

# Trade Wars and Economic Stability: An Empirical Analysis of the Effects on Global Markets

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## ABSTRACT

Trade war between countries leads to global instability, As the theory of economy began to mature, unemployment and economic growth became one of the fundamental macroeconomic indicators. We evaluate the impact of trade wars on the global market, using US-china trade war as an example. The study uses past studies to generate comprehensive data to reveal the various implications of trade barriers, protective policies, high taxes on important and crucial market dynamics. By focusing on the relationship between trade wars and economic stability, our study will closely analyse trade flows, investor sentiment, and overall economic performance of the countries involved in the trade war during periods of heightened trade tensions. The research illustrates various impacts such as disruption in global supply chains, increased market fluctuations and instability, economic instability, low productivity or reduced profit margins as a result of high production cost. These challenges and barriers are capable of impeding the economic stability and growth of a country. The research further illustrates the importance of collaboration, transparent communication in solving trade wars between conflicting nations which would in the long run ensure a productive global market. The investigation also offers comprehensive insights on how policy makers, shareholders, investors and businesses can avoid trade war or the resultant effect of trade war to ensure continuous economic growth.

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## Introduction

The relationship between trade wars and economic stability become an important indicator in the world of business and global market. Various shareholders, policy makers and economist have all gathered enormous interest in the outcome or implications of trade wars on economic stability of a nation. A trade war occurs when various trade barriers are put in place to hamper trade between nations. This including increasing or escalating tariffs, increased taxes among other restrictions on a countries import. In this context, empirical evaluation serves as a vital tool for unravelling the complex dynamics at play and expertise the multifaceted consequences of trade wars on global markets (Devarajan et al., 2018). By examining real-world data and empirical evidence, researchers can discern patterns, identify trends, and assess the magnitude of the impact of trade conflicts on economic stability and market dynamics.

Whenever a country tries to protect its domestic industry by imposing new tariffs or quotas on imports, a trade war begins. In the short term this policy appears to favour domestic producers and

help create jobs but in the long term it creates administrative costs and hinders the overall trade and growth of all participating countries by reducing productivity. Heavy taxes lead to higher prices in the country leading to higher prices. When one country raises tariffs and the other retaliates in kind, a trade war intensifies, which could dampen business investments (Bown & Lu, 2018). This trade war causes problems for the global economy. Globally, wherever tariffs are imposed, they raised prices and acted as a deterrent to economic growth.

Trade has suffered a lot because if the two countries start increasing tariffs and quotas, the volume of imports/exports will definitely decrease, which would have a detrimental effect on the economic stability of the country. As the trade war intensifies, it creates barriers to global exports of goods and consumer goods that damage trade growth and development As President Trump raised tariffs on Chinese imports so, China has retaliated. China, Canada and several EU countries made plans to replace the US. supplier countries. This will enhance the business environment.

Economic stability is a foundational pillar of a prosperous and resilient economy, including a country where key economic indicators reflect a consistent and balanced path. To achieve this stability, spatial balance is needed as inflation, unemployment, sustainable economic growth and international trade. But the state of economic stability is often disrupted by the outbreak of trade wars, a process in which countries engage in reciprocal tariffs and protectionist policies, this can be done by the introduction of levels of volatility and uncertainty to the market (Pasini, 2013).

As countries struggle with the challenges of maintaining the balance of their economies, the impact of trade wars increases, creating uncertainty, market volatility, and challenges in the global economy relief comes which is crucial in understanding the dynamics between the key variables. The aim of this study is to carry out an empirical research on the impact of trade wars on global markets is needed to understand the complex dynamics that affect economic stability globally This insight extends beyond countries many aspects of economic stability, unpack trade wars and shed light on their inner connections shaping today's economic landscape.

## Literature Review

### Trade War scenario

In 2018, the global economy was rocked as the two powerhouse nations of the United States and China engaged in a trade war, which was noticed and had the full attention of other countries. The both countries began the trade war by imposing various trade barriers such as taxes and tariffs on their goods. China's response included tariffs on a variety of products manufactured by America such as aluminium, beef, fruit, and wine, while other countries selling steel and aluminum to the US also joined in by raising their tariffs on American goods. The escalating conflict saw the US imposing additional tariffs of 25% on \$50 billion worth of Chinese imports, with \$34 billion being implemented in July and an additional \$16 billion in August of that same year. The impact of this tense situation extended beyond just these two nations, involving other countries in the complicated web of international trade (Itakura, 2019).

