

# THE US-CHINA TRADE WAR: IMPLICATIONS FOR EU TRADE POLICY

CIAN HENNIGAN

JUNIOR SOPHISTER

*“The US trade war with China caused disruption to the long-lasting economic consensus on the mutual benefits of free trade and the devastation of tariffs. Cian Hennigan explores the fallout of this trade war and the motivations behind it, in an effort to establish whether the economic consensus on trade is still applicable in today’s globalised economy. Hennigan looks at the issue from an EU perspective and discusses the implications for the future of EU trade relations with China, the US, and the UK, as they attempt to balance economic welfare with the goals of sustainability and justice.”*

## Introduction

What originally began as the European Coal and Steel Community, the EU has now become a fully-fledged area of economic cooperation. A founding principle of this economic cooperation entails that member states cannot impose technical or non-technical trade barriers between each other. As a result of this trade liberalisation, the notion of tariffs and other protectionist measures have not existed between member states since the commencement of their membership. In the backdrop of the enlargement of the EU, many other developed nations also moved towards open trade policies in search of increased economic growth and the WTO was established accordingly (Haugh et al., 2016). Consequently, there were no major trade wars in this period. A trade war is a scenario in which two countries continuously impose tariffs on each other in a retaliatory response to an initial tariff by one country. The rise in populism in recent years has led to trade policy being used as a political tool to enforce anti-globalisation agendas, a key pillar of many recent populist platforms (Fajgelbaum & Khandelwal, 2021).

In 2018, the long period of uninterrupted trade liberalisation in the world economy was abruptly ended when Donald Trump decided to place tariffs on some imports

---

into the US market, which mainly targeted China. Examining evidence from this trade war allows us to analyse what trade theory still holds in a modern-day setting and ultimately how this evidence can be incorporated into the goals of EU trade policy.

## The Economic Impact of the US-China Trade War

Trade wars stem from protectionist trade policies, which are pursued by placing tariffs on goods from other countries, in order to make domestically produced goods more competitive. There is overwhelming evidence that increased trade liberalisation is more effective in increasing economic growth and that protectionist policies should be avoided (Haugh et al., 2016). However, this research has failed to thwart the move of some governments towards protectionist trade policies. Additionally, it was still not fully clear how well previous research would apply to a modern-day trade war between two major trading economies.

Trump's protectionist policies were influenced by a number of factors. A key part of his presidential campaign was to protect domestic manufacturing industries that had lost out to China's comparative advantages, mainly in the form of cheaper labour. There was also a belief that Chinese imports of steel and aluminium were a threat to national security (Bown & Kolb, 2021). The initial tariffs led to retaliation from China, and a trade war ensued. High tariffs have mainly been placed on aluminium, steel, and electrical goods such as semiconductors (ibid). China and the US entered a phase one trade deal in 2020, but data shows that China has failed to meet the conditions of the deal (Bown, 2022). There is no certainty when the remaining tariffs will be removed, or whether the current trade deal will hold in the future.

As this trade war is still young, we can only analyse its short-term impacts. Studies by Fajgelbaum et al. (2020) and Cavallo et al. (2021) have found that during the trade war, there has been a complete pass-through of tariffs onto producer prices for both countries, which has implications for tariff welfare calculations. This was in contrast to classical trade theory, which hypothesised that there would be an incomplete pass-through of tariffs for major trading nations. Kreinin (1961) studied tariff pass-through in the US after the Reciprocal Trade Agreements Act\* and found an incomplete pass-through of tariffs for a variety of industries. Globalisation has possibly eroded the trade power of large economies and their ability to affect the global market.

There is compelling preliminary evidence that US manufacturing industries experienced a negative impact on employment and wages as a result of the trade war. An econometric analysis by Flaaen and Pierce (2019) studied the initial effects of the trade war by using rigorous tariff timing data and matching it with US labour statistics to assess

---

\* The Reciprocal Trade Agreements Act (RTAA), which passed in 1934, gave the US president the power to adjust tariffs and negotiate bilateral trade deals.

any changes to the US manufacturing economy. They found that even though the original tariff protection helped US manufacturing employment marginally, this was offset by the increase in input costs from retaliatory tariffs. Analysing producer prices, they also find that rising input costs caused a significant increase which supports the complete pass-through of tariffs to producers. This negative impact is in contrast with one of the original reasons for placing the protectionist tariffs in the first place. As one would expect, the trade war has also had substantial distributional effects, mainly due to Republican counties experiencing the largest welfare losses (Fajgelbaum et al., 2020). The econometric results can be seen in the table below.

