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Tariffs and Trade (Part Two)

Greetings!

Back in April, I wrote some brief thoughts on tariffs and trade wars. As the situation has evolved, I've had questions from some of you. So, I thought it was time to write again.

I've put the **summary at the top** – if that's all you want to read.

There is more below the summary – ***For Those Who Dare to Venture Forth.***

First of All, On Writing on Economic/Political Issues
As I'm sure you know, the difference between economics and politics can be blurred. My intent is to always try to write from an <u>economic</u> – *not* <u>political</u> – point of view.

The Trump Administration (the Administration) has chosen their negotiating strategy. I'm seeking neither to criticize nor ratify the administration's strategy.

People are very sensitive about their politics. This is one of the most challenging letters I've ever written.

The following represents my beliefs on **tariffs and trade**. I'm sure I'll be writing about this subject again.

In summary:

- The markets have been holding up rather well, as I believe the markets perceive the outcome of the trade negotiations could be positive for the U.S.
- The Administration's negotiating style is unconventional. Many believe that conventional tactics have not yielded satisfactory results.
    - Although an unorthodox approach likely has a higher upside (tariffs may fall dramatically around the world), it may present a higher risk of devolving into a trade war.
- Although there are a number of ways to try to effect change, the Administration has decided to take an aggressive approach in the hope of achieving a large degree of success.
- Generally, tariffs raise prices for consumers, stifle innovation and are broadly a drag on economic growth and opportunity.
- In this case, tariffs are being proposed by the Administration only to effect change. The hope is that tariffs will eventually come down around the globe.
- The actual *trade deficit* in <u>dollar terms</u>, with a particular trading partner, tells us very little about fairness. Tariff and non-tariff barriers tell us more about fairness.
- By most obvious measures, the U.S. has generally been fairer than most of its trading partners.
    - Our North American Free Trade Agreement (**NAFTA**) and European Union (**E.U.**) partners levy tariffs that are, on average, higher than those we levy on them – <u>but not by much</u>.

        - I don't believe the playing field, with regard to our NAFTA and E.U. partners, is terribly tilted against the U.S.
    - **China**, on average, continues to levy much higher tariffs on U.S. goods than the U.S. levies on Chinese goods. Also, Chinese *non*-tariff trade barriers are *very* high and are a concern.
        - As with many other *developing countries*, I believe China was given a lot of latitude when it first joined the World Trade Organization (WTO), as developed countries recognized that certain industries in *developing* countries needed to get their footing.
        - As China has evolved into a major trading power, the U.S. believes it has legitimate concerns with regard to China's trade policies.
- Although the Administration is also negotiating with most of our major trading partners, I believe the main concern is with China.
- The U.S. *currently* has negotiating leverage with China it may not have in 10 or 15 years.
- At the extreme, I see the following two potential outcomes:
    1. Tit for tat tariffs could **devolve into a trade war** whereby countries levy highly punitive tariffs on certain industries, leading to higher prices of goods and services, slowing economic growth and potentially leading to economic recession and lower markets.
    2. We could be looking at a world in which **trade barriers are greatly reduced**, leading to lower prices for consumers and significantly higher global trade – to the benefit of most and to the detriment of a few.
        - I believe the eventual outcome will be **somewhere in between**.
- Although I believe consumers will broadly benefit, this kind of change always creates winners and losers – some industries will win and some will suffer.
- I believe the U.S. will be better off in the long run should fairer trade with our partners come to pass.
- I believe there will be nothing smooth about the road to better trade deals. Negotiations are likely to become more volatile before agreements are finalized, as the various parties dig in their heels.
- Although things can change at any time, the global economy has been strong, and I am cautiously optimistic that the economy can currently handle the uncertainty and challenges that will accompany the trade negotiations.

For Those Who Dare to Venture Forth

The Markets Have Been Holding Up Rather Well

Despite all of the consternation caused by the threat of tariffs and trade wars, the markets have generally held up pretty well. Why? I believe:

- The global economic growth has been relatively strong, and
- The markets haven't yet figured out whether the current trade negotiations will help or hurt the economy.

Why Impose Tariffs?

