ECONOMIST IMPACT

Growth amid uncertainty:

how trade policy and geopolitics can shape global opportunities

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About this research

"Growth amid uncertainty: how trade policy and geopolitics can shape global opportunities" is an Economist Impact report, supported by Google, examining the effects of trade policy uncertainty (TPU) on markets and businesses around the world. The report explores the impact of TPU on business practices such as exports, investment and capital. It then looks at a macro view of TPU by modelling two scenarios based on two feasible geopolitical trends—one optimistic and the other pessimistic—to assess the effect TPU could have on the future global economy and, by association, business growth and opportunity.

The modelling conducted in this study utilised the Global Trade Analysis Project (GTAP) model and database. The GTAP model enables the quantitative analysis of trade shocks, such as tariff changes and non-tariff measures, at the national, regional and global levels. The impact of such trade measures on GDP, exports and imports, inflation, skilled and unskilled labour, and other areas, can be examined.

In this study, we have made assumptions about geopolitical choices and their related trade policy decisions among some of the world's major economies. In the optimistic scenario for global trade, major economies take a favourable position concerning their significant trading partners and take decisions to lower the trade barriers.

Conversely, in the pessimistic scenario, major economies decide to heighten trade barriers between regions. The scenarios demonstrate how geopolitical factors can alter trade policy and what these decisions could mean for growth and opportunities for global businesses.

Key findings

- **The geopolitical landscape is changing along with a rise in TPU in recent years. Businesses need to factor this uncertainty into business planning as these trends are likely to continue.** The global economy has undergone significant changes in the past decade, such as Brexit, the US–China trade war, covid-19 and the war in Ukraine. These have had a vast impact on the global trading system, with the effects likely to last for many years. Businesses can build their resilience by taking account of these changes and planning accordingly.

- **Historically, TPU has been shown to reduce exports, investment and capital as businesses lack the predictability and stability of markets.** Demonstrating the significance for companies operating in the global economy, studies on the effect of TPU show broad implications for trade and trading relationships. Economist Impact modelling advances this by showing how potential future geopolitical events could affect these factors. A reduction in these areas will have a knock-on effect on businesses through a change in productivity and employment levels.

- **Evidence suggests that businesses are able to alleviate the effects of TPU by having just one additional country in their export basket.** Uncertainty can have an immense effect on commerce as around 70% of trade today takes place in global value chains (GVCs). As so much production happens within supply chains, a further consequence of TPU is that it can damage the export margins of intermediate goods more than finished goods. It is therefore important to diversify supply chains in terms of partner countries since this ensures that businesses are more insulated from the effects of TPU and rising tariffs.

- **Exporters are more productive than non-exporters, and this productivity premium rises the longer that companies have been exporting.** Top exporting firms are more productive than the average exporting firms, while firms that have recently started exporting are more productive than those solely focused on their domestic market.

- **Businesses that feel more confident in the trade policy of their key markets are more likely to increase participation in the global trading system, leading to further growth.** Due to the significant integration of global supply chains, any changes in trade policy impact all involved. Strengthening links between trading partners helps remove TPU by increasing the predictability and stability of trading relationships. Economist Impact modelling shows that a decrease in TPU through greater liberalisation and more predictable trade rules increases GDP for all countries involved. If the US joined the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), GDP for all countries involved would increase by US$129bn. Therefore, increasing the security and stability of global supply chains is linked to increased economic gain for those involved.

- **Economist Impact's modelling shows that greater trade liberalisation is linked to an increase in GDP, imports and exports, making business growth more attainable.** GDP increases through a rise in consumption practices would create additional consumers and, potentially, markets for businesses. Such growth helps build market confidence, which affords businesses the opportunity to make additional investments and to streamline business practices, providing even further opportunities.
- **The fragmentation of the global trading system significantly reduces growth and opportunity for businesses.** TPU significantly reduces the number of opportunities for businesses to source goods and services and to export their products. Economist Impact modelling shows that if the world split into three factions (a Russia–China-friendly 'Eastern' bloc, a Western-style bloc, and a neutral bloc), there would be a reduction of a little over US$1trn for the Western and Eastern groups. So, while nations may see this as beneficial based on the securitisation of supply chains, it reduces the growth of economies and opportunities for businesses.
- **The fragmentation of the global trading system can increase the effects of intra-region TPU shocks.** In a fragmented world companies would be less likely to diversify outside of their trading blocs due to the increased trade barriers. Less diversification would then lead to more insular companies. The effect would be that TPU shocks within these "friendly" groupings would have far greater consequences due to the lack of diversification in markets outside of their region. The consequences would be particularly acute for small-to-medium-sized businesses as they have access to fewer resources than larger firms.
- **Fragmentation would require companies to restructure their supply chains to account for the prohibitive trade barriers from unfriendly trading blocs or nations.** Fragmentation can increase intra-region trading, with Economist Impact modelling

showing that China's trade with Russia would increase by just over US$46bn were the world to be broken up into three trade blocs. However, the benefit of increased intra-region trading would more than completely reverse by the decline in inter-region trading. Economist Impact modelling shows this as China's lost trade with the EU and US totals just over US$584bn in the fragmented scenario. Moreover, access to raw materials or intermediate inputs may be non-existent or rare within friendly trading blocs. This issue could leave businesses with the choice of paying high prices to import such goods or deciding to restructure their business practices. All of which leads to increased costs for business and a decline in GDP for nations.

- **To help ensure prosperity, businesses need to thoroughly understand the trade landscape and geopolitics in order to weather the consistent shocks to global economies.** Ensuring effective scenario planning to account for uncertainty is central to this. While most shocks cannot be predicted with certainty, some signs could indicate what is to come and which scenarios businesses should plan for. Adjusting practices and policies and factoring in geopolitical trends can minimise the risk of a given shock to trade policy. Including these factors when scenario planning is vital to ensure prosperity and longevity for companies.

- **Economist Impact has modelled two scenarios which demonstrate the impact of reduced and increased TPU.** Businesses should include these factors in their scenario planning. The first, "optimistic", scenario involves the strengthening of trade ties with nations around the world and includes the US joining the CPTPP; the EU and China building on the Comprehensive Agreement on Investment and further reducing trade barriers through greater liberalisation; and the UK and India signing a free trade agreement (FTA). The second, "pessimistic", scenario involves the splitting of the global trading system into three blocs: a Russia–China-friendly Eastern bloc; a Western-style bloc; and a neutral bloc.

Trade winds: where are they blowing?

