Modeling Trade Tensions: Macroeconomic and Trade Models in Different Institutions

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GTAP Conference, June 17-19 2020

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Contribution

- Escalation of trade tensions has spurred analysis in most institutions

- In April last year, some of the main institutions met in Washington

- Exchange notes on frameworks and understand different results

- Reconcile/highlight some differences between DSGE and CGE models

- What does drive results in those models?
Motivation

- Reconciling results on tariff policies could be complex

- Policy scenarios can depend on:
  1. Same tariff increase can be implemented differently
  2. Retaliatory measures (say if a country retaliates in kind or tries to affect particular sectors)
  3. Persistence of the measure (temporary or permanent)

- Results then can differ because of:
  1. Different frameworks (DSGE versus CGE)
  2. Within similar frameworks, different ingredients
  3. Also different calibration
Simple policy experiment

In terms of policy scenarios:

1. 10-percentage-point increase in tariffs
2. Across the board, on all imports
3. Start with the U.S. increasing tariffs on China’s imports
4. Add retaliation
5. Increase the number of countries involved

To tackle issues of frameworks’ comparison:

1. Main framework differences w.r.t. tariff policies
2. Explain the importance of key ingredients
3. Perform same experiment using the same key parameter value
DSGE models: main features

- DSGE used in several institutions (IMF, ECB, EC, FRB)
- Share similar ingredients
  1. Multi-country
  2. Non-Ricardian households
  3. Real and nominal rigidities
  4. Role of currency invoicing
  5. Dynamic consistency
Results US-China trade tensions: SR

- Response in the SR displays a larger range

- Range depends on:
  1. Currency invoicing (rigidities in pricing: LCP vs PCP)
  2. Deep and policy parameters
  3. Nominal and real rigidities
  4. Elasticity of substitution
  5. How the revenue from tariffs is used
Why do those matter with tariff policies?

- Key blocks in DSGE models:
  - Relative demand for foreign varieties
  - Balance of payments
  - Intertemporal conditions for bond holdings
- Tariffs do not \textit{directly} affect last block
- ER jumps to preserve consistency
- How much? Depends on highlighted features
- Exports affected by tariffs and ER (currency invoicing)
Results US-China trade tensions: SR details

- Exports in year 1 depend on currency pricing
- GDP: size of countries matters (FRB); role of investment (ECB)
Absent rigidities or frictions, models are more aligned
Tariffs introduce a distortion on investment
GDP response mainly tracks investment’s
In addition, appreciation of the dollar weighs on U.S. exports
Results US-China trade tensions: LR(2)
DSGE Models

Shock: US and Partners increase tariffs 10 ppt

- Largest losses for the US, smallest for China: U.S. least important partner, China exports more to others
- SR results mostly driven by exports (except for ECB)
DSGE Models

Results global trade war: SR

- Largest loss for China: the most open large economy
- ER changes are modest: rigidities and currency pricing weighs less on differences in exports

<table>
<thead>
<tr>
<th></th>
<th>USA</th>
<th>China</th>
<th>RoW</th>
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<tbody>
<tr>
<td>% Change Real Exports</td>
<td>-11</td>
<td>-10</td>
<td>-9</td>
</tr>
<tr>
<td>% Change Real GDP</td>
<td>-1.2</td>
<td>-1</td>
<td>-0.8</td>
</tr>
</tbody>
</table>

![Graph showing real exports and real GDP changes for USA, China, and RoW under ECB, EC, and IMF scenarios.]
CGE Models

CGE models

- CGE used in several institutions (WTO, WB, Purdue, USITC)
- Share similar ingredients
  1. Complex system of equations
  2. Multi-country
  3. Sectoral disaggregation
  4. Input/output structure
  5. Fixed endowment of factors [most closures in static models]
  6. In dynamic versions, capital is endogenous
CGE models

CGE results: mechanisms

- Tariffs introduce a wedge on relative prices
- Sectors more exposed to trade lose competitiveness
- This generates a contraction of production factor demand
- If total stock of factors is fixed (at regional level), prices fall
- Demand for other sectors may increase
- Resources reallocate across sectors
- Factor returns measure inefficient reallocations caused by tariffs (translates into GDP)
- Crucial: factor reallocation, dynamic response, elasticities, closures
CGE Models

Results US-China impose tariffs

- Dynamic frameworks show larger output loss
- WB: capital cannot freely reallocate across sectors
- WTO: only model with no fixed trade balance
Results US and partners impose tariffs

- Similar results, with dynamic models showing larger output change
- US suffers the largest loss (same as for DSGE models)
Results: US-China impose tariffs: role of elasticities

- Exports’ response subdued with lower elasticities (USA case)
- Generally, tariffs more distortive with lower elasticities
Results US-China impose tariffs: DSGE and CGE

- Exports particularly more responsive in CGE with higher elasticities
## Main takeaways

<table>
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<th><strong>DSGE</strong></th>
<th><strong>CGE</strong></th>
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<tbody>
<tr>
<td>GDP, Exports</td>
<td>Contraction (countries imposing tariffs)</td>
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</tr>
<tr>
<td>Output loss</td>
<td>Factors contraction</td>
<td>Inefficiency of reallocation, factors contraction (only dynamic models)</td>
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<td>Affecting magnitude of results</td>
<td>Deep parameters, size, policy reactions, currency pricing, rigidities, elasticities, trade asymmetry</td>
<td>Elasticities, closures (e.g. trade restrictions), tech. parameters, factors reallocation, trade asymmetry</td>
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Concluding remarks

- Analyze results of tariff policies across institutions
- Design simple experiments that allow for comparisons
- DSGE and CGE display negative effects of tariffs arising from different mechanisms
- DSGE: role of exchange rate, distortions/contraction of factors supply
- CGE: distortion of prices, input-output propagation, inefficient reallocation of factors
- Showed the role of key features in both frameworks
BACK-UP SLIDES
Results US-China impose tariffs: role of elasticities
- case of China

![Graphs showing real exports and real GDP changes for China under different tariff scenarios and elasticities.]