Trade Tensions and Global Financial Stability

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Two Views

The optimistic view:

World Trade worth $25tn. Total US-China tariffs $360bn on Chinese goods, $110bn on US goods so far. Less than 2% in value.

Markets still close to historical highs, in spite of uncertainty on trade war(s). Maybe it's too small to really matter

The pessimistic view:

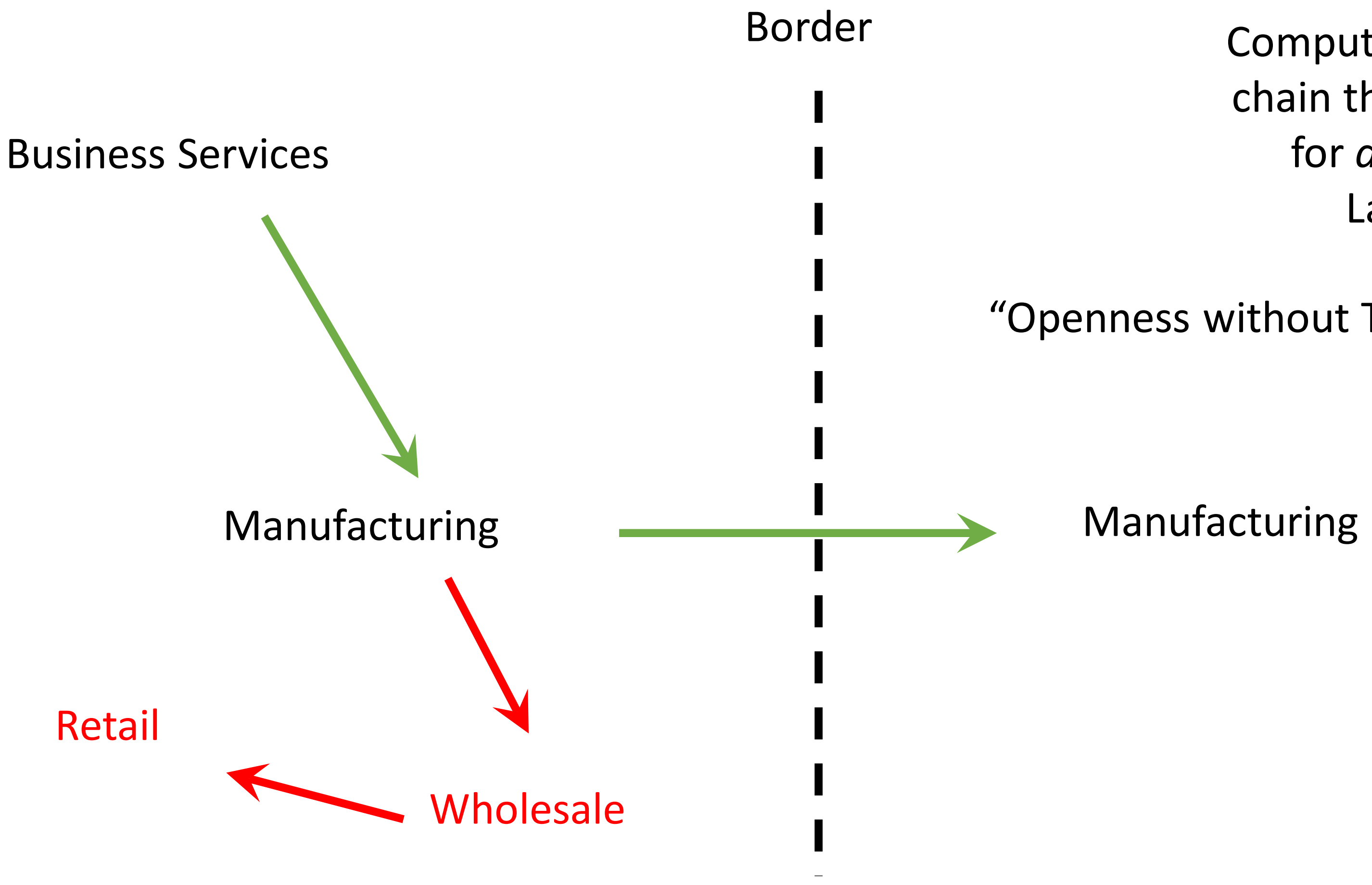
Impact of trade wars on observed trade massively understates the potential consequences.