Trade policy

International trade is part of the fabric of our daily lives. It impacts us through what we eat, the education we receive and the devices we use. It is easy to underestimate how so much of what we consume involves international trade, but that would be a mistake.

The accessibility of goods and services and how much we pay for them are all impacted by trade policy. For example, the umbrella "Buy American" policy has important ramifications for businesses wanting to produce and trade goods and services. The on-shoring of production, which this policy supports, would likely increase costs, reduce choice and decrease the production specialisation capability of nations—all of which would reduce the competitiveness of businesses operating in nations that have such policies.

Trade policy of recent decades ensured the interconnectedness of global supply chains. When a given country changes its trade policy, it increases the risks for businesses if their supply chains aren't diversified enough. For example, Apple works with suppliers in over 40 countries to make its products. Without back-up markets, a change in trade policy in any one of these could impact the availability of resources, production methods, labour or prices for its products.

Supply chain integration has made this possible by allowing countries to produce what they are better at producing and then indirectly producing goods through importation. Through imports, countries can get access to the products they need for long-term sustainable growth. Trade liberalisation is crucial for a healthy global economy.

There has been a steep increase in trade agreements signed in the last two decades, leading to greater liberalisation. World Trade Organisation (WTO) data shows that from 2000 to 2020, 414 regional trade agreements entered into force bringing the world total to 511.[1] Greater liberalisation further enhances the importance of global value chains (GVCs). Organisation for Economic Cooperation and Development (OECD) data shows that 70% of international trade happens within GVCs where raw materials, parts and services are exchanged across borders, often several times, before a final product is produced. International reliance on GVCs is further evidenced by World Bank statistics, which

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World Trade Organisation

1 https://rtais.wto.org/UI/PublicMaintainRTAHome.aspx

Trade as a share of global GDP is 52% and it rises to 55% for high-income countries

World Bank

show that trade as a share of global GDP in 2020 was 52%. This share increases to 55% for high-income countries and is still 42% for low-income countries,[2] highlighting that trade is crucial for economies of all sizes.

As trade barriers have been removed through increased trade agreements, inter-state trade has grown faster than domestic production. Companies, therefore, cannot afford to assume that the success of the domestic market will lead to long-term profitability. Firms must look beyond borders and take advantage of other markets to help them grow.

Trade policy uncertainty

Trade policy reforms are often hampered by the expectation that they may be reversed or altered. Trade and investment are unlikely to follow trade policy reforms unless companies are confident that they will endure. While trade agreements can reduce trade policy uncertainty (TPU) through negotiated commitments, uncertainty can still arise for various reasons such as renegotiations, geopolitical events, technological transformation and climate change.

The covid-19 pandemic is one global event that increased TPU due to the disruption of global supply chains and the rise in protectionist measures as countries scrambled to secure the health of their economies.

Brexit is another example of a change in trade policy that significantly increased TPU, not just for the UK but for countries across the globe. Renegotiation of the UK's trade rules, not just with the EU but with all EU trading partner countries, introduced uncertainty into these trading relationships. This uncertainty significantly reduced UK exports in the months after the 2016 vote to leave the EU.[3] Such events combined with a number of global trade disputes place further global integration in doubt.

Measures of TPU are at levels not seen since the 1970s. Research shows that TPU increased tenfold in the decade before 2018.[4] The years 2017–20 gave rise to a dramatic increase in TPU. However, in 2022, TPU is still nearly double what it was a decade earlier and up over a third of what it was three decades earlier.[5] Questions around the Northern Ireland Protocol, a key clause in the Brexit withdrawal agreement, could cause further TPU by igniting a trade war if the EU suspends cooperation where UK ministers follow their negotiating rhetoric with action and tear up parts of the Protocol.

This recent increase in TPU shows an alarming trend, which will directly affect businesses looking to expand globally. The sections below discuss this more in depth.

"As trade barriers have been removed through increased trade agreements, inter-state trade has grown faster than domestic production."

2 https://data.worldbank.org/indicator/NE.TRD.GNFS.ZS
3 https://ukandeu.ac.uk/wp-content/uploads/2019/02/Renegotiation-trade-agreements.pdf
4 https://www.matteoiacoviello.com/research_files/TPU_PAPER.pdf
5 https://www.matteoiacoviello.com/tpu.htm

Trade: mapping the isobars

Predictability and stability of the global trading system is critical to ensure that business decisions and investments succeed. TPU reduces these factors and thereby reduces trade activity.[6] In response to a TPU shock, such as the Brexit vote or the US–China trade war, trade uncertainty grows and can remain elevated for around three years afterwards.[7]

Research has shown that the number of firms concerned about TPU has increased over time across nearly all industries.[8] Some have shown significantly more concern than others, namely those in the durables, manufacturing and chemical sectors. But whether or not the concern has increased, TPU is associated with lower exports, reduced investment, diminished research and development expenditure, and decreased profits.[9]

TPU decreases exports

It is widely acknowledged that an increase in uncertainty about the global trading system decreases both the probability of exporting and the volume of exports. The WTO found that, were TPU eliminated, exports would increase by 12%. The WTO also found that reducing the threat of a trade war between China and the US would increase export growth by 22% between the two nations.[10]

The stability of not raising a trade barrier can be as important as lowering one as this provides businesses with a predictable assessment of future trade opportunities. Preferential trade agreements (such as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership, CPTPP) are one way to increase this predictability. Research supports this view as after the WTO Information and Technology Agreement came into force, exports of those goods covered increased.[11]

Uncertainty is also an important barrier to trade when production happens in supply chains. The OECD estimates that around 70% of trade today happens in GVCs.[12] Therefore TPU can have an even larger effect on the export margins of intermediate goods than finished goods, as reduced TPU is linked with a significant increase in

Around 70% of trade today happens in GVCs

OECD

6 https://www.nber.org/system/files/working_papers/w25334/w25334.pdf
7 https://www.matteoiacoviello.com/research_files/TPU_PAPER.pdf
8 https://www.matteoiacoviello.com/research_files/TPU_PAPER.pdf
9 https://www.sciencedirect.com/science/article/pii/S002219962200040X
10 https://www.wto.org/english/res_e/reser_e/ersd201505_e.pdf
11 https://www.nber.org/system/files/working_papers/w29672/w29672.pdf
12 https://www.oecd.org/trade/topics/global-value-chains-and-trade/

"In response to a TPU shock, such as the Brexit vote or the US–China trade war, trade uncertainty grows and can remain elevated for around three years afterwards."

intermediate goods trade.[13] The service sector is also impacted as World Bank data found that an increase in TPU is associated with a reduction in services trade volume growth.[14]

All this has led to questions about whether there may be more benefit in decreasing TPU than in liberalising tariffs. An export increase due to lower tariffs was shown to be negated by an increase in TPU due to firms standing more to lose.[15] Therefore, more attention needs to be paid to TPU when designing trade policy. Moreover, businesses that are looking to grow should take advantage of preferential trade agreements since they help to both reduce barriers to trade and increase the stability of trading relationships.