Tariffs raise the price of imported goods relative to goods produced domestically (at home). This may help to shield domestic businesses from overseas competition. This may seem like a good idea on the surface, but tariffs generally:

1. Always lead to higher prices, which takes money out of the pockets of domestic consumers
2. Protect uncompetitive industries, thus stifling competition, which stifles innovation (the evolution of new products and services etc.)
3. Reduce economic growth, which leads to less economic output, tax revenues and job opportunity.

Currently, tariffs are being proposed only to effect change. The hope is that tariffs will eventually come down around the globe.

At the Extreme

Generally, there are two potential outcomes at the extreme (and of course, it could be something in between):

1. Tit for tat tariffs could **devolve into a trade war** whereby countries levy highly punitive tariffs on certain industries
   a. This would be to the benefit of the few (i.e. protected companies and industries) and to the detriment of most (i.e. consumers).
2. We could be looking at a world in which **trade barriers are greatly reduced**. Global trade could increase significantly should tariffs largely go away.
   a. This is a world in which most would benefit – to the detriment of the few.

What Are Trade Barriers?

Trade barriers most noticeably take the form of tariffs, but also include *non*-tariff barriers to trade, such as:

- Laws, regulations, policies and practices etc.
- Corruption (i.e. licensing decisions, awarding of government contracts, theft of property rights etc.). (1)

Is the U.S. Really Being "More Fair" Than Most Other Countries?

Generally:

- Our North American Free Trade Agreement (**NAFTA**) and European Union (**EU**) partners levy tariffs that are, on average, higher than those we levy on them – *but not by much*.
  - Of course, there are *outlier tariffs* (to protect certain industries) that are very high on both sides.
- **China** continues to levy *much* higher tariffs on U.S. goods than the U.S. levies on Chinese goods (**~12%** versus **~4%,** on average). (2) Also:
  - There are a number of **non-tariff trade barriers** such as import quotas, non-standard regulations, overly burdensome licensing requirements, theft of property etc., which make it difficult for U.S. companies to export goods and services to China. (1)

China

Although the Administration is also currently negotiating with most of our major trading partners, I believe our main concern is with China.

Why not band together with our close trading partners and ally against China? I believe:

- This may happen eventually.
- Our close trading partners have similar concerns with regard to relatively high Chinese tariffs and non-tariff trade barriers.

Chinese Non-Tariff Trade Barriers

In addition to higher tariffs on U.S. goods:

- There are a number of **non-tariff trade barriers** (such as import quotas, non-standard regulations, overly burdensome licensing requirements etc.) that are designed to frustrate U.S. suppliers of services – to the benefit China and to our detriment. Furthermore:
    - Although China has undertaken steps to protect <u>intellectual property rights</u> (IPR), their IPR protection and enforcement regime is still inadequate and remains a serious trade barrier.
    - Although China has undertaken steps to protect <u>trade secrets</u>, their enforcement regime is still inadequate and remains a serious trade barrier.
    - Although China has undertaken steps to stem the flow of <u>online piracy</u> (involving the distribution of legitimate music, motion pictures, books and journals, software and video games etc.), the practice continues on a large scale in China, affecting a wide range of industries and remains a serious barrier to trade.
    - Although China has undertaken steps to stem the flow of <u>counterfeit goods</u>, the practice remains widespread and is a serious barrier to trade.
    - The Chinese government continues to <u>subsidize certain industries</u> to the benefit of those Chinese industries and to the detriment of competing U.S. industries.
    - Chinese government financial support in manufacturing industries like steel and aluminum has contributed to <u>massive excess capacity</u> in China driving prices lower around the world – to the detriment of producers and workers in the U.S., and in other countries, as lower global prices and a glut of supply make it difficult for even the most competitive producers to remain viable.

The above represents a partial list of U.S. grievances.

Source: The Office of the U.S. Trade Representative, *2017 National Trade Estimate Report on Foreign Trade Barriers*

U.S. Trade Deficit with China

In 2017, the U.S. imported **$375B** more in goods from China than we exported to China. But this in itself tells us <u>nothing</u> about *fairness*. (3)

Trade Deficits Do Not Tell the Whole Story

All things being equal, <u>a trade deficit for "**Country A**"</u> may mean that:

- **Country A**, on average, *desires* more goods produced by Country B
- **Country B**, on average, produces goods more cheaply than Country A – even after considering transportation costs (a "comparative advantage")
- **Country A** has a very strong economy compared to Country B, so <u>demand for goods in general</u> – including foreign imports – will be stronger for Country A etc.