**Table 4: Point Estimates of Cumulative Effect by Channel:**

Variable	Employment	Industrial Production	Producer Prices
Import Protection	0.080* (0.049)	-0.042 (0.165)	-0.053 (0.069)
Rising Input Costs	-0.463*** (0.122)	-0.357 (0.330)	1.780*** (0.486)
Foreign Retaliation	-0.506** (0.249)	0.180 (0.657)	0.341 (0.538)
Industry Fixed Effects	yes	yes	yes
Number of Industries	76	84	81
Observations	2,440	2,688	2,586

*Sources:* Federal Reserve Board (FRB), U.S. Department of Labor, Bureau of Labor Statistics; authors' calculations.

*Notes:* See equations (7) and (8) in the text. Robust standard errors in parentheses. \*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ .

**Source: (Flaen & Pierce, 2019)**

It is also important to analyse the indirect effects of the tariffs applied. It is reasonable to assume that a trade war creates instability for industries and freezes investment prospects. A study by Caldara et al. (2020) found that trade policy uncertainty increased dramatically in 2018, and this may have reduced US investment by around 1 percent. Analysis of the impact of the trade war estimate welfare losses that range between 0 and 1 percent of GDP for the US and China (P. Fajgelbaum & Khandelwal, 2021). To summarise, initial statistical analysis shows that the trade war negatively impacted growth, which can be seen through the fall in employment and increase in prices for US manufacturing firms. Further study is needed to assess the long run impact, which will be

---

determined by the future trade relations between the two countries.

## Insights for the EU

The recent trade war has brought trade policy into a much more focal discussion. It should be stated that as part of the US-China trade war, the US also placed tariffs on steel and aluminium for the majority of major trading nations, including the EU (Bown & Kolb, 2021). The Commission retaliated by placing tariffs on iconic American goods. On October 31st 2021, the EU and US government agreed to drop most of the tariffs in place between the unions and brought an end to the cycle of retaliation (EU Commission, 2021a). From the evidence shown, this trade policy will benefit manufacturing industries by helping to lower the prices of intermediate goods. The Commission stated that the deal “should reduce costs for steel and aluminium exporters, helping to support the sustainability of two industries that together employ 3.6 million people in the EU” (ibid). It is clear that protecting the employment and output of these industries, as well as political change in the US, were important factors in reaching a deal. More generally, the importance of robust trade agreements with other trading nations is important for economic growth in the EU as a whole. The move to reduce tariffs on steel and aluminium supports the claim that using trade policy to protect manufacturing employment “is complicated by the presence of globally interconnected supply chains” (Flaen & Pierce, 2019). Although tariffs can be initially used to protect domestic employment, it is clear that in a highly globalised world this is not an effective policy for increasing economic growth.

From an intra-EU perspective, the free trade area prevents trade wars between EU members and subsequently helps to improve economic growth in the EU. The benefits derived from this arrangement are often taken for granted by EU nations, but the emergence of the US-China trade war serves as a reminder of the importance of economic cooperation to protect economic growth in the union.

In February 2021, the Commission released a communication regarding the EU’s trade policy objectives in the coming years. The communication stated the importance of keeping European trade open while also emphasising the importance of sustainability and rule-based cooperation (EU Commission, 2021b). Sustainability has become an important part of the EU framework, but there are international differences in the importance of climate change and its urgency. The EU may also find it difficult to maintain rule-based relationships with countries like China and the US, who have both struggled to align their trade practices with WTO guidelines (Bown, 2009). The EU has proposed a reform of the WTO, but one would wonder what policy concessions it will have to make in order to get all major trading nations on board.

## How do the EU Approach the UK and China?

There are many current and potential difficulties facing EU trade. The EU is protected from protectionism due to its democratic structure and has committed to remaining an open trading economic area. The UK and China provide interesting case studies summarising the diplomatic issues the EU will face as they attempt to complete their trade objectives.

In recent months, the UK have increasingly threatened the EU that they may decide to trigger Article 16. This may force the Commission to revoke the post-Brexit Trade and Cooperation Agreement (Webber et al., 2021). Although scrapping the agreement is not guaranteed, it may be needed in order to maintain a harder stance on the UK post-Brexit. From an EU growth perspective, it would be damaging to instigate a trade war with the UK. Around 15% of the EU's total exports go to the UK, and 10% of its imports come from the UK (Eurostat, 2021). This makes the UK a significant trading partner for the EU, especially in the areas of food, drink, and certain manufacturing industries. Using input-output trade data and economic shock models, researchers have estimated the economic impacts of trade barriers between the UK and the EU. A study by Hans-Ulrich and Oliver (2021) found that a reduction in UK import demand would have the biggest relative effect on Irish agricultural and German automotive industries. With a similar model, Wenz et al. (2020) estimate that there would be long run negative output growth for both the UK and the EU, with Ireland being the most exposed due to the use of the UK as a land bridge to access EU markets.