TPU reduces investment and output

TPU also reduces firms' investment and output—in times of uncertainty, companies (across industries) that export reduce their investments more than non-exporters.[16] This impact is true of short-term decisions (pricing and inventory) and longer-run investments, such as delays in firms entering new markets as they wait to ground their decisions in a more predictable context.[17] Waiting to make decisions in times of uncertainty can be more valuable to firms, so they do not expend resources unnecessarily. However, research shows that exporters are more productive than non-exporters, and this productivity premium is greater the longer that companies have been exporting as permanent exporters are more productive than companies that have just started exporting.[18] So firms need to weigh up the risks and benefits effectively.

Bank of England statistics show that business investment has halved since its peak in late 2017, suggesting that an increase in uncertainty (which happened drastically in 2017) has costly impacts on economies.[19]

Uncertainty also affects sectors differently. For goods with a higher tariff risk, exports are likely to decrease further.[20] Goods with a higher tariff risk can include those deemed politically sensitive or those linked to national security.

TPU also causes different impacts depending on the country of origin. Those countries thought to have poorer-quality institutions are more impacted by TPU.[21] The economic consequences of this could be disastrous for some countries and regions as companies focus their supply chains on those with stronger institutions, leading to greater global inequality.

TPU means firms accumulate less capital

TPU leads firms to reduce the scale of their operations due to a decline in exports.[22] This

13 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2983695
14 https://blogs.worldbank.org/trade/how-policy-uncertainty-hurt-world-trade-2019
15 https://www.nber.org/system/files/working_papers/w29672/w29672.pdf
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in turn leads to a reduction in capital. Firms concerned about TPU have been shown to have a 2% reduction in capital compared with firms that are not concerned with it.[23] Further, using the US–China trade war as an example, evidence shows that firms hit by an increase in TPU had an 11.5% reduction in profits.[24] This has knock-on effects for other areas of the business. For example, if a company accumulates less capital because of TPU, this is correlated with a decline in employment at that company. A decrease in exports, lower levels of investment and capital coupled with the postponement of decisions, many indefinitely, greatly reduce the productivity of businesses.

"Exporters are more productive than non-exporters, and this productivity premium is greater the longer that companies have been exporting."

TPU induces precautionary and real increases in markups

TPU has direct consequences for consumers as it is linked with a precautionary increase in markups. Adjusting prices can be costly, so firms respond to TPU by increasing markups to avoid selling at a lower price in the future. Losses from overpricing are preferred over serving a larger market with low or negative markups.[25]

Around the world we are seeing levels of inflation not seen for decades. In the US and UK alone inflation is at a 40-year high and is likely to persist for some time. As this report shows, TPU is also at levels not seen for decades. An increase in TPU reduces exports and, therefore, the supply of goods from nations with a comparative advantage in producing those goods. This leads to a reduction in supply for markets around the world which increases prices. If such trends persist nations may look to re-shore production of certain goods due to the decreased supply. But this would also lead to price increases as they wouldn't have a comparative advantage in producing goods they hadn't previously. An example is African nations producing wheat instead of importing it from Russia and Ukraine due to the supply chain issues stemming from the Ukraine war. Increased costs for producers will likely be passed on to the consumer, leading to higher prices. However, if businesses had diverse supply chains, in the event of a trade shock goods could still be sourced from other nations relatively easily, thereby reducing inflationary pressures.

Andrew Bailey, Governor of the Bank of England, referenced the series of shocks culminating in the Ukraine war as a reason for the current inflation rates.[26] News predicting higher tariffs also increases the expected cost of imports and, therefore, the cost of goods for consumers, thereby reducing demand.[27] Businesses should pay attention to these "warning" risks since they can help to determine where the real risks lie, thereby minimising the impact on consumers.

Combating TPU

Evidence shows that the more diversified a firm's supply chains are in terms of partner countries, the more insulated they are from the effects of

23 https://www.matteoiacoviello.com/research_files/TPU_PAPER.pdf
24 https://www.wto.org/english/res_e/reser_e/ersd201505_e.pdf
25 https://www.matteoiacoviello.com/research_files/TPU_PAPER.pdf
26 https://committees.parliament.uk/committee/158/treasury-committee/publications/oral-evidence/
27 https://www.matteoiacoviello.com/research_files/TPU_PAPER.pdf

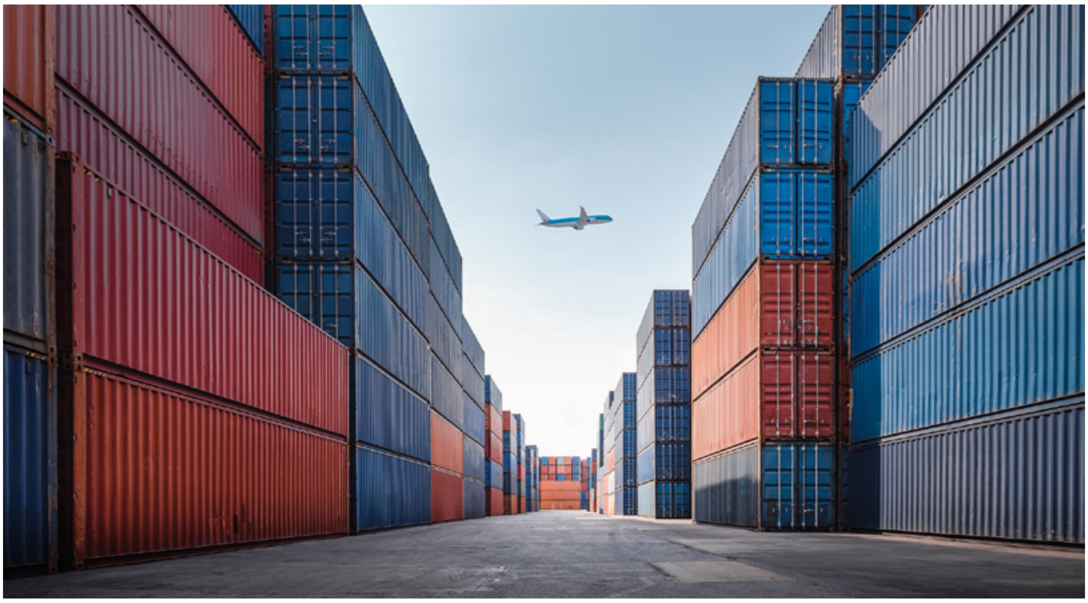
"The more diversified a firm's supply chains are in terms of partner countries, the more insulated they are from the effects of TPU and rising tariffs."