China retaliated by imposing a considerable 25% tariff on \$50 billion worth of US products. After the initial escalation, the USA took further action in September by imposing a 10% tariff on an additional \$200 billion worth of Chinese goods. In response, China hit back by imposing duties on an additional \$60 billion worth of US goods. Later in 2018, the United States announced an increase to 25% on the previous 10% tariff, initially set to take place in January 2019. However, it was not until May 2019 that the higher tariff was actually imposed.

As a result of these ongoing trade tensions, there is a heightened sense of uncertainty which could negatively impact investments and productivity. In another move to ease tensions, China postponed imposing further duties on \$60 billion worth of US goods until June 2019 (Itakura, 2019). There have been truces in the US-China trade war from December 2018 to May 2019 and after the G20 Summit in June 2019, but it is uncertain whether the import tariffs that were raised in 2018 and 2019 will remain in effect or if they will increase further. Additionally, because of the growing risk and lack of transparency resulting from the US-China trade war, investment and productivity in both countries may decline. Therefore, it's critical to implement mitigation measures to avoid future problems related to this issue.

The effect of the trade war is estimated in many recent researches. According to Balistreri et al. (2018), the US-China trade war has minor but positive welfare implications resulting from trade redirection effects on other nations, whereas it has negative welfare effects on the USA and China of around -1.02% and -1.7%, respectively. In their CGE (computable general equilibrium) model, Balistreri et al. (2018) investigate three distinct trade requirements. A traditional trade model à la Armington (1969) that assumes fully competitive marketplaces and consistent returns to scale manufacturing technologies is used in their initial specification.

On the assumption of imperfect competition and growing returns to scale, the second specification is established. Their second criteria for the wide margin of trade is expanded upon in their third specification. The negative welfare effects are less than the third when their first and second specifications are used to their models; under the first specification, the USA and China would have negative welfare impacts of  $-0.20\%$  and  $-0.34\%$ , respectively, and under the second,  $-0.22\%$  and  $-0.63\%$ . The database created by Li (2018) is used by Balistreri et al. (2018) to measure the magnitude of import tariff hikes, and we also utilize the same database for the tariff calculation. Bollen & Rojas-Romagosa (2018) demonstrate that the US-China trade war, which resulted from tariffs on steel and aluminum and retaliation, reduces GDP by  $-0.4\%$  in the USA and  $-1.2\%$  in China. By gathering the official papers that list the targeted items at the 4- and 8-digit levels of the Harmonized System and combining them up to the industry level, they are able to predict the increases in import duties. Their methodology is much the same as Li's (2018) approach to building the tariff database.

**Table 1:** Increase in import Tariffs in 2018 and 2019 (percentage point)

	2018	2019
	Importer--USA	Importer--USA
	Exporter--China	Exporter—China
<b>Agric</b>	8.2	12.3
<b>Mining</b>	9.9	14.8
<b>Food Production</b>	8.6	12.9
<b>Text Apparel</b>	1.8	2.7
<b>Petrochem</b>	7.1	7.9
<b>Metals</b>	10.4	8.8
<b>Machinery</b>	21.2	8.3

Source: Li, 2018

**Table 2:** Increase in US import tariffs on metals (percentage profit)

Metals	
<b>Japan</b>	9.4
<b>China</b>	10.4
<b>Hongkong</b>	0
<b>Taiwan</b>	6.6

<b>Australia</b>	0
<b>New Zealand</b>	0
<b>India</b>	9.2
<b>Thailand</b>	4.0

**Source:** Li, 2018

### Concept of Economic Stability

Because of its nature, the idea of economic stability is ambiguous and open to several interpretations. As a result, several interpretations may be made of the variations in policies that affect economic stability. According to Pasini (2013), the policies being implemented within the framework of economic stability are interconnected and have an impact on one another. Economic stability, in its widest sense, is the absence of sudden fluctuations or severe volatility in macroeconomic indicators. A low ratio of inflation is considered steady from an economic perspective as the economy expands. Additionally, reaching full employment contributes to the restricted definition of the economy's stable state.