Unlike 1929, most world trade is vertical (i.e. value chain), rather than vertical (i.e. manufactures against commodities).

So 2% of direct trade in value could be misleading, as upstream suppliers are affected, with cascading end effects.

A Value Chain based measure of openness

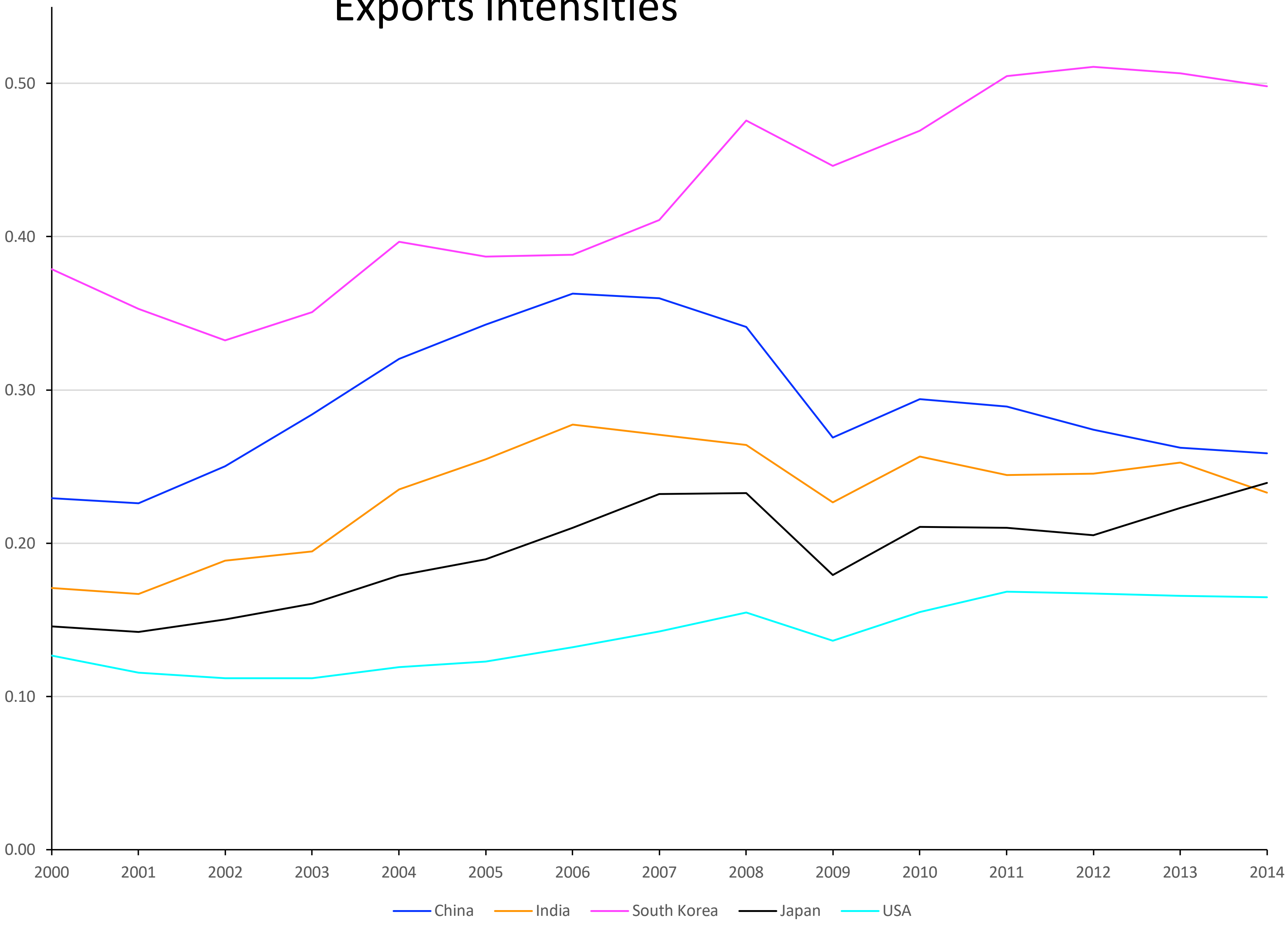
Sectors are “open” even if they do not trade directly – but via downstream linkages.