TPU and rising tariffs.[28] Having just one additional country in a firm's export basket can reduce the impact of TPU on business interests.[29] If businesses focus on having sufficient diversity in their supply chains, the impacts of current and future trade shocks would be dampened. While shocks can cause global ripple effects, their impact usually hurts certain regions more than others. This is the case with the Ukraine war and the US–China trade dispute. Therefore, if businesses sourcing and export markets are sufficiently diverse then a shock that impacts a certain region can be alleviated through the availability of other markets in the businesses' basket.

Changing and diversifying suppliers was shown to decrease the impacts of TPU for Chinese firms in the US–China trade war. This shows the importance of diversification as it helps to insulate companies from trade shocks. While diversification may create additional costs to companies in the short term, taking preventative measures to combat TPU through diversification could provide longer-term security for businesses.

The impact of TPU also has different effects on companies of different sizes as smaller and less-diversified firms face a bigger increase in TPU than larger firms. Therefore, expanding a business could go some way to insulating it from TPU.

Given all this history, businesses and policymakers must understand the potential direction of trade policy. To show how differences in trade policy can have a huge impact on different economies, Economist Impact developed two scenarios that could represent the direction of trade policy in the coming years.



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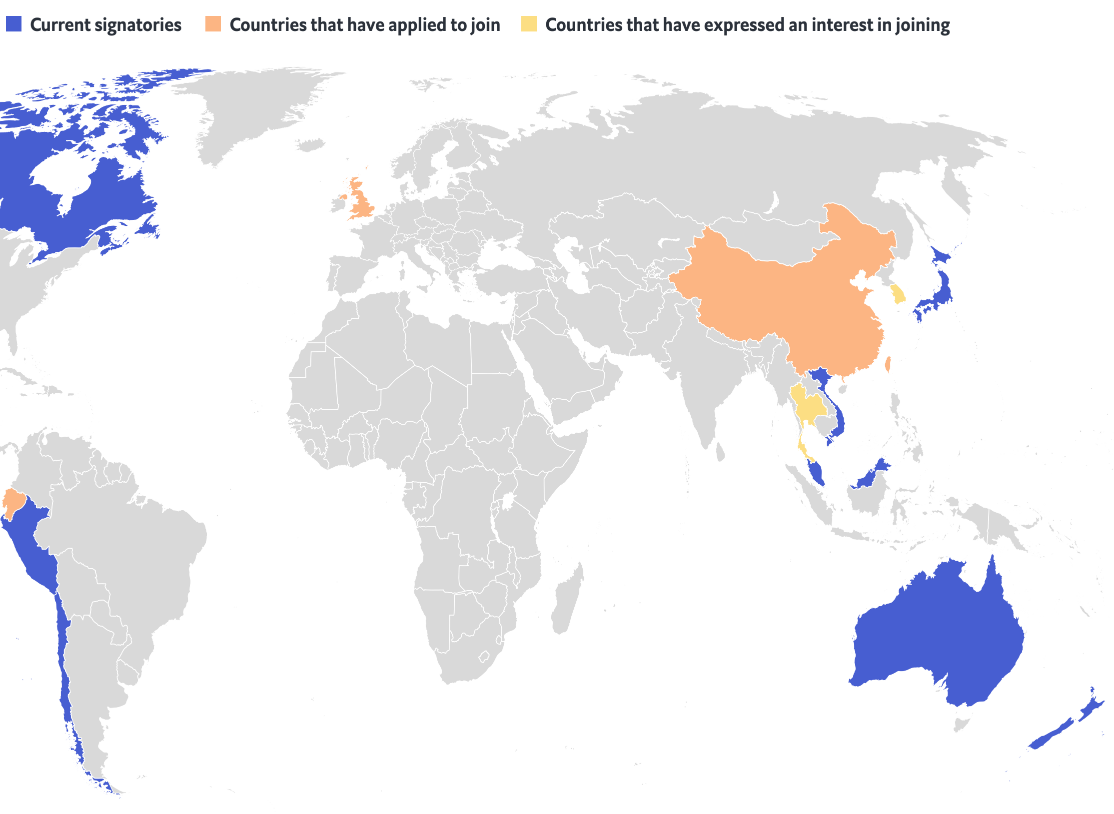
Forecasting the trends: calm or storm?

The first, "optimistic," scenario represents a closer union of trade agendas globally and therefore reduces the amount of TPU compared with the current global situation. We have modelled the following scenario:

- The US joins the CPTPP. Countries that are currently party to the CPTPP are: Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore and Vietnam.
- The EU and China build on the Comprehensive Agreement on Investment and further reduce barriers through greater liberalisation.
- India and the UK sign a free trade agreement (FTA).

Each of these scenarios is possible. New Zealand as the CPTPP repository has recently called for the US to join the trade pact; the EU and China

Figure 1: Map of CPTPP current and aspiring members



Source: Economist Impact

agreed on their investment deal in 2021, and China recently overtook the US as the EU's largest trading partner; and UK–India FTA negotiations have begun and are expected to conclude this year.

The "pessimistic" scenario represents a fracturing of global trading relationships into three blocs. We have modelled the effects on economies for this scenario with the world split into three blocs:

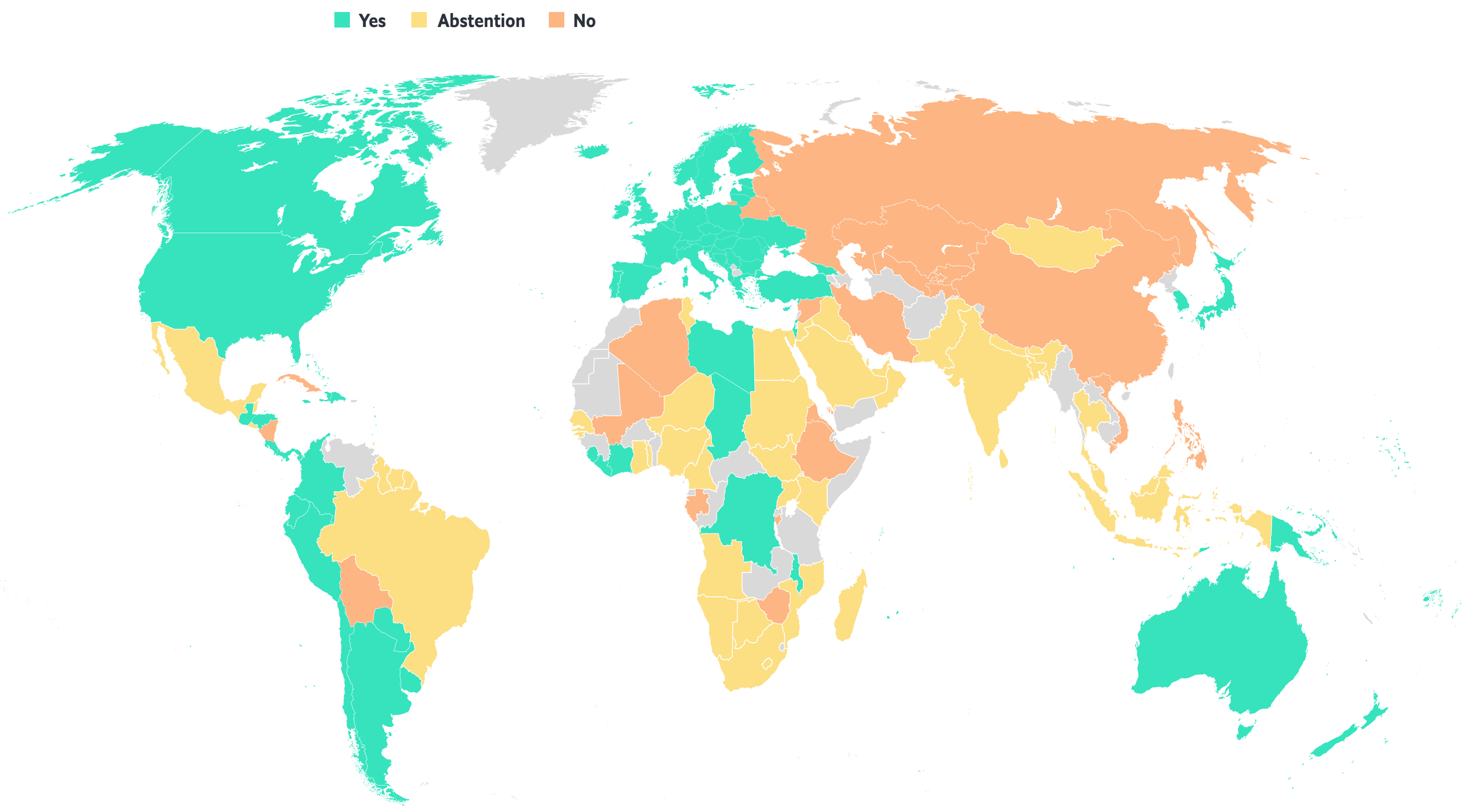
- A "Western" bloc including Australia, Canada, the EU, Japan, the UK and US, among others.
- An "Eastern" bloc including Belarus, China and Russia, among others.
- A "neutral" bloc consisting of other global economies such as India and Indonesia.

This fracturing of global trading relationships is again very feasible. With the number of trade disputes rising and the WTO not having an effective mechanism to resolve them, "friend-shoring" trade could increasingly become a policy favoured by all. Furthermore, the war in Ukraine presents evidence that trade blocs could emerge in the above groupings, as this was how many countries aligned on the UN vote to suspend Russia from the Human Rights Council.

The first scenario analyses the effect of a decrease in TPU as economies form closer trade ties, leading to greater liberalisation and more predictable trading terms. The second looks at the effect of an increase in TPU where a fracturing of economies into opposed ideologies pulls the global trading system further apart. Each scenario significantly impacts global GDP and the economies involved, including those in the neutral bloc, underscoring the existing reliance on GVCs.

Figure 2: How countries voted in the UN vote to suspend Russia from the Human Rights Council

The vote at the UN can indicate which factions countries align with



Source: Economist Impact

Trade trends: tranquillity or turbulence?

Findings show that an increase or decrease in TPU from Economist Impact's scenarios drastically affects the world economy and businesses.

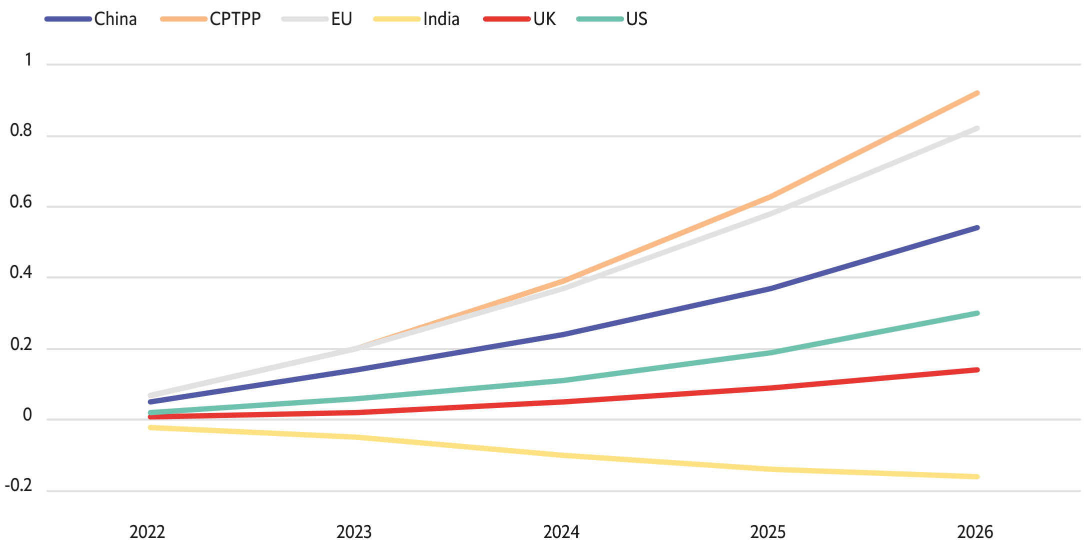
Optimistic scenario

The optimistic scenario shows a positive trend for trade flows across all measures and countries, with the exception of India, analysed from 2022 to 2026. All statistics referenced in the analysis are the 2026 figures unless otherwise specified.