There are two types of economic stability: external stability and internal stability. Stability in prices, full employment, and economic expansion are all made possible by internal stability. Inflation and unemployment are two indicators of the breakdown of internal stability. The balance of payments is guaranteed, which is the second facet of economic stability, namely external stability. Sustaining external stability, often known as external balance, is essential to preserving economic stability on a larger scale. It has to do with a country's balance of payments, which represents its trade with the rest of the world, being in balance. A stable balance of payments signifies that a country's exports and imports, as well as its financial flows, are in harmony over time (Pasini, 2013).

A positive balance of payments indicates external stability as it shows that a nation can fulfil its international financial commitments without using excessive amounts of foreign borrowing or depleting its reserves. However, long-term imbalances—like significant trade surpluses or deficits—can reveal underlying weaknesses and jeopardize the stability of the economy as a whole. Also, key features of external stability include the stability of currency and ability of a country to compete internationally. When a country has a stable currency, the market structure is easily predicted and investors would be at ease in terms of risking their investment in such country (Tsutsumi, 2018).

Both factors that are linked to economic stability are necessary for the proper development of the country as they are key variables that need to be put in place to ensure balance in the economy. Policymakers can improve the stability and resilience of their economies and foster sustained development and prosperity for their population by tackling both external and internal stability challenges.

### **3.0 Theoretical framework of Economic stability**

#### **3.1 Unemployment and Inflation**

In order for public policy to promote economic stability, there are two primary components. Achieving full employment is the second goal, while maintaining price stability is the first. This state of affairs, which we characterize as grappling with unemployment and inflation, gives rise to a variety of views about economic theory. So much so that a plethora of ideas have been unveiled, covering everything from the definition of unemployment and inflation to the pertinent causes, the effects on the economy, and potential solutions (Saidu & Muhammad, 2015). In the short term, unemployment and inflation are caused by classical economic theory.

Because wages and prices are flexible, unemployment and inflation will eventually balance out on their own. A research conducted in England between the years of 1861 and 1957 by Phillips (2008) addresses the exchange, or the negative link between money salary and unemployment. He maintained that shifts in the money pay rate are caused by changes in the demand for labor. Phillips made a contribution by making it possible for the relationship between unemployment and monetary salaries to remain steady. Monetary earnings are steady at the 5.5 percent frictional unemployment rate. The Phillips curve is often used to describe the inverse connection between money and short-term unemployment. Keynesians have maintained that demand-driven policies were necessary since inflation resulted from a situation in which total demand exceeded total supply.

#### **3.2 Economic Growth**

Economic growth is understood to be equal to capital accumulation in traditional growth models. Saving money is a good thing and a significant factor in capital building is savings. Every savings that is turned into an investment will support economic expansion. In the long run, economic growth has stayed hidden because wages and prices are flexible and full employment is assumed. Economic development may be achieved by nation-state economies via the application of Adam Smith's ideas, including division of labor, specialization, the theory of absolute advantages, labour productivity, population expansion, free trade, the invisible hand, and free competition. According to Thomas R. Malthus, the law of diminishing returns applied to agriculture and that food goods rose arithmetically while population expanded geometrically. David Ricardo asserts that the labour force and the amount of physical capital stock are the two main drivers of economic expansion.

Long-term economic development depends on a careful balance. Unemployment or inflation may arise if variables such as capital investment, saving rates, and workforce growth rate deviate too far from stable levels. Also, technological advancements, the natural rate of economic growth depends on the labour force participation rate increasing, and the needed growth rate depends on business and individual saving behaviours. In addition, although the instruments are being developed for short-term implementation, long-term issue solutions will also be sought for (Solow, 1956).