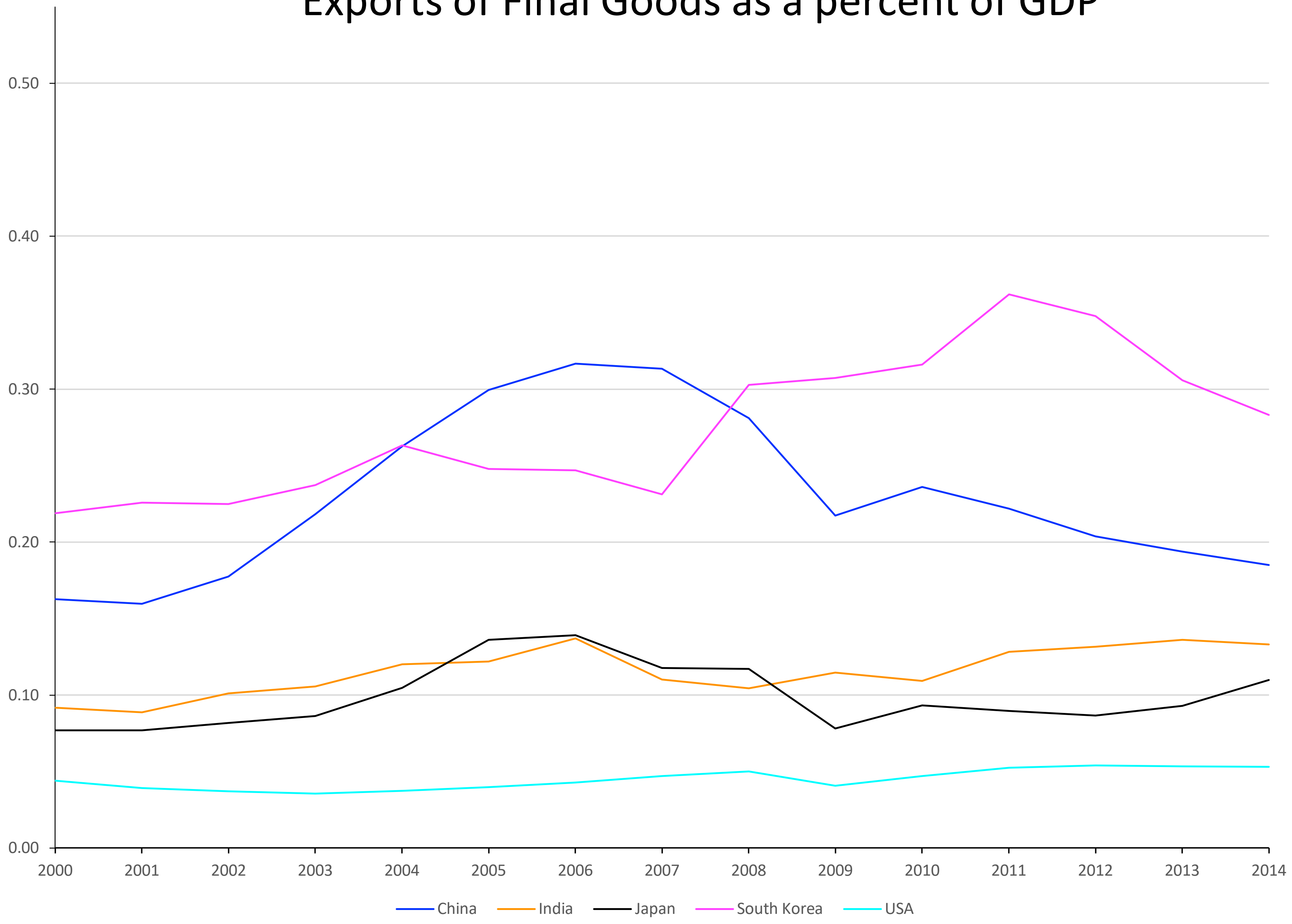
Compute the proportion of a given value chain that crosses a border. Computable for *all* sectors (including services). Label this “Export Intensity”

“Openness without Trade”, Imbs and Pauwels, 2019.