So:

- Tariffs and non-tariff trade barriers tell us *more* about relative "fairness" than do the actual *trade surplus* or a *trade deficit* number.

The Executive Branch Has A Lot of Power with Regard to Trade
According to the Bureau of Industry and Security (BIS), generally, Section 232 of the Trade Expansion Act of 1962 gives the executive branch the ability to conduct investigations to determine the effects of imports on America's national security and give the President the ability to address any threats to national security by restricting imports through tariffs. (4)

Leverage: Who's Got It?
Generally, it seems the U.S. has more leverage to effect change than our trading partners – particularly China. Why?

- We import more than most of our trading partners. For example, China is running out of U.S. imports on which to levy retaliatory tariffs.
- China is highly dependent on the U.S. for exports. Why? As a still-emerging super power with a large rural population, they are trying to keep people employed, as they attempt to transition from an export-driven economy to an economy more supported by domestic consumption.
- Last year China sold the U.S. **~$505B** in goods versus U.S. sales to China of **$130B** of goods. (3)

The Administration's Negotiating Style Is Unconventional

- Question: How do you win a negotiation?
- Answer: You must have a certain amount of leverage, otherwise the other side will give you nothing.

Herein Lies the Risk
If the Administration <u>*isn't* truly willing to risk a trade war</u> (which no one really wants), they may have <u>limited</u> leverage in promoting change.

The Administration has shown a willingness to take a hard line to effect change. This willingness gives them <u>more leverage</u> in negotiations.

But the Administration's willingness to take a hard line comes with more risk. A hard stance means there remains a chance that negotiations could devolve into a trade war, whereby countries raise tariffs on one another in retaliation in a tit for tat manner that spirals. Again, this would be to the detriment of most and no one really wants this.

Regardless of the Strategy, If We're Going to Try to Effect Change, *Now* May Be the Best Time

- As time goes by, if China is able to achieve its long-term goal of developing its domestic economy, it may rely less on exports to the U.S., and our negotiating position may be weaker a number of years down the road.
- The U.S. doesn't *currently* have an inflation problem. Since tariffs generally lead to higher prices our economy may be better able to handle rising prices *now*, versus later when we may be in a weaker negotiating position.
- Although things can change at any time, currently the global economy is broadly the strongest it's been in over a decade. We currently have rare "synchronized global economic growth" – i.e.

all 45 major economies tracked by the Organization for Economic Cooperation and Development (OECD) have generally been growing at the same time.

On Worst-Case Scenarios
As I've written before, most worst-case scenarios don't come to pass. Also, all sides have indicated a willingness to negotiate.

Summary of the summary:

- The trade negotiations remain very fluid, and change daily.
- Since the markets tend move on emotion, over the short-term more volatility is likely until the U.S. and China reach a reasonable agreement.
- Since China exports more than $500B to the U.S. it is in their interest to negotiate with the U.S.
- I believe negotiations are likely to become more volatile before agreements are finalized, as the various parties dig-in their heels.
- Although some industries may be negatively affected, the goods on which tariffs are being proposed represent a very small portion of the U.S. economy.
- This kind of change always creates winners and losers – some industries will win and some will suffer.
- I believe, over the long run, this process will lead to benefits for most (i.e. consumers around the globe), to the detriment of the few (i.e. protected industries and companies).
- If trade barriers are reduced, the increase in consumption will broadly benefit most industries.
- It's possible the current posturing could devolve in a much larger trade conflict, but I believe this is unlikely at this point.
- Although things can change at any time, the global economy has been very strong as of late and may be better able to withstand any negative effects of a devolving situation.

As always, please call me with any questions or concerns.

Let us keep our eye on the horizon.

Best!

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Footnotes:

1. Source: The Office of the U.S. Trade Representative, *2017 National Trade Estimate Report on Foreign Trade Barriers*
2. RiverFront, President Trump's Negotiating Strategy Increases Risk of Trade War, 7/10/2018
3. U.S. Census Bureau, foreign-trade balance
4. The BIS is a bureau of the U.S. Commerce Department.

Other sources:

- The Wall Street Journal

Important Information

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