#### **3.3 Economic Theories on Trade wars and Economic Stability**

##### ***Theory of Mercantilism***

According to the notion of mercantilism, a nation's level of wealth is solely based on how much capital or assets it has on hand and how much trade it engages in with other countries. National economic strategies that seek to build up foreign currency reserves via a favourable trade balance—



particularly in manufactured goods—are also included in the concept of mercantilism. The idea of protectionism served as the foundation of the mercantilist ideology. Using tariffs, quotas, and other trade restrictions to protect home industries from foreign competition was promoted by mercantilist policies (Ekelund, 2007). Governments aimed to secure self-sufficiency in critical commodities and industries, encourage industrial development, and boost economic growth by limiting imports and encouraging local production. Protectionist policies often jeopardized free trade principles and international trade ties in the sake of defending national interests and economic sovereignty.

Moreover, mercantilism fuelled imperialism and colonialism throughout this era. European nations carried out a great deal of colonial expansion, establishing colonies abroad as sources of precious resources, raw materials, and captive markets for manufactured products. The natural resources, labour force, and strategic geopolitical benefits of colonies were exploited, resulting in the economic prosperity and worldwide control of mercantilist empires. As countries fought for colonial supremacy to protect their economic and political interests, the pursuit of colonial lands became closely associated with mercantilist goals.

### **Theory of Comparative advantage**

A country may satisfy demands and reap advantages via international commerce, according to the second theory underlying international trade: the idea of absolute advantage. Adam Smith first put out this thesis in his 1766 book *An Inquiry into the Nature and Causes of the Wealth of Nations*. Smith disclosed that the amount of national money in the form of Gross Domestic Product and the contribution of international commerce are more important indicators of a nation's success than the quantity of metals in the country.

One of the core ideas of the theory is that a nation can still profit from trade even if it is not as efficient as another in producing all goods. It can do this by focusing on producing the goods in which it has a comparative advantage and exchanging those goods for goods produced more efficiently by other nations. This idea emphasizes the possibility of profitable trade exchanges even across nations with varying degrees of productivity or resource endowment (Reinert, 2016).

The principle of comparative advantage casts doubts on the idea that nations should aim to produce all commodities internally or in self-sufficiency. Rather, it supports specialization based on comparative advantage and relative efficiency as well as free commerce (Siddiqui, 2016). Comparative advantage encourages global economic integration and the effective use of resources by enabling nations to concentrate on their advantages and take advantage of regional variations in productivity and resource endowments.

### **4.0 Effects of Trade Wars on Global Markets**

As protectionism continues to escalate, the initiation of a trade war by the United States would have dire consequences for the world economy. Countries implementing various barriers that would hamper trade between countries would suffer the economic implications as well as those not directly involved. The imposition of tariffs would lead to a permanent decrease in global economic output, as they hinder specialization and create misleading pricing signals that hinder productivity. Although it is still not a guarantee, the chances of a full-blown trade war are on the rise. In light of this threat, both China and the US should collaborate to find a mutually beneficial solution to address pressing issues such as market access, intellectual property rights, and technology transfer for joint ventures.

According to An, Mikhaylov, and Richter (2020), the Trade War has hindered globalization. However, the impact has not been solely negative. As Fajgelbaum et al. (2023) note, while the US and China have imposed tariffs on each other, other nations have seen an increase in their exports to both countries. In fact, overall global trade has even seen a 3 percent boost. Trade war between china and USA has led to various opportunities being presented to other nations that are not involved in this war, as nations with high producing rates of goods have seen their exportation levels increase astronomically due to the issue between these two powerhouses (Fajgelbaum et al., 2021).

### **Economic and Supply Chain Disruption**

In the current economic climate, it is clear that trade wars have significant and lasting implications for the global economy. With more and more countries engaging in these conflicts, the negative repercussions on the world economy only grow stronger. Importantly, one of the most detrimental impacts of trade wars is the disruption of international supply chains. Due to trade war among nations, there has been an increase in the cost of production of various products as raw materials used in production is gotten at premium which would directly lead to reduction in sales as few countries would be able to adjust to the new high prices or economic instability.