Exports intensities



Exports of Final Goods as a percent of GDP



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Trade and Capital Flows

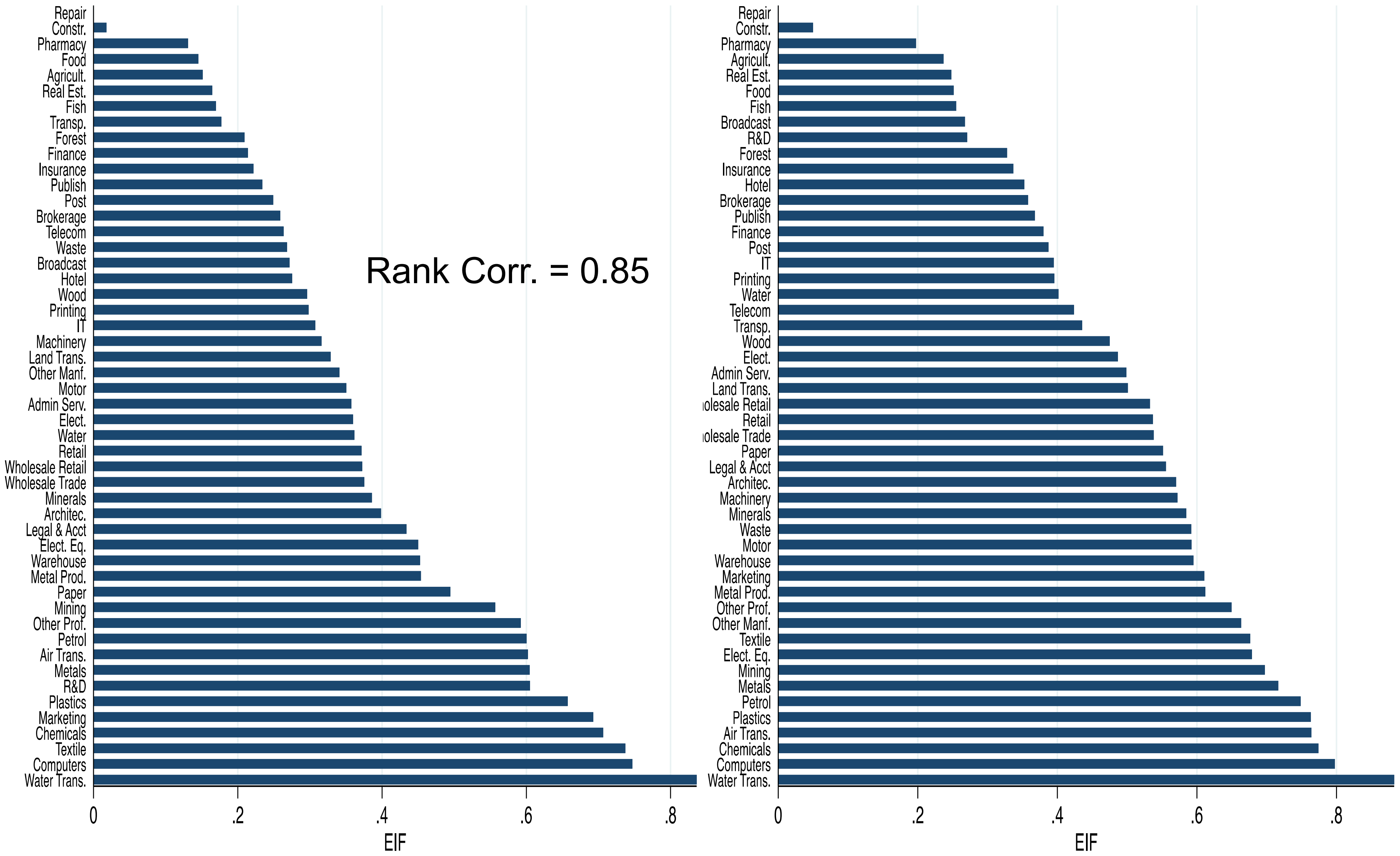
High growth, high productivity, high returns sectors are typically exporting.
So (foreign) capital finances exporting sectors. As a result, they expand.

