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Budget Model

The Effect of the U.S. - China Trade War on the U.S. Economy

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Listen to Knowledge@ Wharton: What Are the Long-term Costs of the China-U.S. Trade War? (originally aired on SIRIUS XM Channel 132, Business Radio Powered by The Wharton School)

Summary: PWBM's Efraim Berkovich, the Wharton School's Marshall Meyer and Mary Lovely of the Maxwell School of Syracuse University discussed how the recently imposed tariffs on Chinese goods are raising prices for consumers, disrupting supply chains and weighing down economic growth in the long-run.

PWBM's Efraim Berkovich, the Wharton School's Marshall Meyer and Mary Lovely of the Maxwell School of Syracuse University discussed the economic impact of the recently imposed tariffs on Chinese goods. The discussion aired on Knowledge@Wharton Business Radio SiriusXM 132 on August 5, 2019. On September 1, 2019, President Trump announced that he will impose additional tariffs on a broader range of Chinese goods which will take effect on September 1, 2019.

Host Dan Loney provided an overview of how China has responded to the U.S. tariffs. Since the U.S. imposed tariffs in 2018, China has introduced tariffs on U.S. goods, reduced purchases of U.S. agricultural goods and allowed its currency to devalue.

Meyer commented on how, at under seven yuan to one U.S. dollar, the Chinese currency is weaker than it has been in more than a decade. Furthermore, China allowing its currency to devalue may have an effect on the economies of other countries in Asia.

Lovely noted that the tariffs, which are scheduled to begin in September will, "be a big hit to cell phones and laptops, anything electronic which is going to hit businesses and households."

Berkovich and PWBM's Zheli He examined the long term effects of President Trump's trade policies. They found two key channels by which tariffs can affect the U.S. economy: First, the output of the U.S. economy would be lower because of the slowdown of trade as a productive economic activity. The second channel is through the financing of federal debt. As Berkovich said, "China actually finances our debt. So, when we shut down the trade channel by which dollars are sent out and come back as foreign purchases of assets we are actually forcing U.S. household to buy the debt." Lower foreign investment flows into the U.S. will crowd out investment and weigh down economic growth.

Berkovich added that it is important to consider “effective openness” of the US economy to international capital flows, which refers to the share of savings from the rest of the world that are actually invested into the U.S. There is an inverse relationship between the average tariff rates and the level of effective openness. In the short-run, lower openness boosts GDP, but in the long-run, it leads to a permanent decrease in foreign capital inflow and foreign ownership of federal debt. The short-run economic boost happens as a result of U.S. households supplying more labor and savings to prepare for the trade war -- “like a squirrel hoarding nuts before the winter.” The longer people expect the trade war to last, the deeper both the short- and long-run effects.

Lovely commented on companies moving their supply chains away from China: “We’re seeing increasing investment in other countries, and companies moving activity that shows that they don’t think this is going to be short term.” As a result, prices are permanently higher to U.S. consumers and firms. Meyer believed that U.S. consumers had enjoyed an enormous discount for the past 15 years, since China joined WTO. He stated, “We may be selling soybeans to Brazil or to Canada. Our farmers are getting a lower price for it. The middlemen are extracting a tax to work around the tariffs. The consequence is that the entire economic system becomes less efficient and that is a long term cost to all of us.”

Berkovich pointed out that when the trade dispute ends, foreigner ownership of American business actually rises. Foreigners end up permanently owning a greater share of U.S. capital than if there had been no trade war because of lower domestic capital. Lovely commented on its consequence: “Our companies are going to have to compete … this is doing permanent damage to the U.S. economy.”

Meyer stepped back and remarked on the big picture: “The dilemma is how we respond … Why aren’t we responding competitively rather than what appears to be defensively? What is the role of the U.S. economy in the global economy 10, 15 and 20 years from now?” Can the U.S. think of additional ways to respond to the Belt and Road Initiative and Made in China 2025 program. Lovely agreed, stressing that tariffs by themselves only hurt the U.S. economy.