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Trade Policy: A Slippery Slope

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The Trump administration's recent effort to impose tariffs on steel and aluminum imports into the United States has provoked a significant backlash among free-market economists, business leaders, and Republicans in Congress, among others. They worry that the imposition of protectionist measures designed to insulate domestic manufacturers from lower -cost foreign competitors could result in retaliation from foreign governments on other products that could expand into a full-blown trade war. As financial market investors dependent upon economic growth, how worried should we be?

When it comes to tariffs, economists are unusually united in their opposition. A recent poll of economists published in the Wall Street Journal showed that 92% either disagree or strongly disagree that imposing new tariffs on steel and aluminum will improve Americans' welfare.[1] What other economic principle has such broad acceptance among economic practitioners?

While imposing tariffs on steel imports will make US steel manufacturers more competitive and save domestic jobs, the cost of products using steel will rise for all US consumers and businesses. So a policy that benefits the few (steel industry workers and their employers) is likely to be a detriment to society at large. Economic theory tells us that output is maximized when goods are produced in locations with the greatest cost advantage. Tariffs distort this economic maxim by artificially raising the cost of certain goods to protect less efficient producers. Perhaps there are other considerations (e.g. political pressure, importance of the industry to national security), but from a purely economic standpoint, economists agree that tariffs are a bad idea.

History seems to support this view. In the midst of the Great Depression, Congress passed the infamous Smoot-Hawley Tariff Act of 1930 to protect American farms and factories from foreign competition. The law increased tariffs on hundreds of goods, prompting a swift response from American trading partners. Foreign trade fell sharply, deepening the depression. The Democratic-controlled White House and Congress reduced tariffs in 1932, which reversed the slide in trade. But European economies maintained steep tariffs, exacerbating the nationalist tendencies that fed into WWII.

So why, then, would an administration threaten a trade war? Because they are so damaging, trade partners can be pressured into accepting new trade terms just to avoid them. In the 1980's, American auto manufacturers pressured President Reagan to impose voluntary quotas on Japanese auto imports, which were making strong inroads into the American car market with a fleet of small, reliable, fuel-efficient vehicles. Japan acquiesced in order to maintain access to the largest consumer market in the world. Japanese car makers then set up plants in the US, employing thousands of American workers. Protectionist-oriented economists cite this as an example of a positive outcome from an aggressive trade stance.

Is President Trump intent on starting a trade war? Probably not. More likely these tariffs serve as a bargaining chip with Mexico and Canada at a time when

[1] WSJ Daily Dot, March 13, 2018

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their NAFTA negotiations have bogged down. If that is the case, the effectiveness of such a move is enhanced by the fact that President Trump is perceived to believe that protectionism is good policy.

Despite whatever we may gain from these policies, there will almost certainly be economic costs. When President George W. Bush imposed tariffs on steel in 2002 in order to protect American steel workers, according to one oft-cited study, the higher costs that flowed through to steel buyers cost Americans some 200,000 jobs.[2] Similarly, President Obama put a tariff on Chinese tires in 2009, but the Peterson Institute concluded that the policy cost American jobs on a net basis.[3]

From an investment standpoint, any policy that restrains global economic growth is likely to be viewed negatively by financial markets. Reduced trade will lower corporate earnings growth, pressuring earnings multiples and stock prices. Raising prices on imported goods would allow domestic manufacturers to follow suit, increasing future inflation risks. Uncertainty around additional protectionist measures could result in higher volatility across all asset classes. And the disruption caused by a mushrooming trade war could have negative geopolitical consequences.

In sum, markets don't like trade wars. President Trump's tariffs on steel and aluminum are relatively insignificant, given that he has at least temporarily exempted Mexico and Canada from the policy. But this could be the first step down a dark tunnel of retaliation from our major trading partners. We will be watching closely to see if this first salvo from the White House escalates into something much more damaging.

[2] Peterson Institute for International Economics, Policy Brief, "US Tire Tariffs: Saving Few Jobs at High Cost", April 2012

[3] Trade Partnership Worldwide, LLC, "The Unintended Consequences of U.S. Steel Import Tariffs: A Quantification of the Impact During 2002", February 4, 2003

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