With protectionism, growth, productivity, returns, investment all get depressed.
So (foreign) capital leaves the economy. Financial Instability.

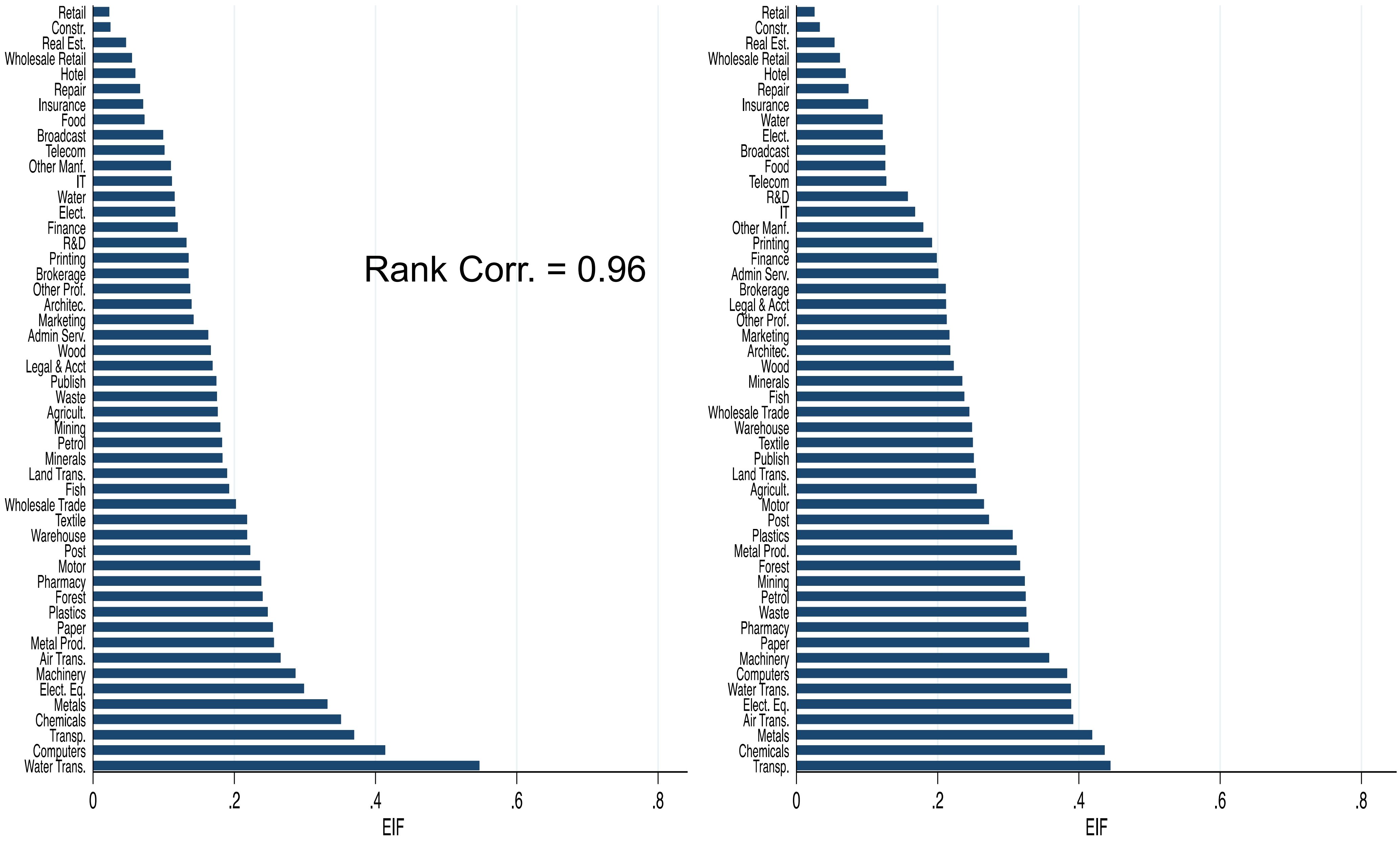
Question: How easy is it to substitute new high growth, high productivity, high returns activities, to avoid (foreign) capital flight?

Answer: Probably hard. 1) Value chains are very complicated and highly persistent objects, 2) Countries specialize in sectors for fundamental reasons.