As the trade war rages on between the United States and China, a palpable decrease in commerce between the two nations has been observed, sending ripples across the global economy. According to the World Trade Organization (WTO), the ongoing conflict between the two economic giants played a significant role in the faltering growth of global goods trade in 2019, which fell from a promising 2.6% in 2018. Beyond the borders of these two nations, other countries with a strong reliance on their trade activities have also felt the brunt of this decline in commerce (Ahmadi, 2016).

The Trade war between US and China also has an effect on the manufacturing sector which would hamper the functionality of their supply chain and also reduce profit margins. This has also led to a decrease in investment as tariffs imposed by the two nations have made it more expensive for businesses to import and export goods (Alghalith, 2010). Apart from the manufacturing sector, the agriculture industry, particularly in the United States. As one of the leading producers of soybeans, the US has suffered greatly from China's role as the largest global importer. The decline in exports and the lowered price of US soybeans, as a result of China's tariffs, have taken a toll on the income of farmers. Though the US government has provided some support to affected farmers, it has not been sufficient in compensating for their losses (Algieri & Arturo, 2017).

Another effect of continuous trade war is reduction in investment capacity of the countries involved which could be due to lack of confidence from potential investors. As trade conflicts escalate and tariffs are put into place, businesses often become hesitant to make investments in these countries. It can hamper economic stability and growths in these nations, ultimately affecting the global economy as a whole. The agriculture industry is particularly vulnerable during trade disputes, as it is often targeted with retaliatory tariffs. As a result, there may be a decrease in demand and lower prices for agricultural products, significantly impacting farmers and the economies of nations heavily reliant on agriculture exports.

The manufacturing industry is not the only industry affected by the trade war situations. The effect could be due to the possibility that businesses' profitability and profit margins might reduce as a result of imposing higher tariffs on imports and raw materials which would make it difficult for countries who manufacture goods to be able to produce items (Liao, 2023). Because of the reduced



flow of investment into the manufacturing sector, there is a possibility of job losses and a slowdown in economic development as a consequence of enterprises being unable to pay salaries and wages owing to lower profit margins. In addition to its negative effects on the economy, the US-China trade war has changed the balance of power in the world as China seeks to increase its influence.

The renowned world trade organization which was created to foster free trade among countries has been criticised for failing to take into account the needs of developing countries and for not changing with the times. The US-China trade spat has brought attention to the need for a more flexible reforms and inclusive global trading system that puts the interests of all nations first. Essentially, the US and China's trade war has hurt not just them but also other countries that depend on their commercial cooperation. Another effect is the disruption of the supply chain in the global market and a decline in industrial and agricultural investment (Bakas & Athanasios, 2018).

### **Market Volatility/Currency fluctuations**

The financial market is also affected by trade war, the trade war between USA and china illustrates the statement, due to the fact results showed high level of volatility and uncertainty in the stock market which lead to confusion on the part of investors as they were unsure of the market direction of the economy and as a result there was a substantial decrease in the level of investments. In addition, the activities of trade war has led to a direction shift in pattern of investment globally as various investors try to find other options to do business, this actions enable them spread their network and reach to other countries globally in order for them to minimize the risk of doing business.

As a result of the high level of stock market fluctuations, there is lack of assurance or confidence on the investors willing to do business. This may lead to a change in global financial trends as people seek out different choices for their money. The long-term effects of trade fights are far-reaching, especially in the world of global trade. Protective measures and a move away from globalization and free trade may be a result of these conflicts as countries favor their own areas of the economy (Liao, 2023).

### **Global Reallocation of Trades**

One of the major effects of Trade wars is the global reallocation of trade which was also experienced in the trade war between USA and china. This involves a complete restructuring of trade distribution as countries try to devise new ways of making trade as a result of the trade war which can include forming new alliances and trade partners as many nations rely on USA and China for trade.

Many nations are reevaluating their trade partnerships and looking for new ways to import and export goods as a result of the trade war. Some countries are looking to diversify their trade relationships in order to lessen the impact of tariffs and trade interruptions which can be described as one of the ways of mitigating the effect of trade wars, while others are cutting down on their dependence on the US and China (Fajgelbaum et al., 2021). To stay competitive and prevent price hikes, nations hit by US tariffs on Chinese imports, for instance, can look for suppliers in other countries for them to continue to do business. To counteract declines in demand from China, countries hit by retaliatory tariffs may look into expanding their exports to other countries.