If the US joined the CPTPP, its economy could be 0.3% or US$62bn larger. US exports and imports would also grow by 1.65% and 1.43%, respectively. The benefits of US accession would be felt not only in the US but also in every other CPTPP member state. The Australian economy would grow the least in percentage terms, but it would still increase by 0.19% (US$2.5bn). Singapore and Vietnam would see the most significant growth in percentage terms, at 1.65% (US$5.6bn) and 1.64% (US$5.6bn), respectively. In terms of dollar value, Canada's economy would grow the most (US$18.7bn), followed by Japan (US$13.9bn) and Mexico (US$12.8bn).

Through further reductions in barriers between the EU and China, growth within and between the two countries would also increase. Economist Impact data shows that the EU's economy would grow by 0.82% or US$125bn, whereas China's would expand

Figure 3: GDP percentage change under the optimistic scenario
The impact that strengthening trade ties could have on economies around the world



Source: Economist Impact modelling

by 0.54% or US$85.9bn. Exports would increase by 0.64% for the EU and 2.92% for China, as would imports, by 0.76% for the EU and 3.45% for China. An FTA between the UK and India would lead to an expansion of the UK economy by 0.14% or US$3.7bn. Interestingly, our modelling shows that the FTA would lead to a reduction of India's GDP by 0.16% or US$4.2bn. A likely explanation is that trade from new markets would compete with the trade that traditionally came from India because of the greater integration of trading relationships in the model. For example, trade in apparel from Vietnam to the US may have replaced trade in apparel from India. While India's trade declined overall, its exports to the UK increased by 55.10%. This result suggests that India, and indeed other nations, could mitigate these trade diversion risks by forming closer trade ties with nations or regions worldwide.

In this scenario, trade between countries not included in these agreements is expected to decline slightly along with their GDP. This result applies to countries such as Brazil (0.11%), South Korea (0.37%), Russia (0.02%) and South Africa (0.07%). Furthermore, the "rest of the world" grouping category also shows a decline in GDP (-0.08% or $US8.2bn), exports (-1.94%) and imports (-2.28%). This trend is likely to be due to trade divergence. As certain countries further liberalise and become more integrated, trade is likely to be diverted from other countries towards new predictable and stable markets. Therefore, countries whose trade policy remains stagnant could see their economic growth and associated business opportunities affected.

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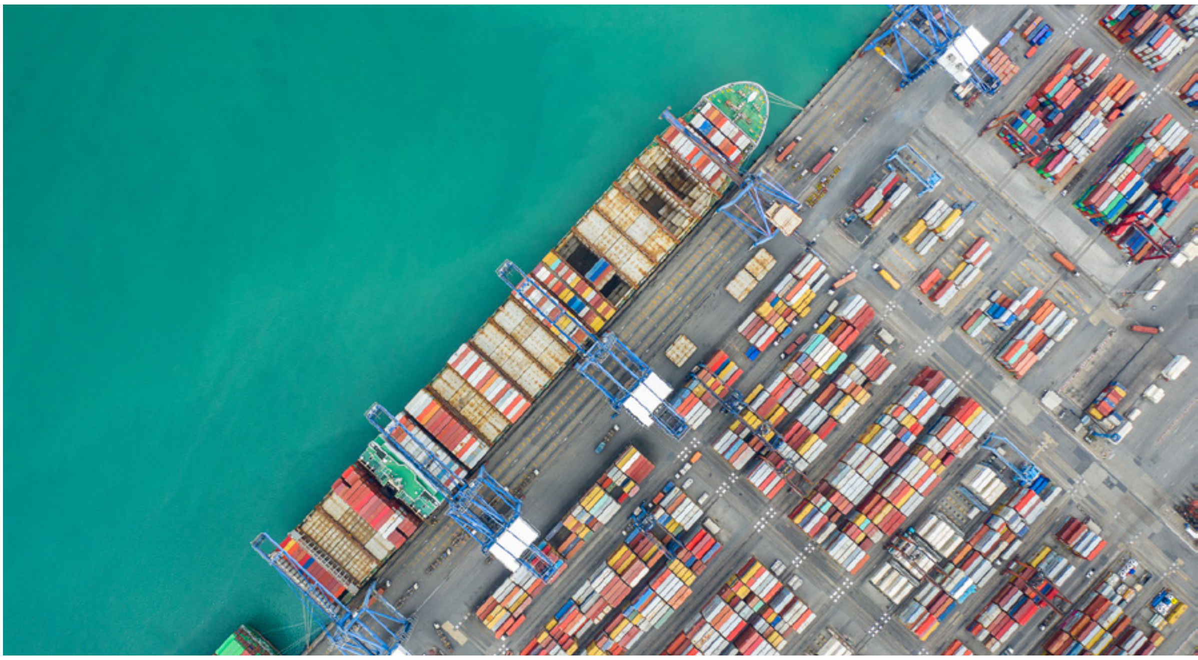
The increase in trade liberalisation between major economies in this scenario will create significant opportunities for businesses looking for growth in the global economy. There will also be knock-on effects of this liberalisation on other trading partners. As businesses look to expand because of new export opportunities, their desire for raw materials, intermediate inputs and services will increase. This expansion will entrench global supply chains and increase benefits for all involved.

The most significant development in the optimistic scenario analysis is the US joining the CPTPP, eliminating tariffs and reducing barriers for 98% of exports in the free trade area.[30] Contrary to US Trade Representative Katherine Tai's statement that FTAs are a "20th-century tool",[31] our modelling shows how these traditional trade agreements are still very advantageous for national economies and companies. If the US joined the CPTPP, opportunities would arise for businesses operating within countries that are part of the trade pact. Specifically, US-based companies would see more significant opportunities in Asia, the world's fastest-growing region. Companies in countries such as Japan, Vietnam and Singapore would see improved access to the US, still the world's largest economy. The US economy is also highly diverse, so US accession to the CPTPP is likely to benefit the economies of all countries involved.

30 https://www.dfat.gov.au/trade/agreements/in-force/cptpp/outcomes-documents/cptpp-outcomes-at-a-glance
31 https://www.strtrade.com/trade-news-resources/str-trade-report/trade-report/march/fta-appears-unlikely-as-u-s-uk-pledge-new-trade-efforts



Chinese and EU-based businesses would benefit from the reduction in trade barriers arising from deepening trade links between the two markets. Chinese companies would increase their exports to the EU by opening up opportunities in a region that houses almost half a billion people. EU-based companies would gain more favourable access to the extensive Chinese market and an economy that remains central to trade and global supply chains, particularly those in the wider Asian region.