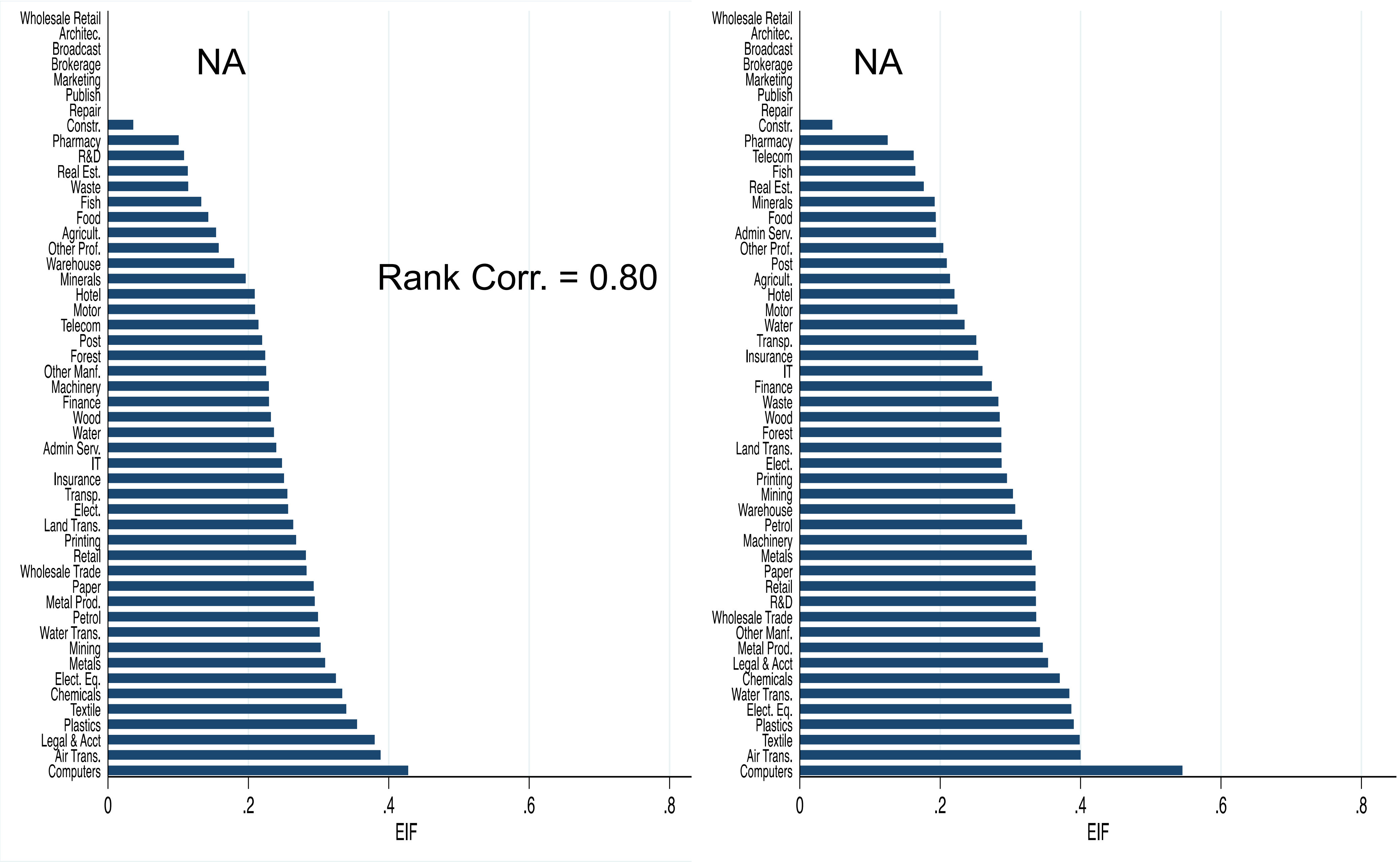
Export Intensity South Korea in 2000 and 2014