Other countries not directly exposed to the trade war between the United States and China were studied by Fajgelbaum et al. (2021b). The “change in product-level exports to the US, China, and

the rest of the world as a function of the US and China tariffs on each other” were taken into consideration. On a general note, in reaction to the US-China tariffs, countries significantly increased their exports to the rest of the world while reallocating shipments toward the US and away from China. According to their findings, a group of nations who saw an increase in exportation to the United States, China, as well as other nations may have seen downward-sloping supply curves as a result of scale economies or other factors (Fajgelbaum et al., 2021b). With the aid of pre-war export shares in weighing the predicted export changes across products, they discovered that “the growth in total exports induced by the trade war was highly heterogeneous across countries, but this heterogeneity was due to country-specific supply curves or demand substitution elasticities with US and China, rather than by product-level specialization patterns” (Fajgelbaum & Khandelwal, 2021:16). In situations of trade wars, bystanders countries take advantage of the trade rift between countries in trade wars, as they increase their export of taxed goods or commodities. This buttresses the fact stated by Fajgelbaum et al. (2021:1), that “trade war created net trade opportunities rather than simply shifting trade across destinations”.

### **Tariff Escalation**

When trading partners in a trade war enforce ever-increasing duties on imported products, a phenomenon known as tariff escalation occurs. As a form of retaliation, tariffs are applied on the exports of the other side during a trade war, causing a tit-for-tat increase in trade barriers.

To safeguard local businesses or combat what is seen as unfair trade practices by a trading partner, one nation may first put tariffs on certain imported commodities. Retaliation might take the form of taxes imposed on imports from the nation that initiated the action by the targeted country. With one side trying to increase the size and breadth of tariffs as a form of leverage and to force the other into concessions, this retaliation might lead to further escalation (Bown, 2018).

Tariff escalation may take numerous forms, including the extension of tariff coverage to other commodities, the increase of tariff rates applied to current products, or the application of duties on higher-value imports. As tariffs rise, they may cause firms to incur more expenses, disrupt supply chains, and ultimately drive up consumer prices.

In 2018-19, a massive trade war erupted between the US and China. The US levied duties on around \$350 billion worth of Chinese goods, and China replied by levying taxes on an additional \$100 billion worth of imports, a retaliatory step authorized under WTO regulations (Bown 2018). Despite an agreement in January 2020 to suspend additional tariff rises, the present ones stay. The size of this trade conflict is considerable. US tariffs harmed roughly 18% of its imports, equal to 2.6% of its GDP, whereas China's response impacted 11% of its imports, equivalent to 3.6% of its GDP.

## **6. Conclusion**

In conclusion, the research on the effect of trade wars on global market has serious consequences on economic stability. Various trade barriers and tariffs are capable of hindering trade, reducing commercial productivity, increase price fluctuations and volatility which could lead to market or economic instability as shown by the cases of the United States and China in the trade war. Supply chains and jobs were impacted by tariffs and punitive actions during the China trade war which also had a direct impact on the economic stability of the country. Investment had decreased as a result of a loss in investor confidence and a sharp increase in consumer spending. These results have dominated international markets and affected economies well beyond the borders of nations.

Nearly all sectoral imports into the USA and China are decreased as a result of the trade war between the two countries. While Chinese imports of agricultural products and transportation equipment are primarily impacted, US imports of metals, machinery, and electric equipment are falling significantly. The United States of America expands its local manufacturing of industrial and electrical equipment, shielded by import barriers. However, the increase in domestic output in the USA diminishes when the trade war discourages foreign investment and has a detrimental influence on productivity. Given the complex processes at work and the knowledge of advanced variety occurrence that protectionist measures give, governments should try to create a more robust and all-encompassing global marketing strategy.

Particularly, politicians, business owners, and other stakeholders may benefit greatly from empirical research on the effects of trade wars, which offers insights that can guide and assist decision-making to promote global economic stability and prosperity and improve the overall business landscapes of various nations.

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