Pessimistic scenario

The predominant finding in the pessimistic scenario is a reduction in GDP across the trading blocs from 2022 to 2026, particularly when compared with the optimistic scenario. All statistics referenced in the analysis are the 2026 figures unless otherwise specified.

Trade for the Western bloc was significantly reduced due to the fragmentation of the global trading system. GDP for this bloc was reduced by 0.90%, or US$487.6bn. Exports, imports, and investment also decreased by 3.33%, 3.72%, and 3.61%, respectively.

Disaggregating the data to look at specific countries shows an unfavourable trading system as GDP for the US declined by 0.53% (US$111.2bn), for the UK by 0.87% (US$23bn) and Japan by 1.13% (US$56.9m). Exports and imports also decreased for all three countries as they did for other nations within this bloc.

There was also a decline in trade for the Russia–China bloc. The GDP for this grouping contracted by 3.27%, or (US$611.8bn). Again, exports (18.13%), imports (14.68%) and investment (6.78%) fell. The sharp decline in exports and imports for this group is mainly due to increased tariffs from some of China's main export markets—most notably the US—as disaggregated data shows that China's exports and imports alone fell by 23.97% and 26.87%. However, Russia's exports and imports also fell by 2.9% and 3.43%, respectively.

There was a positive trend for the neutral bloc as its GDP grew by 0.49% or US$58.5bn. There was also an increase in its exports (3.91%), imports (6.10%) and investment (2.82%).
In a real-world context, these nations would

be likely to negotiate trade agreements between themselves. We felt it necessary to incorporate sufficiently liberal tariffs within this group to reflect the most probable scenario.

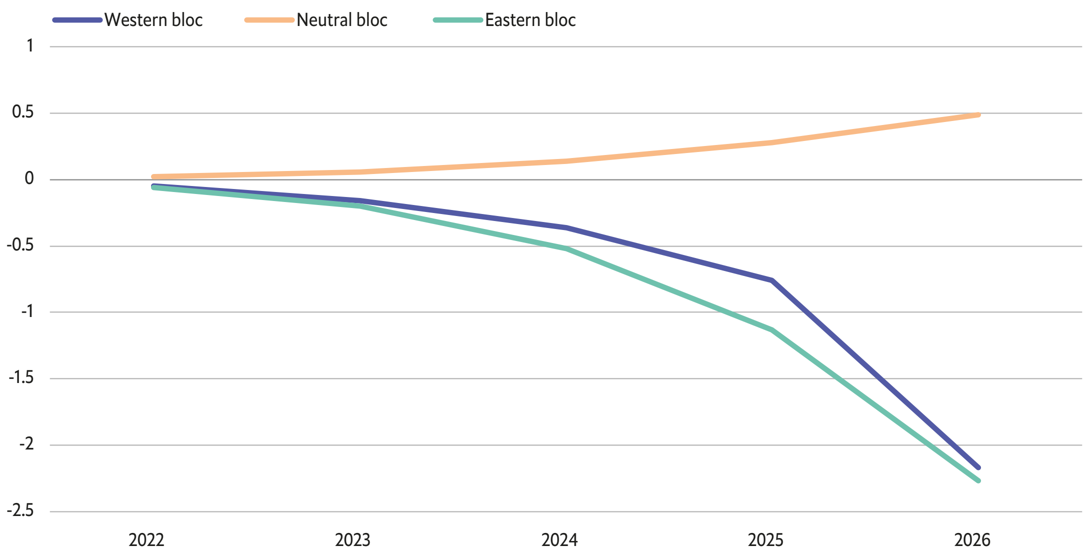
Economist Impact modelling also looked at the trading relationships between different partners in each bloc. Figure five shows that while trade within the major parties of the Eastern bloc increased, it was not enough to compensate for the decrease in trade flows caused by fragmentation. For example, while Russia's trade with China increased by nearly US$9bn, its trade with the EU fell by US$13.19bn. This pattern of trade increasing within groups but being outweighed by the trade lost because of fragmentation applies across the board. Furthermore, trade for all parties increased in the neutral bloc. This is due to trade being diverted from other markets due to the prohibitive tariffs applied by the Eastern and Western blocs on each other.

Geopolitical fragmentation increases trade between friendly countries, thereby offering new export opportunities. However, this benefit is vastly outweighed by the impact of fragmentation. For example, because of fragmentation China's trade with Russia increased by just over US$46bn. This shift offers Chinese companies more opportunities in that market. But China's lost trade with the EU and US totals just over US$584bn, showing that there is no net benefit for trade through fragmentation.

As most trade happens in supply chains, fragmentation would require their complete restructure to account for the prohibitive tariffs against unfriendly trading blocs. Moreover, access to raw materials and intermediate inputs may be non-existent or scarce within friendly trading blocs. This issue could leave businesses with the option of paying high prices to import such goods or deciding to restructure their business practices.

Figure 4: GDP percentage change under the pessimistic scenario

GDP percentage changes if the global trading system separates into three factions



Source: Economist Impact modelling

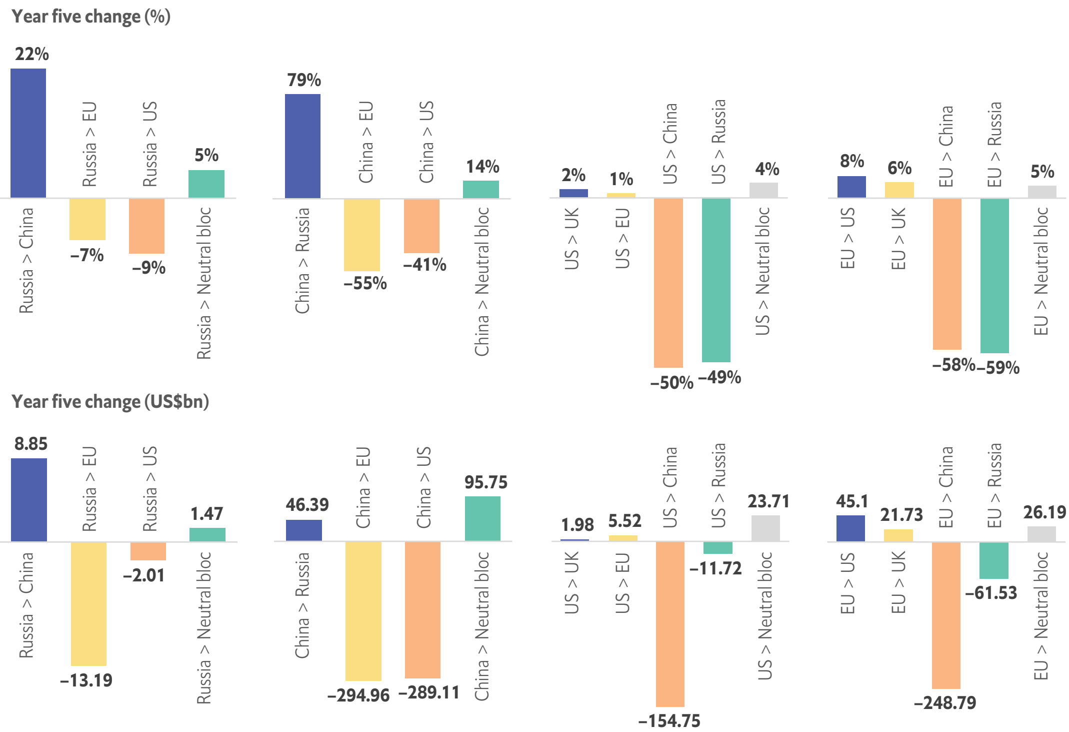
All of this leads to increased costs for business and a decline in GDP for nations. The results presented in figure five highlight the importance of businesses having the necessary geopolitical and trade knowledge to ensure success in the global market. The export and import markets of a business could significantly impact trade volumes and opportunities and, by association, the investment, capital and labour of the business.

