase inflation, but this will be a one-time impact; tariffs also increase downside risks to growth over the medium- to long-term. The Federal Reserve will closely monitor tariffs' effects on inflation, growth, and employment, but will only alter the course of monetary policy if the effects are large and persistent.

CHART: CHINA DIVERSIFIED ITS ECONOMY AWAY FROM RELIANCE ON SALES TO THE UNITED STATES AFTER THE GLOBAL FINANCIAL CRISIS



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