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BY MARK ZANDI — MAY 13, 2019

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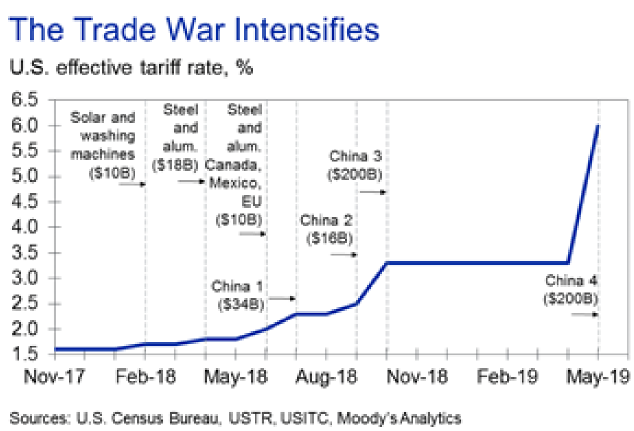
- New escalation of the U.S.-China trade war makes a number of scenarios possible, including one in which the global economy suffers recession later this year.
- Widespread expectations remain strong that the U.S. and China will come to terms in the next few weeks.
- The stakes are high in alternative scenarios, the worst-case and increasingly plausible being that President Trump follows through on most of what he has threatened to do.
- However, there is a general consensus that President Trump won't push it too far.

President Trump has escalated the trade war with China, and nearly everyone has been wrong-footed by the move. Expectations were strong that an agreement ending the war, or at least putting it on hold, was imminent. Odds remain high that Trump and Chinese President Xi will soon come to terms. But suddenly a number of other scenarios seem possible, even one in which the U.S., China and global economy suffer a recession.

Trump upped the ante in the trade discussions with the Chinese last week when he increased the tariff on $200 billion in Chinese imports from 10% to 25%. An additional $50 billion in Chinese imports already have a 25% tariff. China said Monday that it will retaliate June 1 with higher tariffs on many imported U.S. goods.



The higher U.S. duties will impact more than 5,700 different Chinese goods imports but will not apply to goods already in transit to the U.S., only those that left China on or after May 10. It can take more than a month for ocean freight from China to reach the U.S., effectively providing a grace period for further negotiations. No additional trade talks with China are scheduled, but that could, and likely will, change quickly.

It is unclear what prompted Trump to up the ante with the Chinese. His administration suggests that the Chinese were backtracking on some provisions of the deal, most notably around subsidies provided to their large state-owned enterprises. Trump may also be engaged in some brinkmanship, as he appears emboldened by the resilient U.S. economy and stock market to extract more concessions from China.

The baseline scenario

Investor reaction to the surprising turn in the trade war has been modest, at least so far. Stock prices are down only a few percent from the record high set just prior to Trump's tariff hike. Widespread expectations remain strong that the U.S. and China will come to terms in the next few weeks. Chinese retaliation could ultimately increase the up to 10% tariffs the country has imposed on nearly $100 billion of U.S. imports to China to 25%, but that will be the extent of the tit-for-tat tariff hikes. And an agreement to end the war and roll back the tariffs, at least partially, will soon follow.

This is our most likely scenario as well. Given the difficult progress in the discussions up to now, the costs to the economy and stock market if the war drags on, and Trump's innate desire to deal, odds are good that some type of arrangement will be struck by the end of the grace period in mid-June. We attach a 60% probability to this baseline scenario.

The baseline also assumes that Trump does not open a new trade-war front involving vehicle imports into the U.S. The Commerce Department has ruled that vehicle imports are a national security threat, giving Trump the ability to increase tariffs. The president has long been upset with the large U.S. trade deficits with Germany, Japan and Korea, due in large part to the imports of vehicles and parts from these countries, but he will likely table this fight for another day.

The trade deal Trump struck with Canada and Mexico late last year has yet to make its way through Congress, and likely won't. The baseline thus assumes that the previous NAFTA rules will continue to apply, and that the president will not follow through with his threats to renege on NAFTA altogether or—even more serious—to increase tariffs on vehicle imports from Canada and Mexico, where the industry is important.

Under these baseline assumptions, the economic outlook will not change meaningfully. U.S. real GDP growth is expected to come in at 2.5% in 2019 and unemployment is expected to slowly but steadily decline throughout the year. Chinese growth is also not impacted, with real GDP growth of 6.3%, and the global economy continues to grow at close to its 3% potential.

Alternative scenario

An alternative scenario is that Trump can't find a way to shake hands with President Xi, and the higher 25% tariffs remain in place for longer, say through the end of the year. If longer than that, the trade war and its economic fallout would threaten to become a prominent part of next year's presidential election.

The higher tariffs will have a meaningful impact on the U.S., Chinese and global economies. Global businesses can navigate around the impact of a 10% tariff—they can reduce their profit margin, pass along some of the higher costs to their customers, and source their imports from places not facing tariffs—but navigating around a 25% tariff will prove impossible. Global supply chains will be disrupted, hurting business investment and manufacturing output.

This alternative scenario has a 30% probability, and would reduce U.S. real GDP growth this year by nearly half a percentage point to closer to 2%. The Federal Reserve will be tempted to cut interest rates given the uncertainty and weaker growth. However, we assume it ultimately won't do so, since growth remains close to potential and unemployment stable and low. Chinese real GDP growth will be reduced by approximately the same amount to just less than 6% this year, although Chinese authorities may ramp up their economic stimulus to offset the trade war's ill effects. They have shown a willingness and the ability to use their considerable monetary and fiscal tools to support growth.

Worst-case

A much more serious, worst-case, and increasingly plausible scenario is that Trump engages in an all-out trade war, following through on most of what he has threatened to do. This includes putting a 25% tariff on all Chinese imports to the U.S., which comes to some $520 billion for the past year, about one-fifth of all imports into the country. In this dark scenario, Trump also goes all-in on the 25% tariffs on vehicle imports and parts.

The rest of the world doesn't take all this lying down, and retaliates in-kind to the U.S. actions. The Chinese could jack up tariff rates on all of the just over $100 billion in U.S. imports to their country, but more likely China will have a non-tariff response. China could make it more difficult for U.S. businesses to obtain regulatory approval for various business activities or delay the time it takes for U.S. goods to clear customs. It could even allow the yuan to depreciate further in value, as it did last year when the trade war first broke out. An even more extreme step would be to altogether stop buying U.S. goods—like the Apple iPhone. The Chinese boycotted Japanese cars a few years ago in a spat with that nation.

Recipe for recession

The probability of this full-blown trade war scenario is 10%, and is the recipe for a U.S., Chinese and global recession later this year. The Federal Reserve will attempt to cushion the economic blow by cutting rates, and the Chinese will pump up monetary and fiscal stimulus, but these efforts will fall short. The length and depth of the downturn will depend on how long it takes Trump to call a truce, but given the fast approaching presidential election, it is difficult to imagine he would allow the war to continue much into next year.

There is good reason to engage China on its trade practices and generally poor behavior in international commerce. However, Trump's trade war is a costly and likely ineffective way of getting China to reform. The economic costs of a war are potentially too high. There is a general consensus that Trump won't push it too far. Once it does show up in lower stock prices and weaker U.S. growth, he will relent. This makes sense, but it is important to carefully consider alternative scenarios.

We are updating simulations of our global macro model under these alternative scenarios, and will make the results available later this week.

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