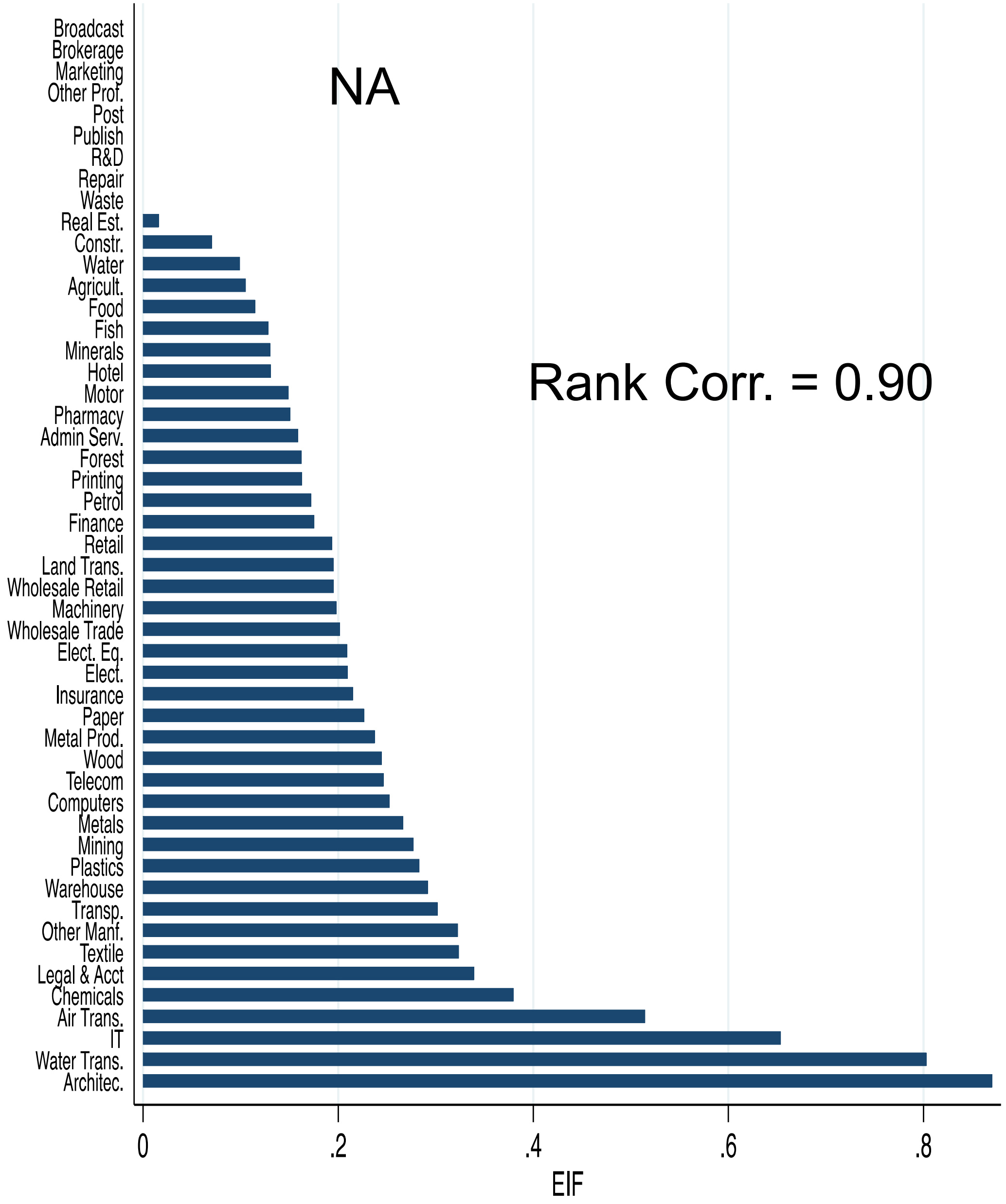
Export Intensity USA in 2000 and 2014

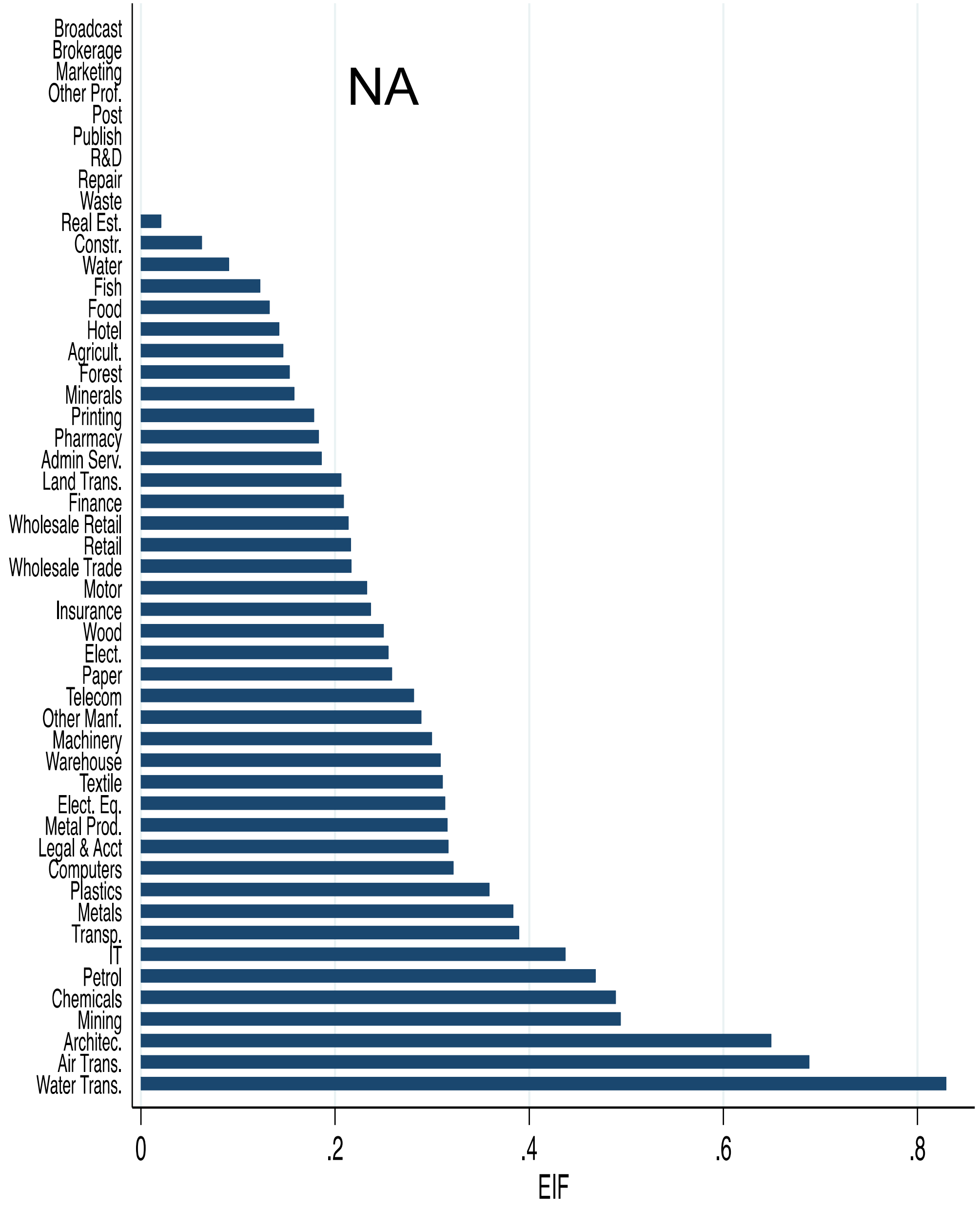


Export Intensity China in 2000 and 2014



Export Intensity India in 2000 and 2014





Takeaways

2% of world trade is misleading. Protectionism disrupts the value chain, not only directly observed trade. Upstream suppliers also affected. Potentially large effect on the economy, and on financial markets.

The value chain is exceedingly persistent. Difficult to dodge the effects of protectionism by sourcing or supplying elsewhere. And so consequences on financial stability and capital flows also difficult to dodge.

Even worse for emerging markets: Specialization is typically constrained by limited access to domestic finance. Export sectors in emerging markets are least dependent on external finance. Difficult to develop alternative activities, that do need external finance. Even harder to move away from sectors targeted by tariffs.

So, why have we seen so little in markets so far? Because still lots of uncertainty around trajectory of trade wars.