Based on the findings above, it would not be surprising if the Commission approach the issue of the current trade agreement with the UK cautiously. If the current agreement abruptly falls through, it will lead to economic uncertainty and instability in the EU area. However, the discovery of a complete pass-through of tariffs for major economies will give some hope to the EU that there may be a high elasticity of supply and new trading partners could be found quite easily to offset the reduction in demand.

The EU's trade relations with China have worsened over the last two years, due to numerous disagreements and policy differences. They brokered a ground-breaking investment deal called the EU China Comprehensive Agreement on Investment (CAI), however, the ratification of this deal has been delayed due to a dispute between China and the EU over the mistreatment of Muslim Uyghurs in northwest China (Emmott, 2021). The purpose of the CAI is to establish a framework of rules that make investments between the two economic areas fairer, and to open parts of China's economy to EU FDI (EU Commission, 2020). The CAI would have been an effective deal at committing the EU to openness while also having China agree to multiple sustainability goals such as peaking their carbon emissions by 2030. However, the issue of human rights is clearly important for the Parliament, and it will not be foregone for increased economic growth.

---

China is an extreme economic player internationally, and the country is still growing at a rapid rate. Their GDP grew by 8.1% in 2021 and is forecasted by the OECD to consistently grow at a rate of close to 5% over the next couple of years (OECD, 2021). The sheer growth of the Chinese economy makes it an important ally for increasing economic growth in the EU and helping to reduce prices for EU consumers. However, China still remains restless when it comes to cooperation and discipline in the WTO. Most recently, China blocked the majority of its trade with Lithuania after it deepened its ties with Taiwan (Lau, 2022). This forced EU Trade Commissioner Valdis Dombrovskis to launch a WTO trade dispute. Disputes with China are common in the WTO, which is likely to continue into the future. Although openness with China is economically enticing, the EU's rule-based approach to trade will be tested by a nation that historically has struggled with discipline on an international level.

## Conclusion

There is a vast amount of evidence on how trade policy affects economies, but a lack of modern-day trade wars has left questions about whether the theory would still hold. In essence, the US-China trade war provides fresh evidence on the applicability of trade policy in the modern-world. The EU can also learn from the US-China trade war that engaging in a tariff war on manufacturing products has a negative impact on growth in the short run at least. It is likely that the impact on growth in the long run will also be negative, but more data is needed before this can be examined. It is clear that globalisation has led to a world where protectionist measures are still economically punished, and possibly more than before.

The intra-EU free trade area has prevented trade wars and harnessed consistent growth in many sectors that rely heavily on imports and exports. It has also led to sustained employment in the areas that suffer the most from tariffs. In order to sustain growth into the future, the EU should focus on minimising tariffs where possible between the EU and other trading nations and maintaining economic cooperation within the EU. The Commission should avoid any abrupt trade policy changes with the UK to avoid unsettling industries that rely heavily on the UK as a trading market. China also provides a huge diplomatic headache for the EU, and it is difficult to predict how cooperative the nation will be as it becomes economically more powerful in the future. As many governments dabble in rogue protectionist trade policies, it is important that the EU continues to implement open trade policies where possible to boost the economic welfare of its citizenry. Nonetheless, the Commission has a responsibility that this should not come with the concession of other important proponents of welfare such as climate and justice. This balance will most likely guide EU trade in the next decade and beyond.