The effects of TPU go beyond these statistics. The scale of fragmentation modelled by Economist Impact would have huge ramifications for other areas linked to trade, such as labour through increased unemployment. It would take a significant amount of time to retrain those unemployed for different sectors and jobs where growth was less hampered or had increased. This shift in labour availability would have significant consequences for businesses in these sectors.

As the Economist Impact analysis shows, fragmentation of the global trading system has two overarching consequences for companies. The first is that it would significantly reduce the number of opportunities for businesses to source goods and services and export their products, thereby restricting growth. Second, it increases the risk of further TPU shocks within the regions as companies are less likely to diversify outside of their trading blocs due to the increased trade barriers. This impact would be particularly acute for small-to-medium-sized businesses that have access to fewer resources compared with larger firms.

Figure 5: Inter-bloc and inter-country trading

Change in year five following the fracturing of the global trading system into three trade blocs



Source: Economist Impact modelling

Business planning: navigating the eye of the storm

The modelling of two very different scenarios shows how changes in trade policy can lead to varying degrees of economic success both for national economies and for businesses operating within the affected markets.

While the two scenarios we modelled are feasible, they are also hypothetical at the time of writing. However, with the number of shocks to today's economies and the growing amount of risk, businesses need to pay attention to trade policy as what is hypothetical today could well come to fruition.

The renegotiation of major trade arrangements across the globe, combined with the increasing number of trade disputes, suggests that prospects for global trade integration are far from certain. The US–China trade war is still ongoing and US President, Joe Biden, is still considering whether to keep or reduce tariffs (implemented as part of the trade war) on Chinese goods; the UK and EU are at odds over the Northern Ireland Protocol, with the UK threatening to tear it up if changes to ease the flow of trade are not made; the war in Ukraine is having devastating consequences for global supply chains; and the WTO Dispute Settlement Mechanism is in disrepair, leading to the likelihood of countries taking unilateral action to alleviate the effects of what they consider to be unfair trading practices. These shocks, among others, have severe impacts on businesses around the world due to the instability of the global trading system and the changes in nations' trade policies.

TPU can even arise, in the short term, from positive trade agendas. On average, trade agreements take around 28 months to negotiate.[32] This is 28 months where businesses are unsure about what commitments will be included, leading to much uncertainty. And while trade agreements ensure the stability and predictability of trade in the long term, the uncertainty during negotiations can have a negative impact. Furthermore, signing a trade agreement could lead to the diversion of trade from other regions as businesses seek to take advantage of new and potentially more liberal trading markets.

These global changes, combined with the development of technology, transport and communications, make it more important for businesses to have a clear and well-thought-out strategy. Effective scenario planning can help businesses prepare for a range of outcomes. Furthermore, limited markets, competitive pressure and the demand for cheaper resources mean that businesses should look outward and change their focus from traditional markets to take advantage of the benefits of the global market economy and ensure greater growth and prosperity.

As businesses navigate the challenges of TPU, there are key considerations to bear in mind. The two scenarios modelled as part of this research show a drastic change in the potential future of markets. In the pessimistic scenario, GDP, along with imports and exports, is forecast to decrease

32 https://faculty.haas.berkeley.edu/arose/MR2Vox.pdf

for all regions involved. The deterioration of economies across the globe impacts businesses as decisions around additional investment to grow the business will be shelved until a healthier economy is realised. The optimistic scenario is an example of this healthier economy as GDP, on average, is forecast to grow along with imports and exports. Business growth will be much more attainable in this scenario as consumption increases as a result of additional consumers and, potentially, markets. Such growth, along with an increase in market confidence, affords businesses the opportunity to make additional investments to streamline business practices and take advantage of new opportunities.

Businesses must understand the geopolitical direction of markets to ensure that they are making optimal decisions and necessary adjustments to business strategy. There is a lot of discussion over whether to prioritise the efficiency or resilience of supply chains. Prioritising efficiency would mean businesses rely on GVCs, whereas resilience would see businesses prioritise diversity and friend-shoring of supply chains. Assessing the geopolitical landscape to understand which countries are friends is critical when making business decisions. Getting a decision right because of adequate scenario planning could make all the difference to business fortunes in the era of increased TPU.

With further integration in recent decades, there is now more opportunity than ever for businesses to expand globally by seeking out new markets. The greatest risk is future shocks to trade policy. While most cannot be predicted with certainty, some signs could indicate what is to come and should be planned for. Furthermore, having a solid understanding of the global trading system allows businesses to adjust their practices and policies to minimise the risk of a given shock to trade policy. The modelling shows the impact TPU can have on ensuring that particular scenarios are accounted for in business decisions in order to reduce the sting of changes in exports, investment and capital. Trade liberalisation, whether global or regional, is not going to end. Businesses need to take all necessary steps to plan appropriately and act in their best interests, no matter what scenario arises.

Profits and consumer preferences don't recognise borders. With supply chains more integrated than ever before, there is an opportunity for expansion while still meeting the needs of consumers from both traditional and new markets. However, businesses need to understand trade policy to help them navigate the system in this increasingly unpredictable world if they are to successfully go global.

"Businesses must understand the geopolitical direction of markets to ensure that they are making optimal decisions and necessary adjustments to business strategy."

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