## References

1. Bown, C. P. (2009). 'U.S.—China trade conflicts and the future of the WTO'. *The Fletcher Forum of World Affairs*, 33(1), 27–48.
2. Bown, C. P. (2022). 'China bought none of the extra \$200 billion of us exports in trump's trade deal'. PIIIE [on-line]. Available at: <https://www.piiie.com/blogs/realtimeeconomic-issues-watch/china-bought-none-extra-200-billion-us-exports-trumpstrade>. [Accessed: 13 February 2022].
3. Bown, C. P., & Kolb, M. (2021). 'Trump's trade war timeline: An up-to-date guide'. PIIIE [on-line]. Available at: <https://www.piiie.com/blogs/trade-investment-policy-watch/trump-trade-war-china-date-guide>. [Accessed: 13 February 2022].
4. Caldara, D., Iacoviello, M., Molligo, P., Prestipino, A., & Raffo, A. (2020). 'The economic effects of trade policy uncertainty'. *Journal of Monetary Economics*, 109, 38–59.
5. Cavallo, A., Gopinath, G., Neiman, B., & Tang, J. (2021). 'Tariff pass-through at the border and at the store: Evidence from us trade policy'. *American Economic Review: Insights*, 3(1), 19–34.
6. Emmott, R. (2021). 'Eu parliament freezes china deal ratification until beijing lifts sanctions'. Reuters [on-line]. Available at: <https://www.reuters.com/world/china/eu-parliament-freezes-china-deal-ratification-until-beijing-lifts-sanctions2021-05-20/>. [Accessed: 22 February 2022].
7. EU Commission. (2020). 'Key elements of the eu-china comprehensive agreement on investment'. EU Commission [on-line]. Available at: [https://ec.europa.eu/commission/presscorner/detail/en/ip\\_20\\_2542](https://ec.europa.eu/commission/presscorner/detail/en/ip_20_2542). [Accessed: 22 February 2022].
8. EU Commission. (2021a). 'Questions and answers: EU-US negotiations on trade on steel and aluminium'. EU Commission [on-line]. Available at: <https://ec.europa.eu/commission/presscorner/detail/en/QANDA215722>. [Accessed: 20 December 2021].
9. EU Commission. (2021b). 'Trade policy review - an open, sustainable and assertive trade policy'. EU Commission [on-line]. Available at: <https://eur-lex.europa.eu/resource.html?uri=cellar:5bf4e9d0-71d2-11eb-9ac9-01aa75ed71a1.0001.02/DOC1&format=PDF>. [Accessed: 24 February 2022].
10. Eurostat. (2021). 'United kingdom-eu - international trade in goods statistics'. Eurostat [on-line]. Available at: [https://ec.europa.eu/eurostat/statistics-explained/index.php?title=United\\_Kingdom-EU\\_-\\_international\\_trade\\_in\\_goods\\_statistics#EU-the\\_United\\_Kingdom\\_trade\\_by\\_type\\_of\\_goods](https://ec.europa.eu/eurostat/statistics-explained/index.php?title=United_Kingdom-EU_-_international_trade_in_goods_statistics#EU-the_United_Kingdom_trade_by_type_of_goods). [Accessed: 19 December 2021].
11. Fajgelbaum, P., Goldberg, P. K., Kennedy, P. J., & Khandelwal, A. K. (2020). 'The Return to Protectionism'. *The Quarterly Journal of Economics*, 135(1), 1–55.

- 
12. Fajgelbaum, P., & Khandelwal, A. (2021). 'The economic impacts of the us-china trade war (Working Paper No. 29315)'. *National Bureau of Economic Research*.
  13. Flaaen, A. B., & Pierce, J. R. (2019). 'Disentangling the Effects of the 2018-2019 Tariffs on a Globally Connected U.S. Manufacturing Sector (Finance and Economics Discussion Series No. 2019-086)'. *Board of Governors of the Federal Reserve System (U.S.)*
  14. Hans-Ulrich, B., & Oliver, H. (2021). 'International trade barriers and regional employment: The Case of a no-deal brexit'. *Journal of Economic Structures*, 10(1), 1–25.
  15. Haugh, D., Kopoin, A., Rusticelli, E., Turner, D., & Dutu, R. (2016). 'Cardiac arrest or dizzy spell'. *OECD Economic Policy Papers*, (18).
  16. Lau, S. (2022). 'EU sues China in WTO over Lithuania blockade'. Politico [on-line]. Available at: <https://www.politico.eu/article/eu-sues-china-wto-lithuaniablockade/>. [Accessed: 26 February 2022].
  17. Kreinin, M. E. (1961). 'Effect of tariff changes on the prices and volume of imports'. *The American Economic Review*, 51(3), 310–324.
  18. OECD. (2021). 'Oecd Economic Outlook'. *OECD 2021*, 2.
  19. Webber, J., Foster, P., Khan, M., & Bounds, A. (2021). 'EU has 'no option' but to retaliate if UK suspends N Ireland protocol'. Financial Times [on-line]. Available at: <https://www.ft.com/content/aad9e68f-5b53-4308-af73-4b9120ba4c28>, [Accessed: 17 December 2021].
  20. Wenz, L., Levermann, A., Willner, S. N., Otto, C., & Kuhla, K. (2020). 'Post-brexit no-trade deal scenario: Short-term consumer benefit at the expense of long-term economic development'. *PLOS ONE*, 15(9), 1–14.